The Business of Defense: Defense-Side Litigation Financing

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INTRODUCTION

Imagine an entrepreneur starting a business: She has obtained the venture capital, developed the product, created the website, and started selling. Her balance sheet is slowly growing when she receives notice that a competitor has filed suit against her. The lawsuit alleges trademark infringement and unfair competition, and the plaintiff is seeking injunctive relief and damages in the millions. The entrepreneur panics. While she doubts that the lawsuit has strong merits, the cost of defending it would require her to use all of the venture capital financing she obtained, and she doubts her business could survive until the end of litigation.[1] Where should she turn?

She might consider turning to a new industry that is developing in the United States: defense-side litigation financing. In exchange for providing the financier a promised rate of return if the litigation is successful, the business can obtain funding to fight the lawsuit and transfer the risk, even if slight, of an unfavorable judgment. With the availability of defense-side financing, the business can continue growing while fighting the litigation.

As the example above shows, defense-side financing can provide a valuable service by filling a risk management gap that has

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1 For an example of this type of scenario, see Colleen Taylor, *Fab Sues Flash Sales Site TouchOfModern for Alleged Trademark Infringement* (TechCrunch, Aug 15, 2012), archived at http://perma.cc/3QKR-44D6.

long been overlooked: litigation risk. Litigation-financing companies are actively seeking new investment opportunities,[2] including defense-side arrangements.[3] Despite the growing availability of investor funds for plaintiff-side litigation financing, *defense-side* financing has yet to take off in the United States. This is contrary to what one would expect given the large amount of money available for investing in litigation.

Professor Jonathan Molot first called attention to the potential market for defense-side litigation financing in *A Market in Litigation Risk*.[4] Molot noted that clients often fail to treat litigation risk like other types of business risk "because lawyers cling to their traditional role as agents for risk-bearing clients" instead of working in fields that "look[ ] at risk as a profit opportunity rather than an evil to be avoided."[5] The article described some of the costs imposed as a result of this market failure and argued that a market in defense-side litigation financing is feasible.[6] Molot wrote the article in 2009, but the litigation risk-transferring and risk-pooling mechanism he advocated has yet to flourish.[7] Part of the reason that this market has been slow to develop is that potential clients, companies that need to off-load the risk of

2 The market view on the litigation-financing industry as a whole, including plaintiff and attorney financing, is bullish due, in part, to the increased demand from clients, from law firms, and from the increased desire of investors to seek uncorrelated investment opportunities. See, for example, Chris Bogart, *The Year to Come in Litigation Finance* (Burford Capital LLC, Jan 25, 2016), archived at http://perma.cc/HC56-WRLX (discussing the positive developments in litigation financing in 2015); Edmond Jackson, *Stockwatch: A Growth Share Defying the Market Plunge* (Interactive Investor, Jan 19, 2016), archived at http://perma.cc/SXD7-BJ6P (noting how the countercyclical nature of litigation financing has helped the share price of Burford Capital, a publicly traded litigation-financing company); *Gerchen Keller Launches New Fund, Secures Status as World's Largest Legal Finance Firm* (PR Newswire, Jan 6, 2016), archived at http://perma.cc/8USY-RPWS (discussing the growing demand for Gerchen Keller's business in litigation financing).

3 In a defense-side financing arrangement, a litigation-financing company, typically a partnership of various capital providers, agrees to fund a client's defense in exchange for future payment. The financing arrangement occurs after the litigation has already begun, and the defendant pays the financier a return on the investment only if the litigation is "successful." For more detail on such arrangements, see Part III.A.

4 See generally Jonathan T. Molot, *A Market in Litigation Risk*, 76 U Chi L Rev 367 (2009).

5 Id at 369–70.

6 Id at 373–75.

7 See Nick Rowles-Davies, *Litigation Finance: The Case for the Defence* (Global Legal Post, July 24, 2015), archived at http://perma.cc/2JT4-VDQY (noting that "defence funding isn't common, even among the best-known litigation financiers"); Maya Steinitz and Abigail C. Field, *A Model Litigation Finance Contract*, 99 Iowa L Rev 711, 725 (2014) (noting "the nonexistence, at the moment, of a market in defenses").

a litigation event, do not fully understand the new financing opportunity, its potential benefits, or the terms likely to be associated with such an arrangement.

This Comment builds off of Molot's article and seeks to alleviate these persisting market barriers by highlighting the potential benefits of consumer defense-side financing and explaining a typical framework for such contracts. This way, defendants considering an alternative financing arrangement will have a better idea what to expect from litigation financing. Part I provides a general introduction to litigation financing. Part II then describes defense-side financing in detail and highlights the various benefits it can provide. Finally, Part III explains a common framework for structuring defense-side agreements.

I. BACKGROUND ON LITIGATION FINANCING

Third-party litigation financing is a type of investment whereby the investor, typically "a specialist funding company or a hedge fund" (the financier), provides the client with funding to cover the cost of litigation in exchange for a portion of the returns.[8] In many ways litigation financing mimics contingency fee structures,[9] but it uses a third party—rather than the attorney—to absorb the excess risk. The litigation-financing industry has gained a strong foothold in the United Kingdom and Australia and, in the past decade, has taken off in the United States.[10] Because most litigation-financing companies are private funds, they do not disclose their funding partners or clients, making it difficult to obtain exact numbers on the size of the industry.[11]

Currently there is minimal regulation of litigation financing, allowing significant flexibility in how the financier, client, and

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8 Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 Minn L Rev 1268, 1275–76, 1304 (2011).

9 A contingency fee (or "contingent fee") is "[a] fee charged for a lawyer's services only if the lawsuit is successful or is favorably settled out of court." *Black's Law Dictionary* 387 (West 10th ed 2014).

10 Some of the major players in litigation financing include Burford Capital LLC, IMF Bentham Ltd, Gerchen Keller Capital, LLC, and Juridica Investments Limited. Other smaller funds are also starting to enter the market. See Julie Triedman, *Arms Race: Law Firms and the Litigation Funding Boom* (American Lawyer, Dec 30, 2015), archived at http://perma.cc/CL8L-9Y2Y; Julie Triedman, *Topping $1 Billion Mark, Big Litigation Funder Gets Bigger* (Law.com, Jan 6, 2016), archived at http://perma.cc/YRE7-YULW.

11 See Sara Randazzo, *Lawmakers Taking Closer Look at Litigation Funding* (Wall St J, Aug 27, 2015), online at http://blogs.wsj.com/law/2015/08/27/senators-call-for-transparency-in-litigation-funding (visited Apr 29, 2016) (Perma archive unavailable) ("[T]he details of [litigation-financing] deals are usually undisclosed.").

law firm structure the deal and contract terms. Some states have enacted statutes for consumer litigation financing, which focus on financing for individual plaintiff claims.[12] Other states have considered or are considering proposed legislation, which again is primarily focused on consumer arrangements.[13] There has been almost no proposed legislation for regulation of commercial litigation financing, which is the focus of this Comment.[14]

The litigation-financing contract may be structured in a variety of different ways depending on the specific litigation, but it often includes the following: a specific commitment amount from the financier; a payout structure requiring the financier to deploy capital in a way that is commensurate with the risk and the client's need; a clear definition of success; and a set of detailed investment return scenarios.[15] A financier may also prefer to purchase a cause of action from a client, becoming a party to the litigation and obtaining the right to the full recovery amount.[16] The contracts are almost always nonrecourse, meaning that if the lawsuit is not successful (as defined by the contract), the client does not need to reimburse the financier.[17]

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12 See, for example, Ark Code Ann § 4-57-109 (regulating the terms and permissible interest rate for consumer litigation financing); 9-A Me Rev Stat Ann §§ 12-101 to -107 (regulating the consumer litigation-financing industry); Neb Rev Stat §§ 25-3301 to -3309 (same).

13 See, for example, Arizona Senate Bill 1403, Arizona State Legislature, 52d Sess (Feb 3, 2015) (proposing regulations for consumer lawsuit loans and capping the annual rate of interest at 36 percent); Civil Litigation Funding Act, Missouri Senate Bill 360, General Assembly of Missouri, 98th Sess (Apr 16, 2015) (regulating consumer litigation financing and limiting the total amount of charges and interest to 33 percent of the winnings from the suit); Non-recourse Consumer Lawsuit Funding Act, Illinois Senate Bill 1397, Illinois General Assembly, 99th Sess (Feb 20, 2015) (regulating consumer litigation financing and limiting the total amount of fees, charges, and interest to 80 percent of the winnings from the suit). See also Heather Morton, *Litigation or Lawsuit Funding Transactions 2015 Legislation* (National Conference of State Legislatures, Jan 8, 2016), archived at http://perma.cc/63HL-WBQQ (cataloging state legislation). For a thorough discussion of the regulation of consumer litigation financing, see generally Martin J. Estevao, Comment, *The Litigation Financing Industry: Regulation to Protect and Inform Consumers*, 84 U Colo L Rev 467 (2013).

14 See Triedman, *Arms Race* (cited in note 10) ("So far, the industry has operated in a relative vacuum of disclosure and without regulation.").

15 See id (discussing various approaches to litigation financing).

16 Purchasing someone's claim is known as assignment. A common example is the traditional "patent troll"—a company that purchases a patent from an inventor and then sues an infringer directly. For a discussion of the assignability of claims, including in the context of patent assignment, see Anthony J. Sebok, *The Inauthentic Claim*, 64 Vand L Rev 61, 74–94, 110 (2011).

17 "Nonrecourse" is defined as "[o]f, relating to, or involving an obligation that can be satisfied only out of the collateral securing the obligation and not out of the debtor's other assets." *Black's Law Dictionary* at 1220 (cited in note 9).

The majority of the time, the financier contracts directly with the party, rather than with the law firm.[18] However, law firms are actively involved in the process. Often, the financier develops a relationship with the law firm, and then the law firm refers the client to the financier.[19] This referral usually occurs when the client wants an alternative fee arrangement (such as a contingency fee) that the law firm is unable to provide. The financier acts as a middleman, providing the client a more flexible fee arrangement but allowing the law firm to be paid under its preferred fee structure. Because the law firm benefits from such an arrangement, it is often willing to provide a discounted fee or a partial contingency fee—essentially sharing some of the risk with the financier.[20] The client may be a single individual, typically in a personal injury suit, or, increasingly, it may be a company that does not want to deploy the cost of litigation upfront, or wants to decrease the risk associated with the cost of defense.[21]

Within the broad market of litigation financing there are many ways that the contract can be structured and many legal considerations that are shaping the market. Part I.A discusses the three primary types of consumer litigation financing. Part I.B then provides a summary of some of the key legal considerations universal to the consumer litigation-financing industry.

A. Types of Consumer Litigation Financing

There are three primary types of litigation financing, classified according to which party receives funding from the litigation financier (the counterparty): attorney financing, plaintiff-side financing, and defense-side financing. This Section provides a brief overview of each type of financing and highlights the distinguishing elements.

In an attorney-financing arrangement, the financier enters into financing arrangements directly with the law firm either to provide support for pending litigation or to help smooth a firm's

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18 Steinitz, 95 Minn L Rev at 1276 (cited in note 8) ("[T]he client contracts directly with the funder in [typical funding] agreements.").

19 See id ("[I]nformal agreements between the funder and the attorney are at times involved.").

20 See id (noting that "funders leverage their emerging relationships with law firms to negotiate reduced contingencies, reduced hourly rates, flat fees, or some combination of the aforesaid").

