

FINANCIERS AS MONITORS IN AGGREGATE LITIGATION

BY ASSOCIATE PROFESSOR
ELIZABETH CHAMBLEE BURCH



The class action isn't quite dead, though efforts aimed at extinguishing it have metastasized over the past 15 years and culminated most recently in the Supreme Court's *Wal-Mart Stores, Inc. v. Dukes* opinion.

Without class certification, aggregate litigation offers all of the perils and few of the promises of a class action.

Granted, class actions posed problems too, but without the closure they generate and the judge ensuring a fair settlement, lawyers have dreamed up new means for achieving finality that evoke class-action nostalgia.

To name but a few, they have exploited the attorney-client relationship to coerce clients into accepting a settlement, threatened to withdraw from representing nonconsenting clients, paid off holdouts to fulfill defendants' demands for complete resolution, forged ongoing "sweetheart" business relationships with settling defendants and overcompensated weak but prevalent claims to attract more clients.

Editor's Note: This piece was excerpted from Associate Professor Elizabeth Chamblee Burch's article titled "Financiers as Monitors in Aggregate Litigation" in 87 New York University Law Review 1273 (2012).

The problem, in part, is that plaintiffs' attorneys are both financiers and agents, and those dual roles sometimes pull them in divergent directions.

Just as they did in class actions, lawyers front the costs of litigating massive nonclass cases.

But these cases are even more expensive than class actions; attorneys must spend time advertising and recruiting clients. Then they must track each case, hire paralegals to handle the added paperwork, establish specific causation, and spend time persuading each client to settle.

Add to that the cost of expert witnesses, investigation, document review and coordinating with other multidistrict litigation attorneys and the expenses could easily bankrupt a small firm.

So, when a defendant puts money on the table – even money with many strings attached, like withdrawing the settlement offer if too few plaintiffs accept it – it tempts plaintiffs' attorneys to strong arm their clients to settle so they can recoup and profit from their financial investment.

Because the plaintiff's and the lawyer's interests never overlap perfectly, the lawyer's monetary self-interest and duty of loyalty may be at odds with one another.

Yet, nonclass aggregation lacks a monitor to police these settlements the way a judge polices class actions.

Although some judges have likened large multidistrict litigations to class actions and tried to oversee them accordingly, the existence of a legal basis for policing a "voluntary" settlement between private parties is uncertain at best.

The clients themselves are unlikely to monitor their attorneys because the very aggregation that increases the economic viability of their claims fosters collective-action problems and makes meaningful information from their attorney difficult to attain.

When cases are interdependent, learning the progress of one's own case may yield little information about the overall litigation and vice versa.

Plus, individual plaintiffs tend to be unsophisticated about legal matters and trust their attorney's advice – that is, after all, why they hired her.

But the potential for a private monitor does exist in the unlikely guise of third-party financiers – hedge funds, private investors and venture capitalists.

Alternative litigation financing has gradually made its way from Australia and the United Kingdom into the United States, causing substantial controversy in the process.

Despite the controversy, allowing third parties to fund nonclass aggregation helps to manage principal-agent problems by freeing attorneys from their financial self-interest and encouraging them to act as more faithful agents.

It does so by (1) unbundling the attorney's competing roles as investor and adviser, (2) shifting financial risk to a third party who pays the attorneys on a billable-hour basis (plus, perhaps some small percentage of the recovery as a bonus) and (3) putting in place a sizeable stakeholder with the sophistication and incentive to monitor the agents.

If plaintiffs assign a financier a portion of the litigation's proceeds (as the contingent fee does now) in exchange for financing the lawsuit on a nonrecourse basis, the financier would become a super stakeholder.

Third-party financiers have already started funding aggregate litigation: Napoli Bern made headlines when it borrowed some \$35 million from Counsel Financial to fund the Ground Zero workers' personal-injury cases against the City of New York

and tried to pass \$6.1 million in interest costs onto the workers. Burford Capital funded thousands of Ecuadorian plaintiffs in their controversial personal-injury battle against Chevron. Likewise, in a toxic-tort case against BNSF Railway, attorney Jared Woodfill borrowed more than \$3.5 million from a hedge fund to help finance litigation on behalf of some 400 plaintiffs with skin and gastrointestinal cancers allegedly caused by chemicals used to make railroad ties.