21 Id at 1277 ("Whereas it was traditionally individual plaintiffs who resorted to third-party funding, often in personal injury cases, the recent trend is aimed at very different markets: corporate litigants, including corporate *defendants* . . . .").

balance sheet by providing loans based on fees earned but not yet collected.[22] As an example of the former, a class action plaintiffs' firm may request funding to help support client recruitment in a large class action suit. The funder would then earn its investment return by claiming a portion of the firm's class action fees. As an example of the latter, after a settlement agreement or judgment has been entered in the court, the law firm may wish to obtain its fees immediately, even though the actual payment may take a few months. The financier can provide a loan to the firm, collateralized by the future fee payment. Litigation-financing companies are better suited for this type of lending than banks are, because such companies have the expertise to evaluate the strength of a given case or portfolio of cases. Generally, because these arrangements are with only the law firm, and are collateralized by a class action or portfolio of cases, the individual plaintiffs are not part of the agreement.[23]

Plaintiff-side litigation financing is generally a more intuitive type of litigation financing. In many ways it is similar to the contingency fee model—under which the attorney receives a set percentage of the recovery if the case is successful, rather than the standard hourly fee—used by many plaintiffs and class action attorneys. On the plaintiff side, the financier serves as a middleman between the attorney and the plaintiff—absorbing some of the risk assumed by the attorney in a contingency fee arrangement, but still allowing the plaintiff to enjoy the benefit of pursuing a case without up-front costs.[24]

Defense-side litigation financing "allows corporations . . . to shift the costs and hedge the risks [of litigation]."[25] Defense-side

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[22] For an example of this type of financing agreement, see Amanda Robert, *Litigation Funding Can Drive Early Settlements, Legal Scholar Says* (LegalNewsline, Dec 22, 2015), archived at http://perma.cc/7Q4V-URN6 (describing a high-interest, $50 million deal between AkinMears and Gerchen Keller to finance mass tort multidistrict litigation).

[23] For a discussion of a typical law firm financing agreement, and the potential impact on the firm's client in the event of breach, see *LFG National Capital, LLC v Gary, Williams, Finney, Lewis, Watson, and Sperando PL*, 874 F Supp 2d 108, 112–15, 121 (NDNY 2012).

[24] For more detail on the structure of plaintiff-focused third-party litigation-financing contracts, see Steinitz and Field, 99 Iowa L Rev at 745–49 (cited in note 7).

[25] Steinitz, 95 Minn L Rev at 1276 (cited in note 8). Individuals could theoretically also take advantage of defense-side financing to transfer risk. Individuals, however, face minimal uninsured litigation risk. See, for example, Neal Frankle, *What Is Personal Liability Insurance? (And How Much to Own)* (Wealth Pilgrim, 2016), archived at http://perma.cc/8NJY-467S (noting that, "if you have automobile, renters or homeowner's insurance, you already have some liability insurance" and that there are other insurance products to cover individuals' additional liability insurance needs).

financing is a form of risk management that focuses on legal risks:[26] it provides a form of after-the-event insurance[27] that is not available through traditional insurers, thereby filling a market gap.[28] At a high level, a defense-side financing agreement transfers the downside risk of a costly adverse judgment "from the one-time litigant to an entity better able to bear it."[29]

In a defense-side agreement, the two parties (the defendant and the financier) agree on a definition of a "successful" outcome, often settlement below a certain dollar threshold.[30] The financier then commits a set amount of money toward the cost of defense, to indemnify the counterparty for a settlement or judgment above a set threshold, or both.[31] The parties also agree on an investment return that the financier will receive in the event of a successful outcome.[32] The contract may also specify exactly how the defendant will pay the investment return to the financier—such as through a lump sum after resolution of the litigation or via periodic payments. For example, a defendant being sued for $50 million may agree to pay a litigation-financing company 30 percent of any savings below the $50 million in exchange for the financier covering the cost of defense. If the litigation ultimately gets resolved for $30 million, the financier would make $6 million and the defendant would have saved $14 million plus avoided having to spend money up front defending the suit.

B. Current Legal Status of the Litigation-Financing Industry

The advent of the litigation-financing industry raised many questions regarding its impact on attorney-client privilege and how to reconcile litigation financing with the ancient doctrines of champerty and maintenance. Additionally, public perception of the industry has raised policy concerns about whether litigation financing is socially beneficial. This Section discusses those legal

26 See Molot, 76 U Chi L Rev at 370–72 (cited in note 4).

27 The parties enter into the agreement after the defendant has already been brought into litigation. The financing agreement may occur at any point in the litigation life cycle depending on when the client needs funding.

28 See Molot, 76 U Chi L Rev at 377–78 (cited in note 4).

29 Id at 378.

30 Christopher P. Bogart, *The Case for Litigation Financing*, 42 Litig 46, 48 (Spring 2016).

31 Id.

32 For a comprehensive discussion of the difficulties of pricing defense-side financing agreements, see Molot, 76 U Chi L Rev at 380–92 (cited in note 4). The most significant difficulty presented in pricing litigation risk is the individualized nature of the risk: "once a litigation-triggering event has occurred, the risk of a high or low judgment or settlement is a highly individualized risk that can turn on a variety of case-specific variables." Id at 382.

and policy concerns. The legal impact of litigation financing is starting to stabilize, and it is becoming clear that in most states litigation financing is legally viable. The public policy debate is still ongoing, but this Comment argues that litigation financing, and especially defense-side litigation financing, is socially beneficial and not contrary to any public policy goals.

1. Attorney-client privilege.

Since the advent of litigation financing, many scholars and practicing attorneys have been concerned about the impact that involving a third-party financier might have on attorney-client privilege and the discoverability of confidential information.[33] In order for financiers to profitably underwrite litigation, they must be allowed to obtain detailed information about the litigation. However, because they are not serving in the capacity of attorneys, there is concern that sharing information with a financier could waive privilege.[34]

Financiers have largely overcome this hurdle by avoiding material that is protected solely under attorney-client privilege and by ensuring that all other communication among the three parties is protected under the work product doctrine.[35] The financier typically has the client sign consultant and nondisclosure agreements so that the financier is treated as a nontestifying expert consultant.[36] This brings the financier comfortably under the broad protection of the work product doctrine, as the financing agreement and any related documentation are undoubtedly created "because of" litigation.[37]

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33 See generally, for example, Grace M. Giesel, *Alternative Litigation Finance and the Attorney-Client Privilege*, 92 Denver U L Rev 95 (2014); Meriam N. Alrashid, Jane Wessel, and John Laird, *Impact of Third Party Funding on Privilege in Litigation and International Arbitration*, 6 Disp Res Intl 101 (2012).

34 See Alrashid, Wessel, and Laird, 6 Disp Res Intl at 102 (cited in note 33) (explaining that a financier's due diligence "raises a critical concern vis-à-vis the disclosure consequences of sharing documents with a third party that would otherwise be protected by the privileges that exist between a lawyer and his or her client").

35 See Steinitz and Field, 99 Iowa L Rev at 733 (cited in note 7) ("While information protected only by the attorney–client privilege cannot be shared without risking waiver, the resulting information asymmetry problem can be substantially addressed by sharing attorney work product.").

36 See, for example, id at 729–35, 751–52 (illustrating these provisions in a model contract). See also Alrashid, Wessel, and Laird, 6 Disp Res Intl at 127–30 (cited in note 33) (describing how such a relationship could lead to disclosures being protected).

37 For a comprehensive discussion of the disclosure concerns posed by third-party litigation financing, see Grace M. Giesel, *Alternative Litigation Finance and the Work-*

Although there is not yet much case law interpreting these nondisclosure agreements,[38] a recent case in Delaware suggests that courts will not require disclosure of the details of litigation-financing agreements.[39] In this case, the court considered a motion to compel discovery of the plaintiff's litigation-financing agreement with payment terms unredacted.[40] Although the plaintiff had already produced the redacted version as part of the discovery for a different legal question, the court denied the motion and declined to compel the plaintiff to produce information relevant to the pricing and amount of financing.[41] The court held that "the payment terms at issue in the Financing Agreement were prepared in anticipation of litigation and . . . are afforded nearly absolute protection from discovery under the work product doctrine."[42] The ease with which the court reached this decision and the persuasive support from academics suggest that the work product doctrine will protect litigation-financing agreements.

2. Champerty and maintenance.

A second set of threshold issues for litigation financing involves the doctrines of champerty and maintenance, and whether they bar third-party funding. "Maintenance" is defined as "[i]mproper assistance in prosecuting or defending a lawsuit given to a litigant by someone who has no bona fide interest in the case; meddling in someone else's litigation."[43] At common law,

Product Doctrine, 47 Wake Forest L Rev 1083, 1140 (2012) (analyzing existing work product doctrine jurisprudence and concluding that "[m]aterials evaluating litigation and created in the context of [alternative litigation financing] should enjoy . . . the protections of the work-product doctrine"). For a discussion of how third-party financiers can structure their contracts to ensure protection under the work product doctrine, see Steinitz and Field, 99 Iowa L Rev at 733–34 (cited in note 7) ("[W]ork product can be shared freely . . . provided that the work product is shared pursuant to a confidentiality agreement and the information recipients are not associated with the opposing side.").

38 For a discussion of the minimal amount of existing case law on discovery and litigation financing, see Giesel, 47 Wake Forest L Rev at 1113–14 (cited in note 37).

39 See *Charge Injection Technologies, Inc v E.I. DuPont de Nemours & Co*, 2015 WL 1540520, *4–5 (Del Super).

40 Id at *1–3.

41 Id at *5.

42 Id. See also *Carlyle Investment Management LLC v Moonmouth Co*, 2015 WL 778846, *9 (Del Chanc) ("Thus, even though claim funding is the business of financing lawsuits, which means the Discovery Documents serve a business purpose, those documents simultaneously also are litigation documents and work product protection is appropriate.").

43 *Black's Law Dictionary* at 1097 (cited in note 9).

there was a general prohibition on maintenance.[44] Over time, that prohibition has largely eroded, except with respect to champerty.[45]

Champerty is a type of maintenance whereby the maintainer is "rewarded for his support of the litigant."[46] Champerty is one of the primary legal concerns for plaintiff-side litigation financing.[47] In its purest sense, a prohibition on champerty prohibits nonrecourse third-party litigation financing.[48] However, the doctrine has eroded in most states to a softer prohibition governed by policy concerns: "speculation in lawsuits, the bringing of frivolous lawsuits, or financial overreaching by a party of superior bargaining position."[49]

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44 *McKellips v Mackintosh*, 475 NW2d 926, 928–29 (SD 1991) (discussing the development of the common-law doctrines of champerty and maintenance and noting that, because the common law has not been abrogated by statute, maintenance is still prohibited in South Dakota).

45 See Sebok, 64 Vand L Rev at 98–120 (cited in note 16).

46 Id at 73. See also *Black's Law Dictionary* at 279 (cited in note 9) (defining "champerty" as "[a]n agreement between an officious intermeddler in a lawsuit and a litigant by which the intermeddler helps pursue the litigant's claim as consideration for receiving part of any judgment proceeds").

47 For discussions of the impact of champerty on litigation financing, see Sebok, 64 Vand L Rev at 107–20 (cited in note 16) (reviewing state courts' approaches to "maintenance for profit," which would include the litigation-financing industry); Christy B. Bushnell, Comment, *Champerty Is Still No Excuse in Texas: Why Texas Courts (and the Legislature) Should Uphold Litigation Funding Agreements*, 7 Houston Bus & Tax L J 358, 363–74 (2007) (reviewing arguments for and against litigation financing and arguing that litigation funding should not be considered champertous because it is not "intermeddling" when the client approaches the financier); Susan Lorde Martin, *Financing Plaintiffs' Lawsuits: An Increasingly Popular (and Legal) Business*, 33 U Mich J L Ref 57, 83–85 (1999/2000) (arguing that, in modern times, "a ban on champerty [is] completely unnecessary" and should not serve to prohibit litigation financing).

48 For examples of state prohibitions on champerty, see Ga Code Ann § 13-8-2(a)(5) (stating that maintenance and champerty contracts contravene public policy); Ky Rev Stat Ann § 372.060 (stating that champertous contracts and conveyances are void); *Sneed v Ford Motor Co*, 735 S2d 306, 309 (Miss 1999) ("Mississippi has declared champerty and maintenance unlawful.").

49 *Saladini v Righellis*, 687 NE2d 1224, 1226–27 (Mass 1997). For descriptions of how some states have taken this softer approach, see *Adkin Plumbing & Heating Supply Co v Harwell*, 606 A2d 802, 803–04 (NH 1992) (noting that changed attitudes had led to the conclusion that "contracts in champerty . . . no longer constituted a violation of public policy"); *Van Gieson v Magoon*, 20 Hawaii 146, 148–49 (1910) (enforcing a seemingly champertous contract because "[t]he conditions of society under which the law of maintenance and champerty originated no longer exist"); *Metropolitan Life Insurance Co v Fuller*, 23 A 193, 196 (Conn 1891) ("Under our present law public policy is the sole consideration, and contracts formerly held void by reason of champerty and maintenance may or may not be contrary to such policy."). See also Steinitz, 95 Minn L Rev at 1289–90 (cited in note 8) (discussing New York's "cautious approach" to applying the principle of champerty). For a more detailed discussion of the law of champerty in each state, see Paul Bond, Comment, *Making Champerty Work: An Invitation to State Action*, 150 U Pa L Rev 1297, 1333–41 (2002).

Only a few of these states have explicitly ruled on whether plaintiff-side litigation-financing contracts are champertous, but most courts that have directly considered the issue have found that litigation financing was not illegally champertous because it did not involve the underlying policy concerns.[50] A Delaware court was recently presented with this question in *Charge Injection Technologies, Inc v E.I. DuPont de Nemours & Co*.[51] Charge Injection Technologies (CIT), the plaintiff in the case, obtained litigation financing midway through the litigation in order to continue its claims against DuPont. The court found that the financing was not champertous because "CIT did not bargain with [the litigation financer] to enforce claims which CIT is not disposed to prosecute."[52] Additionally, the court noted that the contract did not give the financier ownership or control over the litigation. Because the financing was not *encouraging* litigation, and because CIT retained control, the court found that the agreement did not constitute "champerty and maintenance," and denied the defendant's motion to dismiss.[53] This case can be contrasted with one in which an Indiana court considered an indemnification agreement formed when Jan Glaser, the CEO of one company, asked CMG Worldwide, another company, to bring a suit against a third party and agreed to indemnify CMG if the suit was not successful.[54] The court held that the indemnification agreement was unenforceable because it was illegal maintenance.[55] In this case, the court refused to enforce an indemnification contract it deemed to be illegal maintenance because Glaser requested that CMG pursue the litigation "for strategic reasons"—he knew that his company "would benefit from CMG's pursuit of the Lawsuit," and he was interested in the lawsuit only "to try to deplete [the defendant's] resources."[56]

As more states are presented directly with the question whether litigation financing violates the doctrines of champerty

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50 See, for example, *Charge Injection Technologies, Inc v E.I. DuPont de Nemours & Co*, 2016 WL 937400, *3–6 (Del Super) (finding that the plaintiff's litigation-financing agreement was not illegal champerty or maintenance); *Miller UK Ltd v Caterpillar, Inc*, 17 F Supp 3d 711, 726 (ND Ill 2014) (holding that the litigation funding did not violate the Illinois statute against champerty because the financier did not "engage[ ] in exciting or stirring up" of litigation).

51 2016 WL 937400 (Del Super).

52 Id at *4.

53 See id at *3–6.

54 *CMG Worldwide, Inc v Glaser*, 2015 WL 133742, *2–3 (SD Ind).

55 See id at *4.

56 Id (quotation marks omitted).

and maintenance, the trend is in favor of finding that such financing is permissible as long as the financier does not have any ulterior motives in the litigation.[57] However, the lack of clarity and potentially unfavorable precedent in some states present a significant barrier to plaintiff-side litigation financing, which is one of the reasons the market is still relatively new.[58] Champerty can be used as an affirmative defense by the direct parties to the litigation being funded, as was attempted in the Delaware case, and can be a defense against enforcing the terms of the financing contract, as was attempted in the Indiana case. Thus, as part of the underwriting process, litigation financiers must consider the champerty and maintenance laws in both the state where the litigation is being conducted and the state that will govern the terms of the contract.

3. Policy considerations of litigation financing.

Another barrier faced by litigation financing is the "ick factor."[59] There is a feeling by some that litigation financing "turns a courtroom into a stock exchange and litigation into a commodity," and that it "corrupts the values" of our justice system.[60] Although most academics do not agree that litigation financing degrades the legal system,[61] some courts have adopted this public distaste

57 See Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L Rev 571, 584–90 (2010) (noting that the law on champerty has "progressed so far in the other direction" that courts will likely "set aside maintenance and champerty as obsolete, at least insofar as they may be applied to third-party litigation finance").

58 See Steinitz, 95 Minn L Rev at 1286 (cited in note 8) (noting that maintenance and champerty "effectively prohibit third-party funding and greatly limit the penetration of the [litigation-financing] industry into the United States").

59 Lincoln Caplan, *Lawyers and the Ick Factor* (New Yorker, July 9, 2015), archived at http://perma.cc/FH4V-M6BV.

60 Id. See also Randazzo, *Lawmakers Taking Closer Look at Litigation Funding* (cited in note 11) ("[C]ritics have long complained that [ ] third-party investors give outsiders undue influence over legal decisions and allow frivolous lawsuits to go forward, driving up the overall cost of litigation.").

61 See, for example, Elizabeth Chamblee Burch, *Financiers as Monitors in Aggregate Litigation*, 87 NYU L Rev 1273, 1315–26 (2012) (explaining how litigation financing can solve many of the common conflicts of interest that arise in nonclass aggregate litigation); Courtney R. Barksdale, Note, *All That Glitters Isn't Gold: Analyzing the Costs and Benefits of Litigation Finance*, 26 Rev Litig 707, 738 (2007) (arguing that, for some plaintiffs, the benefits of litigation financing outweigh the costs); Martin, 33 U Mich J L Ref at 84–86 (cited in note 47) (concluding that limitations on litigation financing should be lifted because litigation financing can create more efficient and more just outcomes). But see John Beisner, Jessica Miller, and Gary Rubin, *Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States* *2 (US Chamber Institute for Legal Reform, Oct

of litigation financing and voided litigation-financing agreements as contrary to public policy.[62] The feeling that litigation financing somehow distorts the legal system by commoditizing litigation impacts the entire litigation-financing industry.

Feeding this policy consideration is also a concern that litigation financiers may take advantage of naïve litigants who do not understand the full value of their lawsuits.[63] In response, many states have extended consumer protection laws to litigation financing. For example, the Supreme Court of Colorado held that consumer litigation-financing agreements are loans under the state's Uniform Consumer Credit Code even if the financing agreements are nonrecourse.[64] This ensures that such financing agreements are subject to state usury laws.[65] Other states have adopted explicit consumer litigation-financing legislation that regulates the terms of such agreements.[66] So far, most of the policy debate in state legislatures has focused on consumer, not commercial, litigation financing. The policy considerations that drive regulation of consumer litigation financing—both the concern that financiers will take advantage of naïve consumers and the concern that the financiers will ultimately take control of the litigation—are significantly less prevalent in the commercial context. As defense-side litigation financing develops, there is a potential that the policy debate will spread to courts' consideration of commercial agreements. For example, courts may view defense-side agreements as improperly shifting the balance of justice by allowing the defendant to escape liability for wrongful behavior through accessing funds not otherwise available.

Courts may be hesitant to enforce defense-side agreements if the underlying act that is the source of potential liability is

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2009), archived at http://perma.cc/E3QP-9RE6 (arguing that "third-party litigation financing [should] be prohibited in the United States").

62 See, for example, *Rancman v Interim Settlement Funding Corp*, 789 NE2d 217, 221 (Ohio 2003); *Lingel v Olbin*, 8 P3d 1163, 1167 (Ariz App 2000); *Wilson v Harris*, 688 S2d 265, 268–70 (Ala Civ App 1996). But see Ohio Rev Code Ann § 1349.55 (2008) (abrogating *Rancman* by regulating—but not banning—litigation financing).

63 See Barksdale, Note, 26 Rev Litig at 730–32 (cited in note 61).

64 See *Oasis Legal Finance Group, LLC v Coffman*, 361 P3d 400, 401–02 (Colo 2015).

65 See id ("[T]hese transactions are 'loans' under the Code."). For Colorado's usury statute, which applies to "loans" under the code, see Colo Rev Stat Ann § 5-2-201.

66 See, for example, Ark Code Ann § 4-57-109 (regulating the terms and permissible interest rates for consumer litigation financing); Tenn Code Ann §§ 47-16-101 to -110 (regulating consumer litigation financing). For a discussion of existing and proposed consumer protection and litigation-financing regulations, see Estevao, Comment, 84 U Colo L Rev at 479–95 (cited in note 13).

deemed socially objectionable. In a somewhat analogous context, the Eighth Circuit found that an agreement to cover personal and family obligations in the event a member of a tax-protest organization was imprisoned was void as a matter of public policy.[67] The court noted that "an agreement which contravenes some recognizable public policy is void."[68] The contract in the aforementioned case was not intrinsically illegal, nor was it explicitly encouraging either party to break the law.[69] However, because the group's overall mission was to "refuse payment of all unconstitutional taxes," the court found that the contract implicitly encouraged members to violate the law.[70] A court could similarly conclude that a defense-side financing agreement implicitly encourages illicit behavior by reducing the cost of the behavior that gave rise to the lawsuit. The argument is that the availability of defense-side litigation financing for impermissible behavior lowers an individual's overall cost of engaging in such behavior and therefore undermines the ultimate deterrent effect of civil liability.[71]

This line of reasoning has some initial appeal, but it is not convincing. The defense-side agreement prices the risk of the claim in line with the risk-adjusted expected value of the litigation based on a true assessment of the merits.[72] A defendant who committed an egregious act that created substantial civil liability would not be able to obtain favorable litigation financing. Therefore, from an ex ante perspective, a potential defendant could not rely on the existence of litigation financing to reduce the expected cost of engaging in liability-inducing behavior. The presence of defense-side financing should not have any impact on the deterrent effect of litigation, and therefore in no way "contravenes [ ] recognizable public policy."[73] Of course, the difficulty of pricing

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67 See *McBrearty v United States Taxpayers Union*, 668 F2d 450, 450–51 (8th Cir 1982) (per curiam).

68 Id at 451.

69 See id at 450–51.

70 Id at 451.

71 See, for example, *Northwestern National Casualty Co v McNulty*, 307 F2d 432, 440 (5th Cir 1962) (noting that allowing individuals to shift the risk of punitive damages to a third party ex ante gives the individuals "a freedom of misconduct inconsistent with the establishment of sanctions against such misconduct").

72 The practice of pricing risk-transfer contracts to reflect the amount of risk is at the core of the insurance market. In the most basic insurance market, automobile insurance, insurance companies adjust their pricing based on the likely risk that the insured will be in an accident—for example, by imposing surcharges for a prior history of accidents or traffic violations. See Christopher J. Bruce, *The Deterrent Effects of Automobile Insurance and Tort Law: A Survey of the Empirical Literature*, 6 L & Pol 67, 84–87 (1984).

73 *McBrearty*, 668 F2d at 451.

defense-side litigation financing weakens the ability of the market to neutralize this concern.[74] However, the individualized nature of the pricing arrangement and the fact that the agreement occurs *after* the liability-inducing behavior indicate that a business could not rely on the ability to underprice its defense through litigation financing as a way to reduce the costs of egregious behavior.

Although the public perception of litigation financing is not wholly positive, academics and courts are becoming more accepting of the arrangements. Policymakers should not be unduly persuaded by public perception, but should instead look to the extensive research weighing the costs and benefits of litigation financing. For defense-side financing specifically, the policy arguments weigh in favor of allowing the financing—such arrangements have the potential to better align the private and public incentives for litigation and deter socially wasteful litigation.[75]

II. THE DEFENSE-SIDE LITIGATION-FINANCING MARKET

The most fertile segment of the defense-side litigation-financing market is noninsured business disputes.[76] Businesses are well suited to assessing their risk tolerance in a way that can be monetized and to paying a premium for certainty and the ability to deploy current capital toward something other than litigation defense. As a result, this discussion of the defense-side litigation-

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74 See note 32.