These financing arrangements, however, do not follow this article's blueprint.

Lending money to plaintiffs' law firms on a *recourse* basis (where the firm must

repay the loan regardless of whether it wins or loses the lawsuit), as was the case for Napoli Bern and Jared Woodfill, may either intensify the pressure on plaintiffs to settle or present them with unexpected interest charges.

As this suggests, the way in which financiers bankroll aggregate litigation is critical; this new relationship raises a panoply of questions about maintenance, champerty, barratry, confidentiality, privileges, consent, decisionmaking authority and incentives.

A TAXONOMY OF THIRD-PARTY FINANCING

Presently, there are three main types of third-party financing – consumer legal funding, loans to plaintiffs' law firms and commercial dispute funding – each of which raise distinct legal and ethical concerns.

Third-party funding took root in the United States when companies started loaning money to cash-strapped plaintiffs who could not use their lawsuit as bank collateral but needed money for day-to-day expenses.

This so-called "*consumer legal funding*" is a nonrecourse loan where a litigant would not need to pay any more than what she receives from the lawsuit; there is no personal liability – if she loses the suit, the lender loses the money.

The way in which financiers bankroll aggregate litigation is critical; this new relationship raises a panoply of questions about maintenance, champerty, barratry, confidentiality, privileges, consent, decisionmaking authority and incentives.

Given the risk involved, however, interest rates can be quite high – between 36 and 150 percent per year – but the nonrecourse basis enables funders to avoid state usury laws.

Consumer legal funders making cash advances to plaintiffs traditionally run up against historical maintenance doctrines, which prohibit third parties from assisting a litigant in pursuing a lawsuit.

Over time, a second type of financing emerged: *loaning money to plaintiffs' law firms*, as opposed to cash-advance loans to plaintiffs themselves.

As of early 2010, only around nine companies provided loans to law firms; but as of late 2011, that number had grown to around 12.

When financiers lend money to law firms, they secure those debts not by a single case, but by all of the firm's assets, including future fee awards from other cases.

Occasionally, funders will lend lawyers money based on a trial verdict on appeal.

Unlike a nonrecourse loan, plaintiffs' firms must repay the money regardless of whether they win or lose a particular case. Such was the case in financing the Ground Zero workers' litigation; Napoli Bern would have to reimburse Counsel Financial regardless of the litigation's outcome.

Interest rates are significantly higher than what a bank might charge for a loan based on traditional assets – rates tend to be “north of 20 percent” – which makes the loans unattractive to well-financed firms.¹

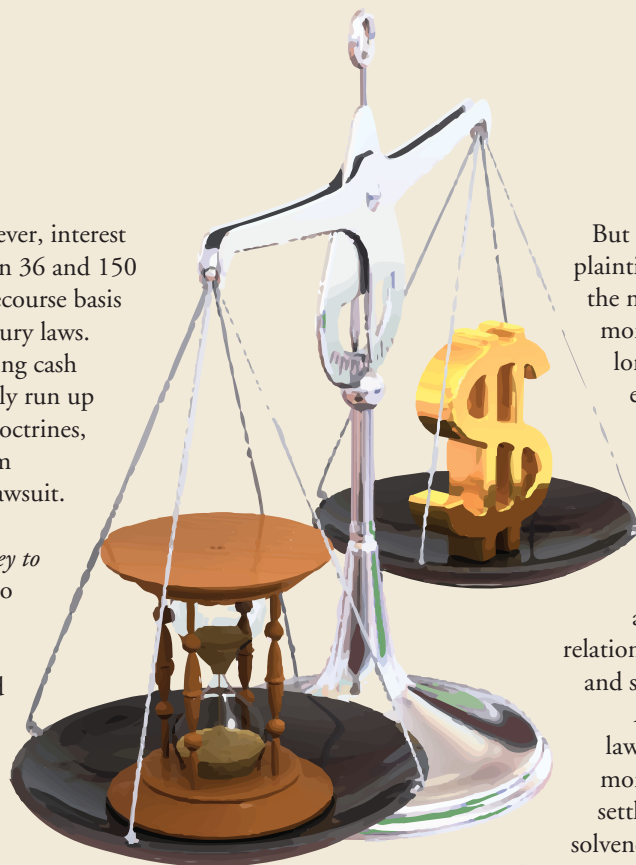
Still, lenders in this area can do what banks cannot; banks loan money based on traditional assets and collateral, not on potential winnings.