75 See Part II.B.

76 It is unlikely that defense-side financing would serve the individual defendant faced with civil litigation as this role is largely assumed by insurance. There is the potential that defense-side financing could evolve in the criminal liability sphere, but such arrangements would look vastly different from the business defense-side financing discussed in this Comment. Criminal defense-side financing could be used as a way to alleviate the strained public defender system. See Bennett H. Brummer, *The Banality of Excessive Defender Workload: Managing the Systemic Obstruction of Justice*, 22 St Thomas L Rev 104, 106 (2009) (arguing that financing difficulties have made the right to counsel for indigent defendants in many jurisdictions "a sham"). Such financing would likely provide an income-share-style agreement similar to those that have been proposed for funding higher education: the financier would "'buy' a share in an individual's earning prospects" in exchange for the financing to cover the cost of defending the charges. Milton Friedman, *Capitalism and Freedom* 103 (Chicago 2d ed 1982) (proposing this arrangement in the context of higher education). This equity-style financing arrangement has gained popularity as a solution for higher education. See, for example, Kate Bachelder, *Escaping the Student-Debt Trap* (Wall St J, June 13, 2014), online at http://www.wsj.com/articles/the-weekend-interview-escaping-the-student-debt-trap-1402699281 (visited Jan 30, 2016) (Perma archive unavailable). If this model proves successful in the education context, it is feasible that it could be applied to the costs of criminal defense.

financing market focuses on how the market would work for businesses defending uninsured suits. Part II.A reviews the basic economic principles that impact a defendant's decision to litigate or settle when faced with a lawsuit and how defense-side financing changes the calculation. Next, Part II.B discusses the private and public benefits that result from those changes. Finally, Part II.C provides a simplified example to show how such benefits may be realized in practice.

A. The Economics of Litigation Defense

To understand the benefits of defense-side financing, it is imperative to understand the economics underlying litigation and the decision to litigate or to settle. At the most basic level, defendants will defend a claim only if the cost of the defense and the expected loss from litigation is less than or equal to the settlement amount.[77] As a result, defendants will settle rather than continue defending the claim when the plaintiff agrees to settle for an amount less than the sum of the expected cost of defense and the expected value of the trial outcome.[78]

There are many considerations that go into the cost of a defense beyond the obvious attorney's fees. These include the cost to reputation if the defendant engages in a public legal battle, the opportunity cost of deploying capital toward litigation rather than another business opportunity, and the costs associated with uncertainty. For example, the pending risk of an unfavorable outcome in the litigation may force the defendant to pay a higher price for capital during the litigation period because investors are less willing to invest in a company that has substantial legal risks.[79] Or a defendant may be unable to pursue a desirable business opportunity because it is expending those resources on litigation. The higher the defendant's expected cost of litigation, the more likely it is that the defendant will settle. The plaintiff is able to capture the benefit of a perceived increase in the defendant's litigation cost by extracting a higher settlement value.[80]

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77 See Steven Shavell, *Foundations of Economic Analysis of Law* 402 (Belknap 2004) (noting that "the maximum amount that [a] defendant would be willing to pay in settlement [ ] is his expected loss from trial plus his expense of going to trial").

78 See id at 401–07 (describing a simple model for the conditions for settlement).

79 Molot, 76 U Chi L Rev at 374–75 (cited in note 4).

80 See Shavell, *Foundations of Economic Analysis of Law* at 420–21 (cited in note 77) (discussing how plaintiffs can take advantage of high defense costs in "negative value suits" strategies).

Additionally, the calculation for the expected cost of the total litigation is fraught with error potential. The defendant does not know with 100 percent certainty the likelihood of success at trial, nor the amount of judgment that will result if it loses. Thus, there is substantial possibility for error in the defendant's estimation of both the probability of loss *and* the probable maximum liability. At the outset, the defendant does not truly know the strength of the plaintiff's case or what information the plaintiff plans to present at trial. The defendant likely does not have the substantial legal expertise or the experience with the specific forum necessary to accurately determine a probability of loss or to determine what a jury is likely to award in damages. The lack of information may cause the defendant to over- or undervalue the expected loss.[81]

The defendant's risk preference further impacts the decision to litigate or settle. If the defendant is a corporation, it will likely be risk-averse and therefore will value certainty, creating a value-of-certainty premium.[82] This magnifies the cost of uncertainty by causing the defendant to overweight the worst-case scenarios, and makes it even more likely that the defendant will accept a settlement offer rather than go to trial. Thus, plaintiffs may be able to benefit from the defendant's risk aversion by extracting a higher settlement value.[83]

The cost-benefit analysis performed by defendants leads some defendants to settle claims that have a negative expected value (NEV).[84] The prospect that defendants will settle motivates

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81 For a discussion of the considerations informing the choice between settlement and trial, see id at 401–11.

82 See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 Yale L J 857, 884 n 78 (1984) ("Most top managers [of corporations] are likely to be risk averse in establishing the firm's policies.").

83 Id. While it is not true that all defendants are more risk averse than all plaintiffs, "[i]n all low-merit suits, defendants will be risk averse and plaintiffs will be risk seeking." Note, *Risk-Preference Asymmetries in Class Action Litigation*, 119 Harv L Rev 587, 599 (2005). But see Charles Silver, *"We're Scared to Death": Class Certification and Blackmail*, 78 NYU L Rev 1357, 1367 (2003) (asserting as a general matter that "plaintiffs and their lawyers are more risk averse than defendants"). Ultimately, it is difficult to develop a general rule that defendants or plaintiffs are *always* more or less risk averse than their counterparts. What is undisputed is that asymmetry in risk preferences can distort settlement agreements to the disadvantage of the more risk-averse party. See Note, 119 Harv L Rev at 597–603 (cited in note 83) (explaining how risk preference asymmetry can result in distorted class action settlements, whether in favor of the plaintiff in the form of "blackmail settlements" or in favor of the defendant in the form of "sweetheart settlements"). Thus, when the defendant is more risk averse than the plaintiff, the plaintiff will be able to take advantage of that asymmetry by extracting a larger settlement.

84 See generally Lucian Arye Bebchuk, *Suits with Negative Expected Value*, in Peter Newman, ed, 3 *The New Palgrave Dictionary of Economics and the Law* 551 (Macmillan 1998).

plaintiffs to bring NEV suits, and defendants rationally opt to settle NEV suits when there are information asymmetries—when the plaintiffs possess more of the information necessary to evaluate the strength of the case—or disproportionate allocations of litigation costs.[85] All litigation involves information asymmetries—the plaintiff and the defendant each know different facts that will impact their assessments of the case. In a situation in which some plaintiffs bring claims that have positive value, while other plaintiffs do not (for example, when the existence of a product defect is known but the issue of causation is plaintiff specific), the defendant's inability to know whether the plaintiff's case has value will lead the defendant to settle.[86] For example, in the litigation that followed the General Motors ignition switch defect, although there was no doubt that the switch was defective, it was extremely difficult to know whether a specific accident was actually caused by the defect and how much harm, if any, a specific plaintiff may have suffered because of the defect.[87] More significantly, when the defendant will bear the brunt of the cost of litigating the suit, the plaintiff knows that the defendant will not go to trial and may thus bring a lawsuit to induce settlement even if that lawsuit would not be economical for the plaintiff to pursue to trial. Such a cost discrepancy may occur for a variety of reasons, including an actual difference in the cost of litigation, the frontloading of fees toward the defendant, or plaintiff-side alternative fee arrangements.[88] Additionally, certain plaintiffs (or plaintiffs' firms) may have a reputation for going to court even for NEV suits, creating a credible threat that the suit will result in trial if there is no settlement.[89]

Defense-side financing potentially impacts the defendant's cost-benefit analysis when deciding how to proceed in a lawsuit. Defense-side financing may lower the defendant's actual cost of defending a suit or improve the defendant's bargaining position in settlement discussions so that the defendant can capture more of the settlement value. First, defense-side financing may lower the defendant's total economic cost of litigating by reducing the

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85 For a basic discussion of why NEV suits prevail in the legal system, see Shavell, *Foundations of Economic Analysis of Law* at 420–22 (cited in note 77).

86 Bebchuk, *Suits with Negative Expected Value* at 552 (cited in note 84).

87 For a discussion of the litigation that resulted from the faulty ignition switches, see Margaret Cronin Fisk, *What Will Faulty Ignition Switches Cost GM?* (Bloomberg, Mar 10, 2016), archived at http://perma.cc/N2TZ-5HEN.

88 Bebchuk, *Suits with Negative Expected Value* at 552–53 (cited in note 84).

89 Id at 553.

opportunity cost of financing litigation and by using economies of scale to lower the actual cost of litigation. The financier also likely has more comprehensive litigation expertise than the defendant[90] and therefore will be able to help an inexperienced defendant more accurately assess the risk of the litigation. The financing agreement can also provide a minimum guaranteed outcome for the defendant through the carefully constructed definition of success, eliminating the value-of-certainty premium built into settlement.

Defense-side financing also aligns risk preferences by shifting the legal risks from the risk-averse corporation with minimal capacity to absorb risk to the risk-seeking investor with substantially larger risk capacity.[91] By investing in multiple litigations simultaneously—whether all defense-side, all plaintiff-side, or a mix of plaintiff- and defense-side—the financier pools the risk of a negative outcome, allowing it to absorb more risk than an individual litigant. The entry of financiers into the defense-side sphere is part of a broader desire to diversify risk. Some seek to incorporate defense-side into a portfolio-financing arrangement.[92] Others seek to expand the general pool of single-case financing opportunities to which they can deploy capital; there are strong and weak cases on both sides of the aisle. The risk pooling that financiers achieve is similar to insurance—by aggregating a number of litigation events, it ensures that success in one investment will help offset a loss in another.[93]

The impact of defense-side financing on the economic framework for litigation defense affords a variety of potential benefits. The next Section discusses these various benefits and explains when they are most likely to be realized.

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90 Most litigation-financing companies specialize in litigation and are staffed by attorneys. See, for example, *Team* (Burford Capital LLC), archived at http://perma.cc/HS4W-4392.

91 The discussion that follows is based on a typical application of the portfolio theory developed by Professor Harry Markowitz. See generally Harry Markowitz, *Portfolio Selection*, 7 J Fin 77 (1952).

92 See id; Rowles-Davies, *Litigation Finance* (cited in note 7). A portfolio arrangement is one in which the financing arrangement is based on a group, or portfolio, of cases, rather than simply one litigation.

93 Molot, 76 U Chi L Rev at 374 (cited in note 4) ("Just as accident costs are more easily borne when they are spread over a larger pool, so too can litigation risk be more easily borne when it is spread over a broader group."). But see Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns* *26 (RAND, 2010), archived at http://perma.cc/HL5R-TB8C (noting that commercial litigation financing may not provide enough investment opportunities for financiers to benefit fully from the law of large numbers).

B. The Benefits of Defense-Side Financing

When Professor Molot first advocated for a defense-side litigation-financing market, he noted that one of the primary benefits of such arrangements would be the ability to transfer litigation risk that was interfering with a company's ability to engage in a significant transaction (such as a merger or acquisition).[94] However, the benefits from defense-side financing are broader than that. This Section highlights some of the additional private benefits that defense-side financing can provide individual companies. It also discusses some potential public benefits that may result from a robust defense-side litigation-financing industry. Policymakers should note these social benefits when determining whether, and to what extent, to regulate the industry.

1. Private benefits.

As this Comment has already noted, the most significant benefit that defense-side litigation financing provides is a mechanism for transferring litigation risk.[95] While insurance is available for many types of litigation risk, it is not available for all litigation events. As Molot noted, "Many litigation-triggering events are not covered by conventional liability insurance policies, which exclude 'business risks' and conventional commercial contract disputes."[96] Even if a business has insurance covering this type of risk, the policy limits may not be high enough to cover the full liability exposure, subjecting the business to continued risk.[97] Common liability risks that are generally not covered by insurance include trademark infringement, unfair competition, antitrust liability, and patent infringement. Ex ante, these types of liability are generally considered uninsurable because they are not fortuitous events, but are to some degree within the business's control. Once litigation is initiated, this type of liability is generally treated as uninsurable for "after-the-event" insurance because the risks are idiosyncratic, and insurance companies do not have the institutional expertise to accurately price the risk.[98] Litigation-financing companies are best situated to serve this risk-transfer need because of their strong litigation expertise[99]

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94 Molot, 76 U Chi L Rev at 376–77 (cited in note 4).

95 See Part II.A.

96 Molot, 76 U Chi L Rev at 377 n 21 (cited in note 4).

97 See id at 377.

98 Id at 380–81.

99 See note 90 and accompanying text.

and their funds' private equity–style structure, which makes the funds better suited to handle idiosyncratic risks than are insurance companies.

For businesses, not all forms of uninsured litigation risk necessarily make sense to transfer to a litigation-financing company. But a business faced with a legal threat so substantial that a negative outcome will destroy it will certainly want to consider obtaining litigation financing to mitigate its risk. Here, even if the possibility of a disfavorable outcome is low, the risk is so catastrophic that the defendant may be tempted to settle at a high premium. The unmanaged risk may also impede the company's ability to continue with its other operations, especially if it is a smaller start-up. Along this line, even if a company is not facing enterprise-threatening litigation, it may face litigation risk that is impeding a critical aspect of the company's strategy. Here, the risk-transfer mechanism removes a barrier for the company to pursue a desired course of action.[100] Additionally, a company facing liability that could extend to its board of directors may wish to transfer the risk of runaway liability away from its board members to a third party.[101] Finally, a company that is engaged in numerous lawsuits may wish to enter into an arrangement that minimizes the aggregate risk imposed by those suits. It may not make economic sense to transfer the risk of each individual litigation, but by doing a portfolio arrangement, the business would be able to gain the benefits of defense-side financing and cap its total aggregate liability.[102]

Defense-side financing can also help improve a defendant's position in settlement negotiations. When the defendant creates a contingency fee–like arrangement for financing the litigation, the defendant is able to credibly tell the plaintiff that it is willing to go to trial, which makes the defendant better situated for settlement negotiations than under the typical hourly fee arrangement.[103] Under a contingent fee–style arrangement, the defendant "is indifferent between trial . . . and settlement" at the expected

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100 See Molot, 76 U Chi L Rev at 376 (cited in note 4). According to Molot, this is one of the strongest reasons why a corporation may wish to seek defense-side financing. See id.

101 See *Litigation Finance Industry Is on the Rise* (Bloomberg, Apr 6, 2016), online at http://www.bloomberg.com/news/videos/2016-04-06/litigation-in-the-financial-industry-is-on-the-rise (visited June 8, 2016) (Perma archive unavailable).

102 See Rowles-Davies, *Litigation Finance* (cited in note 7).

103 See Lucian Arye Bebchuk and Andrew T. Guzman, *How Would You Like to Pay for That? The Strategic Effects of Fee Arrangements on Settlement Terms*, 1 Harv Negotiation L Rev 53, 62 (1996).

value of litigation "only because the amount paid to the lawyer does not depend on whether or not there is a trial."[104] As a result, the plaintiff must either make a settlement offer below the defendant's expected value of the case or go to trial. By effectively transferring the added cost of going to trial to the litigation-financing company, the defendant has created a situation in which it can credibly threaten to go to trial. Thus, the plaintiff cannot rely on the defendant considering the additional cost of trial when negotiating a settlement. Plaintiffs already routinely utilize these strategies through contingent fee arrangements and nonrefundable retainers.[105] Providing defendants with the ability to mimic these financing arrangements helps level the playing field for settlement negotiations. When a financed defendant negotiates with a similarly financed plaintiff, the costs of the litigation will evaporate from the settlement discussions, and one would expect the ultimate settlement value to coalesce around the true value of the litigation.[106]

A defendant that is not a regular player in the world of litigation may also benefit significantly from the financier's litigation expertise and repeat-player status. The financier will be able to help the defendant properly assess the risk and obtain quality counsel, perhaps even at a discounted rate. The litigation between C.K. Coolidge, Inc (CKC), Barton Research and Development, and Tolemite Corporation, a common negotiation case study for business students, is a perfect example of when a onetime defendant could have benefited from litigation financing. In this litigation, CKC spent over $300,000 and three years defending a case, despite having received settlement offers for less than the cost of defense.[107] CKC was accused of infringing Tolemite's patent in its synthetic drug manufacturing process.[108] Tolemite had exclusively licensed its patent to one of CKC's competitors, including the right for that competitor to sub-license, and was required to help the competitor enforce the patent against all other potential

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[104] Id at 61–62. The example shown in the next Section demonstrates how this principle would be applied in practice to a litigation-financing contract.

[105] See David C. Croson and Robert H. Mnookin, *Scaling the Stonewall: Retaining Lawyers to Bolster Credibility*, 1 Harv Negotiation L Rev 65, 69–70 (1996).

[106] Bebchuk and Guzman, 1 Harv Negotiation L Rev at 62 (cited in note 103) ("If both sides have a contingent fee arrangement, the settlement amount will be [the expected judgment] since neither side faces litigation costs.").

[107] See John S. Hammond, *C.K. Coolidge, Inc (Abridged)* 3, Harvard Business School Case No 9-607-006 (Harvard 2007).

[108] Id at 1.

infringers.[109] CKC had a strong case that the Tolemite patent was invalid, but there were costs associated with *winning* the litigation (namely, the loss of its competitive advantage over the competitors that were licensing Tolemite's questionable patent).[110] CKC was myopically focused on the merits of its case and, as a result, failed to recognize the advantages of settling early.[111] Had CKC been working with a litigation financier, it likely would have seen the benefits of settlement much sooner, even though its case had strong merits. The expertise and additional benefits that the financier brings to the defendant must be substantial enough to warrant the additional premium, however, so not every litigation will be worth bringing to a financier.

Companies facing major litigation may also struggle to finance the cost of defense; for example, a start-up that does not yet have steady cash flow could risk going out of business from just the cost of the defense, regardless of the expected liability. Some defendants may be unable to continue all operations under normal conditions during the litigation and thus need additional capital to fund basic business operations in addition to the litigation. Companies in this position may struggle to obtain traditional financing because of the uncertain nature of the ultimate cost of litigation and because banks lack expertise in properly assessing litigation risk. This is further magnified if the liability faced is enterprise threatening. Here, the financier can serve as a source of capital in addition to absorbing some of the litigation risk.

Along the same lines, obtaining financing for a defense can help smooth out a company's balance sheet. This may be especially critical for a defendant that is in a highly cyclical business and thus does not have cash flow available to pay legal fees consistently, or for a company that has alternative business opportunities it wishes to pursue while the litigation is progressing (for example, opening a factory). The defense-side financing agreement can mimic a reverse contingency fee model,[112] ensuring the defendant does not need to pay until after the litigation is resolved. In this situation, the defense-side financier is providing

109 Id.

110 Id at 3–4. The case does not specify whether Tolemite was required to assist the sole licensee in enforcing the patent. However, for ease of analysis, this example assumes the contract contained such a provision.

111 See Hammond, *C.K. Coolidge* at 3 (cited in note 107).

112 See *Black's Law Dictionary* at 387 (cited in note 9) (defining "reverse contingent fee" as "[a] fee in which a defense lawyer's compensation depends in whole or in part on how much money the lawyer saves the client, given the client's potential liability").

much the same service as a plaintiff-side financier would: acting as a middleman between the law firm and the client to facilitate a contingency fee structure.[113]

2. Public benefits.

Defense-side financing may also be able to provide broader benefits that go beyond the individual defendant. First, it can help coordinate multiple defendants facing similar litigation and allow for cost sharing. Many large legal battles involve multiple defendants as well as multiple plaintiffs. While defendants do not aggregate as readily as plaintiffs do when there are common questions of law and fact,[114] they do often coordinate their defense strategies and share the costs of both the defense and the final settlement.[115] Defense-side financing can help facilitate such cooperation by creating a contingency fee–like structure that replicates the plaintiff class action model and by providing an objective third party to coordinate the multiple parties.[116]

By providing meritorious defendants—those that would likely be victorious at trial—with access to the benefits of litigation financing just discussed, defense-side financing may help reduce the overall amount of frivolous litigation.[117] For example, in a David-and-Goliath-style commercial litigation dispute, a large

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113 See Part I.A.

114 See Robert R. Simpson and Craig Lyle Perra, *Defendant Class Actions*, 32 Conn L Rev 1319, 1319 (2000) (describing defendant class action lawsuits as "uncommon").

115 An example of such a situation is the litigation that followed the Lac-Megantic train derailment that occurred in 2013 and killed over forty people. The class action lawsuit involved nearly two dozen corporate defendants that worked together to reach a settlement agreement with the plaintiffs. See Giuseppe Valiante, *$77-Million Settlement Proposed for Lac-Megantic Families* (HuffPost Business Canada, Apr 2, 2015), archived at http://perma.cc/224G-M4EA.

116 For additional discussion of the benefits of coordinating multiple defendants, see Assaf Hamdani and Alon Klement, *The Class Defense*, 93 Cal L Rev 685, 711–13 (2005).

117 Frivolous litigation includes NEV suits, which are considered socially undesirable, although there are situations in which NEV suits may be socially beneficial. See Shavell, *Foundations of Economic Analysis of Law* at 422–23 (cited in note 77). For a specific example of such a suit, see Croson and Mnookin, 1 Harv Negotiation L Rev at 66 (cited in note 105):

> Suppose a contractor has an entirely legitimate claim that she is owed an additional $30,000 by a property owner for work rehabilitating an old building under a construction contract. Suppose also the costs of actually trying the dispute would be $40,000 for the contractor and $20,000 for the property owner. . . .
>
> . . . [A] rational plaintiff would not spend $40,000 to recover $30,000.

company plaintiff may go after a smaller company defendant because it views the defendant as an easy target.[118] With access to defense-side litigation financing, the smaller company would be able to level the playing field. By providing the defendant with sufficient resources and protection to fight, a financing arrangement can ensure that the defendant is more likely to see the litigation through to the judgment phase and obtain a favorable judgment. The availability of financing may also increase the likelihood that the defendant files counterclaims against the plaintiff or brings a case for malicious prosecution after the initial litigation is resolved.[119] The plaintiff, aware that the defendant has an external way to match the plaintiff's own deep pockets, may ultimately be deterred from bringing the claim in the first place.

Defendants' access to litigation financing may also help reduce frivolous or nuisance lawsuits—often motivated primarily by plaintiffs' attorneys seeking to extract settlements that provide significant attorney's fees but do not provide societal benefit or meaningful recourse to the plaintiffs.[120] As discussed above, defense-side financing provides defendants with a tool akin to plaintiffs' retaining fee arrangements.[121] Creating defendants and plaintiffs that have transferred the additional cost of going to trial will severely limit the ability of either side to extract settlements. Plaintiffs would no longer have an incentive to bring cases that have no expected judgment value. It is far too early to determine if the industry will actually have this effect on litigation. It may (and, in the short term, likely will) result in more cases going to trial that would have otherwise settled. The defendant and plaintiff may not know that the other party has actually positioned itself to be indifferent between settlement and trial and may think the other is merely posturing. Additionally, while defense-side financing can help eliminate trial costs from the settlement negotiations, it will not resolve differences between the parties with

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118 For a discussion of how companies deploy litigation to preserve their competitive advantage, see *How Companies Use (and Abuse) Law for Competitive Gains* (Wharton, May 19, 2004), archived at http://perma.cc/EGU9-W25T.

119 See Caplan, *Lawyers and the Ick Factor* (cited in note 59) (discussing the use of litigation financing to defend a small business owner on appeal after he had won a jury award of $14.5 million in a defamation suit).

120 See Lance P. McMillan, *The Nuisance Settlement "Problem": The Elusive Truth and a Clarifying Proposal*, 31 Am J Trial Advoc 221, 223 & n 5 (2007) (noting that most nuisance lawsuits—those in which the plaintiff knows the claims are meritless but brings the case regardless "in order to extort a settlement"—are primarily driven by plaintiffs' attorneys).

121 See notes 103–06 and accompanying text.

respect to the expected value of a judgment. There may also be concern that the threat of stronger defendants will deter meritorious claims from making it into court, not just frivolous lawsuits. However, if the market for defense-side financing works properly, litigation financing will be cost justified only to defendants that have a strong likelihood of success on the merits.

Defense-side litigation financing may also help courts reach the socially optimal number of lawsuits. The common-law system makes litigation necessary to create law, and individual parties' decisions to litigate or settle generally do not take into account the potential precedential value of litigation.[122] For example, parties in a suit do not know if law students will someday study the outcome of their case. They care about resolving the specific business dispute at hand—the plaintiff wants to get damages, and the defendant wants to avoid paying them. As a result, the parties will settle when it is in their interests even if the legal question presented by the case could provide a meaningful development in the law. Because litigation financiers are repeat players in the litigation industry, they will have stronger incentives to internalize the value of precedent and will think of litigation more strategically.[123] It is likely that this additional incentive will be small; however, as the industry and litigation financiers specialize in certain areas of the law, it is possible that litigation financiers will be motivated in part by a desire to drive the evolution of certain areas of the law. This is true on both the plaintiff and defense side; however, if litigation financiers finance only the plaintiff side, the incentive will be distorted toward creating more plaintiff-favorable precedent. Having litigation financiers involved in both sides of the litigation will help ensure that the parties weigh the possible value of precedent in deciding whether to settle or litigate.

Another inevitable impact of defense-side litigation financing is that it will lower the overall expected liability of defendants. This has the potential to be either socially positive or socially negative. Assuming litigation financing provides favorable pricing to

[122] See Shavell, *Foundations of Economic Analysis of Law* at 391–401 (cited in note 77) (discussing the divergence between private and public incentives to litigate).

[123] In litigation financing, the ultimate decision to settle or continue litigating remains with the client. However, the terms of the contract can be arranged to ensure that the client's incentives align with the financier's interests. One would expect that the financier's perceived benefit of developing precedent in a specific case would be reflected in the terms of the contract. For a longer discussion of how the financing contract balances control between the financier and the client, see Part III.C.

the defendants who are least likely to be liable, litigation financing reduces the overall expected liability of defendants by more accurately allocating the liability to those truly responsible. In essence, by thoroughly vetting defendants as part of the underwriting, defense-side financiers help reduce the error costs in the litigation system. However, information asymmetries and other barriers to profitably underwriting potential defendants present their own possibilities for error costs.[124] The concern that the weakest defendants will be the ones seeking litigation financing, a phenomenon known as adverse selection, further magnifies this risk. Thus, it is possible that defense-side financing simply reduces overall expected liability without properly allocating the reduction to the defendants with the strongest cases. However, the market should serve as a check—if a fund is offering affordable defense-side financing to defendants with weak cases, the fund will not perform well. Here, the individualized nature of the litigation-financing industry will make it difficult for adverse selection to persist.

C. An Example of Defense-Side Financing in a Business Dispute

A simple example highlights many of the potential benefits just mentioned. Imagine a company is sued by a competitor for an alleged antitrust violation. The plaintiff's complaint requests damages of $100 million, and, after surviving a motion to dismiss, the plaintiff has indicated that it is willing to settle for $20 million. The defendant estimates that it will cost $2 million to fully litigate the dispute, if it comes to that.

The defendant is sure the claims have little merit and estimates that there is an 85 percent to 95 percent probability that it will get a favorable ruling. Using $100 million as the maximum potential liability, the defendant's expected liability in the case is $12 million.[125] Despite the strong likelihood of success, the defendant may be especially nervous about the risk of an unfavorable judgment. Further, if the defendant loses at trial, it will likely be

[124] See note 32.

[125] The expected cost of the lawsuit is equal to the cost to litigate plus the probability of a loss times the maximum liability in the event of a loss:

$$\$2 \text{ million} + (0.10 \times \$100 \text{ million}) = \$12 \text{ million}$$

For the sake of convenience, this expected value calculation assumes that the expected probability of success is 90 percent—the midpoint of the range of the defendant's estimate of the probability of success.

responsible for the plaintiff's attorney's fees,[126] estimated as equal to the cost to defend ($2 million). This makes the true maximum liability $102 million. Thus, the $20 million settlement offer is only slightly higher than the top of the defendant's settlement range.[127] If the defendant is especially risk averse, it may accept the settlement offer. Additionally, if the defendant is cash strapped, it may prefer accepting the settlement and taking on debt to fund the settlement, because it will be easier to obtain traditional financing once the value is certain.

Litigation financing can provide the defendant an alternative to settling.[128] In one possible arrangement, the financier agrees to pay the cost of defense, committing up to $2 million toward litigation expenses, and agrees to indemnify the defendant for any judgment or settlement above $12 million. The parties define a successful outcome as a settlement amount of $10 million or less, and the defendant is required to pay the financier only in the event of a successful outcome. This definition of success reflects the point at which the defendant is indifferent between the settlement offer and going to trial, now that the financier is covering the cost of litigation.[129] The agreement may also provide the defendant with a longer-term payment plan, alleviating the defendant's cash flow concerns. This allows the defendant to negotiate more aggressively with the plaintiff: the defendant's liability is capped, and it knows it can afford to take the case to completion if the plaintiff refuses to negotiate, creating a credible "[b]est [a]lternative to a [n]egotiated [a]greement."[130]

If the defendant pursues the case to completion and obtains a successful ruling at summary judgment, resulting in no payment to the plaintiff, then the defendant would have to pay the

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126 Although under the American rule each party typically pays its own litigation costs, some statutes, including the statute governing private antitrust litigation, allow for the prevailing party to recover attorney's fees. See 15 USC § 15(a).

127 The highest acceptable settlement amount for a risk-neutral defendant is equal to the highest reasonable probability of a loss times the maximum liability in the event of a loss, including the plaintiff's litigation costs, plus the defendant's own cost of litigation:

$$0.15 \times (\$100 \text{ million} + \$2 \text{ million}) + \$2 \text{ million} = \$17.3 \text{ million}$$

128 For the sake of simplicity, this example contemplates only an agreement between the financier and the defendant, and does not include any contingency arrangements with the attorney.

129 See text accompanying note 104.

130 William Ury, *Getting Past No: Negotiating in Difficult Situations* 21–24 (Bantam 1991). The "Best Alternative to a Negotiated Agreement" (BATNA) is a common concept in negotiation strategy. One of the best ways to improve one's negotiation position is to improve one's BATNA. Id.

financier only the amount of capital it deployed in defending the case plus some agreed-upon multiplier return. Assuming the full $2 million was deployed and the parties agreed on a three-times return for the financier, the defendant would pay the financier $6 million. This is a win for the defendant, both from an expected liability perspective (it originally believed its liability would be $12 million) and in terms of what it would have likely been willing to settle the case for without financing ($20 million).

Even in a less victorious outcome, the defendant would be satisfied with the result. If, because of the defendant's improved bargaining position, the case settles quickly for $4 million, the defendant would be responsible for the $4 million to the plaintiff and then would pay the financier its investment return for the deployed capital. If the financier deployed $500,000 prior to the settlement, which is subject to a three-times return, the defendant would ultimately spend $5.5 million. If the case instead takes a less favorable turn and ultimately settles for $12 million, the financier would not be entitled to recover any capital it deployed to the case (a maximum of $2 million), but the defendant would be responsible for the full judgment ($12 million). Even if the case ultimately settled above the initial $12 million offer, for example, at $25 million, the defendant would have to cover only the first $12 million and then the financier would cover the additional $13 million and its deployed capital (a total of $15 million).[131]

The defendant is therefore agreeing to pay the financier up to $6 million in exchange for (1) increased bargaining power with the plaintiff in settlement negotiations and (2) certainty that its liability will not exceed $12 million. And the financier receives a 300 percent return on investment upside in exchange for an estimated $15 million downside risk.[132]

By providing certainty and immediate capital, defense-side financing lowers the realized cost of the lawsuit for the defendant. It also improves the defendant's bargaining position, allowing it to capture more of the value in the settlement negotiation. As this example shows, there are clearly benefits to be realized from the defense-side litigation-financing market. Potential clients may

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[131] Given the high rate of settlement, this example assumes the parties would reach a final settlement agreement rather than go to trial.

[132] Technically, it is possible the litigation could go all the way to trial and result in the full $100 million in damages, for which the financier would be responsible. However, given the financier's assessment that the defendant has a strong case, it would not estimate its reasonable downside risk when evaluating the opportunity as the full amount of the damages.

still be hesitant to enter into such agreements because they do not know what to expect from the contract. The final Part of this Comment reviews the key considerations that are unique to a defense-side financing agreement so that parties can anticipate what they should consider when negotiating such agreements.

III. Structuring Effective Defense-Side Financing Agreements

Defense-side financing is a new product, and, as a result, potential clients who want to take advantage of the new arrangements may be unsure what to expect from these agreements. This final Part is geared toward those potential clients who have not had any experience with the litigation-financing industry. It highlights the specific elements financiers consider when structuring the agreements and how those considerations may manifest in the actual agreements.

One concern that has unique implications for defense-side agreements is how to properly structure incentives. There are two key incentive problems that the contract should alleviate: the principal-agent problem and the risk of moral hazard. Agency relationships, in which party A (for example, a client) contracts with party B (for example, an attorney) to perform a service for party A's benefit, present a principal-agent problem. Ideally, agreements between a principal and an agent should be structured so that the parties' incentives align.[133] The principal-agent problem is not unique to defense-side financing, but the financing adds a complication by separating the financial interest in the litigation further from control of the litigation.[134] Because the financier and the defendant will both have financial interests at stake in the litigation, however control of the litigation is divided, the parties must recognize and account for the agency problem. Additionally, the attorney will have significant control, especially in settlement negotiations. If the attorney is being paid on an hourly fee–based system, then she is not absorbing any of the risk of the

[133] See Adam Shajnfeld, *A Critical Survey of the Law, Ethics, and Economics of Attorney Contingent Fee Arrangements*, 54 NY L Sch L Rev 773, 792 (2009/2010).

[134] For a discussion of the impact of litigation financing on the principal-agent problem, see Bert I. Huang, *Litigation Finance: What Do Judges Need to Know?*, 45 Colum J L & Soc Probs 525, 527 (2012).

litigation but is exercising substantial control.[135] This specific agency problem is not unique to litigation financing, but the litigation-financing agreement can help alleviate it by having the attorney agree to a partial contingency so that she absorbs some of the risk along with the financier and defendant.

There is also substantial risk of moral hazard in defense-side financing agreements. Moral hazard arises in risk-transfer situations in which the party transferring the risk may be more likely to take on risk or engage in riskier behavior because it has transferred the downside of that risk-taking to someone else.[136] In the defense-side litigation-financing context there are two primary moral hazard risks: First, there is a risk that the defendant misrepresents the strength of its case, most likely by failing to provide all of the relevant information to the financier prior to consummating the deal. Second, once the deal is consummated there is a risk that the defendant will settle the case on unfavorable terms because it is immune from the financial harm of the judgment. These moral hazard risks can be mitigated through careful construction of the contract terms.[137]

This Part discusses four critical contractual elements that present unique challenges for defense-side arrangements and that can be used to mitigate the principal-agent and moral hazard problems. Part III.A focuses on defining success and offers suggestions on how to craft the definition of success to minimize moral hazard. Part III.B focuses on clarifying performance obligations, which can further minimize moral hazard risks and offset potential information asymmetries. Part III.C considers ways to allocate control of the litigation, including leveraging conditions and warranties, to solve the principal-agent problem. Finally, Part III.D considers what will occur in the event of breach, and how the parties can use liquidated damages clauses to reduce some of the uncertainty.

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135 For a discussion of the attorney principal-agent problem, see generally Bruce L. Hay, *Contingent Fees, Principal-Agent Problems, and the Settlement of Litigation*, 23 Wm Mitchell L Rev 43 (1997).

136 See Tom Baker, *On the Genealogy of Moral Hazard*, 75 Tex L Rev 237, 267–68 (1996).

137 Much of the potential moral hazard prevalent in litigation financing can also be mitigated prior to entering the contract with sufficient due diligence on the part of the financier. See Garber, *Alternative Litigation Financing* at *24–26 (cited in note 93).

A. Defining Success

One of the most significant challenges for defense-side financing agreements is appropriately defining success. A well-crafted definition of success is necessary to achieve accurate pricing, determine when parties' obligations are triggered, and mitigate moral hazard risks. When negotiating the terms of the contract, both the defendant and the financier must agree on the expected value of the litigation. This is the "strike price"—the break-even amount or expected settlement value.[138]

As discussed in Part II, the expected settlement also incorporates litigation costs.[139] If the financing arrangement is structured so that the financier pays defense costs and any judgment or settlement above the agreed-upon strike price, the strike price will likely change as the financier deploys more capital toward litigation, even if the probability of a loss remains constant. This is because the defendant has essentially shifted the cost of the litigation to the financier, but the financier may want to ensure that the defendant is still internalizing some of the litigation costs when evaluating settlement offers.[140] To do this, the definition of success should include multiple scenarios that account for how changing circumstances might affect the value of the case over time: Early success—for example, within a certain number of days after entering the financing agreement or before a major procedural element of the case, such as when the parties move for summary judgment—would be a relatively high settlement value to reflect the litigation cost not yet expended. Medium-term success could be a pretrial, postdiscovery settlement value that is lower than the early settlement value but still contemplates litigation cost savings. And late success should be defined as a final, low, posttrial settlement or even outright victory at trial (because the financier has deployed substantial capital at that point). This is similar to, but the inverse of, how financiers define success on the plaintiff side.[141]

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138 Molot, 76 U Chi L Rev at 404–05 (cited in note 4).

139 See id.

140 This is in slight tension with one of the benefits of defense-side financing discussed above—that the arrangement allows the defendant to negotiate without considering the costs of litigation. Thus, the extent to which the strike price should incorporate litigation costs will vary depending on the specific litigation at issue and what benefit the client is seeking to gain from the defense-side agreement.

141 See Steinitz and Field, 99 Iowa L Rev at 742–44 (cited in note 7) (describing how plaintiff-side litigation financiers use defined milestones in the case, such as the close of

Assuming that the financing agreement is nonrecourse,[142] the financier wants to define success as broadly as possible. A broad definition of success lowers the overall risk of the investment and allows the defendant to obtain the financing at a lower rate of return. Additionally, a broad definition helps avoid the moral hazard risk that the defendant might settle the case just above the point of success. For example, the parties may elect to include multiple potential "litigation events" within the definition of success (for example, succeeding on a motion to dismiss, getting a subset of the claims dismissed, or obtaining a favorable ruling on specific questions of law at the summary judgment phase); the parties may wish to define success as a percentage of a moving target (such as 60 percent of the most recent reasonable estimation of the expected liability); or the parties may wish to include specific non-litigation events within the definition (for example, consummation of a pending transaction, which may have been the impetus for the defendant to seek the financing). However, if success is defined too broadly from the start, the defendant may not be properly incentivized to accept a "successful" settlement. This is especially true if the agreement does not include the financing litigation costs, but includes only indemnification for judgments above a certain value.[143] The parties will thus want to tailor the definition of success based on the type of funding provided and the performance obligations triggered by success.

If the financier is covering litigation costs, but not committing capital toward any potential settlement agreement, a single-tiered definition of success tied to the expected value may be sufficient. This is the most like a reverse contingent fee arrangement, in which the financier earns a return on the investment only if the litigation results in a savings for the defendant relative to the expected judgment value. The parties must agree on the level of success that will result in payment—typically a settlement (or judgment) that is a set percentage, or less, of the expected value. In the event of success, the defendant pays the financier a multiplier of the deployed capital or a set percentage of the total amount saved (the difference between the expected value and the ultimate

discovery, to determine whether to invest further or exit based on the information available at that time).

142 See note 17 and accompanying text.

143 See Molot, 76 U Chi L Rev at 404–05 (cited in note 4) ("[W]hen a case could be settled just below the strike price, the attorney litigating the case might have a strong incentive to go to trial and hope for a defense verdict.").

settlement amount) in addition to any settlement or judgment. If the litigation was not successful—a judgment or settlement at or above the agreed-upon threshold—then the financier is out the deployed capital and the defendant must pay the settlement or judgment. The definition of success thus reflects the value to the defendant of obtaining the litigation financing.

If the financier is covering litigation costs and committing capital toward a potential settlement, a multitiered definition of success is necessary to ensure appropriate incentives. For example, the parties may keep the initial, single-tiered definition of success discussed above as the penultimate success. However, the agreement should also include a middle layer of success whereby the financier is reimbursed its deployed capital, but does not receive a multiplier. The agreement may also include a tertiary layer whereby the financier does not recover its deployed capital, but is not obligated to deploy any capital toward the settlement or judgment. The ultimate "failure" would be a judgment larger than the third layer of success as defined in the agreement, in which the financier deploys its full commitment. In this situation, the financier would be out what it expended on litigation costs and would be obligated to contribute toward the settlement, and the defendant would be responsible for the portion of the settlement not covered by the financier. Thus, both parties would be required to expend resources, but ultimately the defendant would pay less in this failure than if it had not obtained any financing.

Given the information asymmetries inherent in litigation financing,[144] the parties may wish to preserve the right to renegotiate the definition of success at key stages in the litigation, such as after completion of discovery. The parties could include this as a part of the definition of success, or as a separate term in the contract that provides the financier with the option to amend, subject to the defendant's consent. The financier will likely be more concerned with preserving the right to redefine success, because it is at an information disadvantage. However, the defendant may also want to preserve this right because new information exposed during litigation may alter its analysis of the deal as much as the financier's. Depending on the nature of the litigation, the parties may wish to clarify in the agreement the method they will use for reevaluating the definition of success.

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144 See Steinitz and Field, 99 Iowa L Rev at 729–34 (cited in note 7).

Ultimately, once the parties are able to agree on an expected value of the litigation based on the merits of the defense, they will be able to create an appropriate definition of success. The definition must be broad enough to account for the information asymmetries inherent in the negotiation and the risk preferences of the parties; however, it must also be narrow enough to ensure the defendant is properly incentivized to accept a reasonable settlement negotiation.[145]

B. Clarifying Performance Obligations

Another challenge presented by defense-side agreements is clarifying the performance obligations of both the defendant and the financier. Part of the difficulty includes clearly identifying when the various obligations are triggered, which ties back to having a clear definition of success. In addition to including performance obligations for the financier to deploy capital and for the defendant to provide the investment return on a successful outcome, there should be performance obligations for the defendant regarding the acceptance and denial of settlement offers and the disclosure of critical information throughout the life of the investment. These performance obligations are vital to properly aligning the incentives of the contracting parties and reducing information asymmetries and related moral hazard risks.

Certain performance elements of the contract—namely, the deployment of capital and the return on investment—are fairly straightforward. The return on investment is more complicated for defense-side financing arrangements than for plaintiff-side arrangements because the funding available for the investment return does not come directly from the litigation result. The defendant will want to negotiate a specific method for returning the financier's investment based on the particular reason the defendant sought the financing. If the transfer of litigation risk was obtained to facilitate a specific transaction, or to allow the company to pursue an alternative investment, the financier may require that its investment be returned upon successful completion of the relevant transaction. If the agreement was obtained because the

145 The parties do not necessarily need to agree on the precise valuation of the litigation to agree on a definition of success, but they do need to have overlapping valuation ranges in order to agree on a definition of success. In fact, the difference in valuation of the case may provide an opportunity for arbitrage that would make defense-side financing attractive to a hedge fund. However, the parties must ultimately agree on the definition of success, as that will be the trigger for performance requirements.

defendant did not have sufficient capital to cover the cost of litigation, then it is unlikely it will have adequate capital to quickly pay the investment return even in the event of a successful outcome. In this event, the method of payment should be spread over time with periodic payments—for example, a portion of net revenues paid monthly or quarterly until payment is complete. The example in Part II.C would follow this latter payment path.

The contract must also clearly delineate the defendant's performance obligations throughout the litigation. This should include obligations to keep the financier informed of developments in the litigation, including all settlement offers, and settlement-specific obligations.[146] Parties must carefully consider how they want to structure these nonpayment obligations, which should be included in the contract as conditions and warranties, rather than as performance obligations. If the obligation is termed as a performance of the contract, then the defendant's failure to perform will constitute a breach, and the financier may be able to obtain damages. Structuring the obligations as conditions instead makes it easier for the financier to walk away in the event that the defendant fails to meet one of the conditions; however, if the financier does not immediately terminate the contract upon the failure to adhere to a condition, the financier may waive its right to walk away or otherwise recoup damages.[147] This Comment recommends addressing the handling of settlement offers through conditions, rather than as performance obligations. In order to facilitate this use of conditions, the agreement must include an obligation for the defendant to disclose all settlement offers to the financier in a timely manner.

C. Leveraging Conditions and Warranties to Balance Control of the Litigation

Ultimately, no matter how control of the litigation is divided, the insertion of a financier into the litigation creates potential

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146 Similar obligations are involved in plaintiff-side financing arrangements. See, for example, Steinitz and Field, 99 Iowa L Rev at 761 (cited in note 7) (modeling possible contract terms for defining the plaintiff's duty to inform in a plaintiff-side litigation-financing contract).

147 See *In re Carter*, 134 A2d 908, 911–15 (Pa 1957) (discussing the differences between conditions and warranties and noting that a party cannot recover damages for breach if a party fails to meet a condition, with the only options in such a case being to cancel the contract or allow the condition to be waived).

principal-agent problems. If control is left completely with the defendant, then the party with the most at stake financially—the financier—is left at the mercy of the defendant. Conversely, if the defendant turns over control of the litigation to the financier as part of the agreement, the defendant, who has reputational and other economic interests at stake, is left at the mercy of the financier.[148] Further, an arrangement in which the financier has full control may subject the financier to obligations—and potential liability for failing to meet those obligations—to settle, similar to an insurer's duty to settle.[149]

Rather than picking between one of these two extremes, the parties will likely want to choose a middle path effectively sharing control. The best way to straddle the risks involved in the control element is to include specific conditions and warranties in the financing agreement so that the defendant maintains ultimate control but the financier has the opportunity to walk away should the defendant fail to conduct the litigation in an agreeable manner or to provide accurate information.[150] One way to achieve this is to condition deployment of capital on certain defendant performance outcomes. For example, the agreement could condition the second wave of financing on a certain discovery outcome. Or the agreement could condition deployment of capital on the defendant accepting a settlement offer that meets the definition of success.

The extent to which the financier will want to exert control over the litigation will depend on the extent of the financier's commitment. If the financing agreement includes indemnification for

148 Because the issues of champerty are less threatening to defense-side agreements, there is less of a legal barrier to the financier obtaining control of the litigation. For a general discussion of champerty, see Part I.B.2.

149 See W.E. Shipley, *Duty of Liability Insurer to Settle or Compromise*, 40 ALR2d § 2(a) at 170–71 (1955):

> [W]hile it has occasionally been contended that such an insurer has an absolute duty to accept any offer to settle for an amount within the policy coverage, and rejects such an offer at its own risk, the vast majority of the courts have held, and it is probably the accepted rule in all jurisdictions at this time, that the insurer is bound to give some consideration to the insured's interest in such a situation.

(citation omitted). For an updated description of the state of the law regarding an insurer's duty to give equal consideration to the insured's interest as it does to its own, see Cindie Keegan McMahon, *Duty of Liability Insurer to Initiate Settlement Negotiations*, 51 ALR5th § 8 at 723–27 (1997).

150 See note 147 and accompanying text. Conditions in contract law are a way to clarify a party's obligations under a contract and can, for example, require perfect tender rather than merely substantial performance to trigger certain obligations. See Restatement (Second) of Contracts § 224 (1981).

settlements or judgments above a certain amount, as the example in Part II.C did, the financier will want to maintain more control than if the financier is simply providing the financing for the cost of litigation. The parties must ensure that the balance of control does not present any ethical dilemmas for the attorney handling the case.[151] For example, some courts may be unwilling to enforce a contract that explicitly requires the defendant to accept a specific settlement because it may run afoul of the attorney's sole obligation to the client[152] or be deemed unconscionable.[153] Assuming the defendant remains a client of the attorney, the financier will not have the right to unilaterally dictate settlement terms.[154] The attorney could be liable for breach of fiduciary duty if she attempted to follow the financier's settlement wishes instead of the defendant's.[155] Therefore, any condition seeking to force the defendant to settle could be viewed as interfering with the attorney's fiduciary obligation.[156]

151 See Ethics Committee of the Commercial and Federal Litigation Section, *Report on the Ethical Implications of Third-Party Litigation Funding* *9 (New York State Bar Association, Apr 16, 2013), archived at http://perma.cc/L8R5-K6M5 ("Where [a litigation-financing] transaction is otherwise lawful, the ABA cautions that an attorney must exercise care to ensure that the arrangement does not run afoul of . . . [the] prohibition against compromising the lawyer's independent professional judgment.").

152 See ABA Commission on Ethics 20/20, *Informational Report to the House of Delegates* *26 (Feb 2012), archived at http://perma.cc/S8FF-7MW7. The American Bar Association's *Ethical Guidelines for Settlement Negotiations* state that all settlement decisions ultimately rest with the client. *Ethical Guidelines for Settlement Negotiations* § 3.2 (ABA, Aug 2002), archived at http://perma.cc/XB32-ST72.

153 See Restatement (Second) of Contracts § 208 (1981).

154 If the defendant transferred all of the litigation risk to the financier, then it is possible that the financier would ultimately become the client because the defendant no longer has a financial stake in the litigation. In this situation, the financier would be functionally equivalent to an insurer whose policy affords complete coverage. In those situations, the insurer maintains the right to control the litigation. See James M. Fischer, *Insurer or Policyholder Control of the Defense and the Duty to Fund Settlements*, 2 Nev L J 1, 1 (2002) (noting that "[w]hen the duty to defend is triggered, the insurer enjoys, and is burdened with, the contractual duty to assume control of the defense") (citation omitted); Steinitz, 95 Minn L Rev at 1323–24 (cited in note 8). However, this Comment assumes the defendant retains at least some of the risk.

155 See, for example, *Teague v St. Paul Fire and Marine Insurance Co*, 10 S3d 806, 821–24 (La App 2009) (describing the standard of care owed by an attorney to a client in the context of settlement negotiations); 14 *Couch on Insurance* § 203:9 at 203-17 to -18 (West 3d ed 2005) (noting that some "jurisdictions have required the insured's consent where a settlement would obligate the insured financially"); *Ethical Guidelines for Settlement Negotiations* § 2.1 at *2 (cited in note 152) (noting that "[d]uring settlement negotiations and in concluding a settlement, a lawyer is the client's representative and fiduciary, and should act in the client's best interest and in furtherance of the client's lawful goals").

156 See Restatement (Second) of Contracts § 193 (1981) ("[A] promise that tends to induce [a violation of fiduciary duty] is unenforceable on grounds of public policy.").

To avoid entering the ethical gray area, success could be defined based on settlement offers, rather than the finalized settlement. This way, regardless of the defendant's decision to accept a settlement offer, the investment return would be triggered. The defendant would not be tempted to reject a good settlement offer, as defined by the agreement, in order to avoid paying the investment return. Alternatively, the financier's rate of return on the investment could be tied to settlement offers. This option provides more flexibility than defining success based on actual settlements, but still aligns the defendant's and financier's incentives. If the defendant rejects a good settlement offer in favor of taking its chances at trial—exposing the financier to additional risk—it would have to compensate the financier by paying a higher rate of return, for example, a five-times multiplier instead of a two-times multiplier.

The financing agreement should also include warranties from both the financier and the defendant.[157] Warranties can be especially helpful in protecting against the information asymmetries present in litigation financing.[158] However, if the financier is committing to provide capital solely in the event of a higher-than-expected judgment, rather than committing to pay for the expenses of litigation, it may wish to structure the veracity of the defendant's representations as conditions instead of warranties. This would allow the financier to easily withdraw from the contract should any of the information originally assumed as part of the evaluation turn out to be inaccurate.

D. Assessing Damages in the Event of Breach

The suggestions made in Parts III.A through C for conditions and warranties help determine when a breach of the agreement has occurred. This still leaves the problem of how best to assess damages in the event of breach. Given the underlying uncertainty of the investment asset—litigation—a court may find it difficult to assess the proper remedy in the event of breach. Expectation

157 Warranties in contracts serve as promises that give rise to damages for breach if they turn out not to be true. See *In re Carter*, 134 A2d at 914–15 (distinguishing between conditions and warranties).

158 For an example of representations and warranties that can be included in plaintiff-side litigation-financing agreements, see Steinitz and Field, 99 Iowa L Rev at 757–60 (cited in note 7). Similar warranties should be included in defense-side agreements.

damages, the most common remedy for breach of contract,[159] require certainty with respect to the expected result that full performance of the contract would have yielded. Litigation-financing contracts are founded on uncertainty, and thus the background facts make it extremely difficult to calculate appropriate damages after a breach occurs. In order to avoid litigating the expected value of the finance arrangement ex post, the parties will want to include a liquidated damages provision.[160]

The defendant will likely want to specify liquidated damages for the potential that the financier may breach by failing to deploy committed capital during the litigation. If the breach occurs at a critical moment in the litigation, the attorneys or an expert witness could withdraw, or else the defendant may have to change a critical piece of its strategy. Without specified damages, courts would ideally remedy this type of breach by requiring specific performance. If, however, the defendant was unable to enforce its contractual rights in time to obtain the financing for the litigation from an alternative source, specific performance will be insufficient.

In the absence of a liquidated damages provision, the defendant could instead seek consequential damages related to how the financier's breach impacted the ultimate litigation.[161] To prove consequential damages for a breach of contract in litigation, the defendant would need to establish "but for" proof similar to what the plaintiff must prove in legal malpractice claims.[162] The defendant would need to show that, had the financier provided the dedicated capital at the time promised, the result of the litigation would have been different. As the case law on legal malpractice shows, this can be a very difficult factual question to prove.[163] The

[159] See Restatement (Second) of Contracts § 344, comment a (1981) ("Ordinarily, when a court concludes that there has been a breach of contract, it enforces the broken promise by protecting the expectation that the injured party had when he made the contract.").

[160] A litigation-financing contract is an ideal contract for a liquidated damages provision because the actual damages are uncertain and the contract is highly individualized. The drafters should be careful to ensure that the liquidated damages provision reflects a reasonable attempt at estimating fair compensation in the event of breach; otherwise, courts will perceive it as a penalty for breach and decline to enforce the remedy. For a more detailed discussion of the status of liquidated damages provisions in contract law, see Michael Pressman, *The Two-Contract Approach to Liquidated Damages: A New Framework for Exploring the Penalty Clause Debate*, 7 Va L & Bus Rev 651, 656–66 (2013).

[161] Consequential damages are "[l]osses that do not flow directly and immediately from an injurious act but that result indirectly from the act." *Black's Law Dictionary* at 472 (cited in note 9).

[162] *Viner v Sweet*, 70 P3d 1046, 1048 (Cal 2003) (defining the "but for" test as requiring "that the harm or loss would not have occurred without the attorney's malpractice").

[163] See *Price Waicukauski & Riley, LLC v Murray*, 47 F Supp 3d 810, 819 (SD Ind 2014).

defendant would likely have to prove that: (a) it had to make a change in its litigation strategy as a result of the financier's default; (b) the change led to a resolution of the case that cost the defendant more than the expected settlement or judgment value the parties had agreed upon; and (c) the litigation was otherwise on track to meet the expected valuation prior to the financier's default.[164] A liquidated damages provision—which provides that the defendant would receive a premium beyond the committed-but-not-deployed capital in the event that the financier's breach forced the defendant to alter its litigation strategy—would alleviate the need for such a fact-intensive effort.

On the other side, there are multiple ways that the defendant could breach the contract: by failing to provide material information; by failing to conduct the litigation in a manner agreed on by the parties (for example, declining to accept a settlement that meets the definition of success); or by failing to provide the investment return. Some breaches may prompt the financier to withdraw from the contract. The contract must clearly specify which provisions remain in force, even in the event of breach, and which are subject to cancellation.

For other types of defendant breach, the financing agreement should specify liquidated damages. For example, to avoid having to litigate materiality following a breach involving the failure to disclose information, the agreement should clarify what type of information is considered material. Experts propose defining material breach based on how the absence or change of information impacts the valuation of the case.[165] Because the financier has an

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[164] This is based on the extensive legal malpractice case law discussing what is required to establish causation. See, for example, *Barouh v Law Offices of Jason L. Abelove*, 17 NYS3d 114, 148 (NY App 2015) (finding that the plaintiff failed to establish causation because she did not establish "that but for Abelove's conduct, the plaintiff would not have sustained damages in defending against the . . . motion"); *Schrowang v Biscone*, 9 NYS3d 420, 422–23 (NY App 2015), quoting *Marchell v Littman*, 107 AD3d 1082, 1083 (NY App 2013) ("Where . . . the underlying claim is resolved by agreement, [causation] may be established by evidence that the 'settlement . . . was effectively compelled by the mistakes of counsel.'") (second ellipsis in original); *Price Waicukauski & Riley*, 47 F Supp 3d at 819, 823 (noting that, under Indiana law, the plaintiffs could establish causation by showing either that the outcome of the case would have been different or that the attorneys' malpractice resulted in unnecessarily higher legal fees); Restatement (Third) of the Law Governing Lawyers § 53, comment b (2000) (discussing the ways that a client may prove causation in legal malpractice).

[165] For an example of such a provision in a model plaintiff-side financing agreement, see Steinitz and Field, 99 Iowa L Rev at 768–69 (cited in note 7) (providing that any breach by the plaintiff is a material breach if it reduces the value of the litigation by more than 33 percent).

established method for evaluating the case, the financier would be able to calculate how specific information affects the valuation, regardless of how it ultimately affects the final outcome. This can be explicitly stated in the agreement so that there is no doubt how courts will compute damages in the event of such a breach.

The financier may want to include terms in the agreement addressing what happens if the defendant fails to pay the return on investment. This is critical if the investment return is tied to the defendant's postlitigation revenue or profits. Here, if the defendant breaches, the court may have to determine whether the defendant had a contractual obligation to continue operating the business.[166] The contract can alleviate some of the uncertainty regarding continued obligations by specifying which provisions will stay in force in the event of breach. The parties may wish to specifically include, for example, pricing and valuation provisions. This also ensures that any deployed capital will remain protected in the event of a late breach.

This Section reviews some of the critical aspects of the litigation-financing agreements but is by no means an exhaustive list. Further, the specific terms of the agreement will necessarily vary widely depending on the needs of the client and the circumstances of the litigation. But ultimately every agreement will need to ensure that the deal makes economic sense for both parties, provides proper incentives, and mitigates information asymmetries and moral hazard. A carefully drafted definition of success, clear performance obligations, the proper use of conditions and warranties, and clear damages provisions can help to achieve those aims.

CONCLUSION

Armed with the high-level framework for a defense-side litigation-financing agreement, potential clients should be well positioned to take advantage of this new risk-transfer mechanism. As this Comment has shown, there is significant potential for a market in defense-side litigation financing, and there are substantial benefits to be gained from this new industry. Defendants facing substantial litigation risk should consider whether defense-side financing makes sense for them as part of their risk

[166] See, for example, *Advent Oil & Operating, Inc v S & E Enterprises, LLC*, 48 S3d 70, 71–73 (Fla App 2010) (holding that the defendants had breached by failing to continue operations for a four-year period in order to earn sufficient profits to repay the investment of the plaintiff).

management strategy. Through careful consideration and drafting, the defendant and financier can develop a financing arrangement that is mutually beneficial and helps to minimize the costs of unmanaged litigation risks. Policymakers and those seeking to regulate the industry should be careful not to overlook the unique benefits presented by defense-side arrangements and should ensure that any regulatory framework that develops for litigation financing maximizes those benefits.