Finally, a burgeoning market of around seven lenders provide money directly to businesses to finance *commercial, business-versus-business disputes* in exchange for either a percentage of the plaintiff's eventual recovery or a multiple of the supplied capital.

Those percentages range from 35 to 67 percent of the lawsuit's recovery. This kind of lending may run into historical prohibitions on champerty, a form of maintenance where the lender receives an interest in the suit's outcome.

Two of the lenders in this area, Juridica Investments and Burford Capital, are publicly traded companies in the Alternative Investment Market on the London Stock Exchange and principally bankroll international arbitrations, as well as intellectual property, breach of contract and antitrust disputes.

Most commercial dispute lenders currently steer clear of funding aggregate litigation and leave those investments to funders who loan money to plaintiffs' law firms.



But this model of contracting with the plaintiffs for a portion of their proceeds has the most potential for creating a workable monitor. And for those investors seeking a longer-term investment with a potentially exponential payoff, funding aggregate litigation is a logical next step.

FINANCIERS AS INTERMEDIARIES IN AGGREGATE LITIGATION

Layering a financier's incentives atop an already complex principal-agent relationship can fundamentally alter litigation and settlement dynamics.

An investor who bankrolls a plaintiffs' law firm on a recourse basis and accrues monthly interest may care less about speedy settlements so long as the law firm's financial solvency is not in doubt.

If the loan is nonrecourse in the same scenario, then both the funder and the lawyer have powerful incentives to settle quickly, perhaps at their clients' expense.

But it is also possible to overlay the financier's incentives with the plaintiffs' incentives such that the financier, who has litigation expertise, sophistication, and substantial capital involved, will monitor the attorney and thwart at least some of the agency problems that tend to arise between contingent-fee attorneys and their clients.

Allowing third parties like commercial-claims lenders to invest in the dispute's outcome by contracting directly with plaintiffs generates two principally positive effects.

First, it disentangles – at least in part – the lawyer's role as investor from her role as a fiduciary and adviser. When litigating no longer threatens the law firm's solvency or ability to take on other matters, the attorney's loyalty no longer divides between self-preservation and the clients' best interest; she can afford to be a faithful representative.

Second, assigning a financier a percentage of the plaintiffs' winnings converts that financier into a sizeable stakeholder and incentivizes it to monitor the attorney's and the litigation's costs. Because aggregate litigation is capital intensive, the investor can act as an advocate for the plaintiff by keeping costs reasonable.

If the attorney wants to borrow money for travel and experts at a high interest rate, the investor has the incentive to prevent that transaction and finance those expenses at a much lower cost. And unlike geographically dispersed plaintiffs who face collective-action problems, a single, experienced financier can, for instance, require attorneys to keep their travel budgets reasonable.

But the need for monitoring and the degree to which agency is disentangled from risk depends chiefly on how the third-party financier compensates the lawyer for her services.

THIRD-PARTY COMPENSATION OPTIONS

Consider three options for compensating attorneys and third-party financiers: (1) financiers pay the attorneys an hourly rate on the billable-hour system, (2) attorneys receive a discounted contingent fee that accounts for the lack of financial risk, or (3) financiers pay attorneys on a billable-hour rate plus some small percentage of the proceeds as a bonus.

1. Paying plaintiffs' attorneys on a billable-hour system

Paying attorneys a billable-hour rate cleanly cleaves a lawyer's role as a risk-taking investor from her role as a client adviser and fiduciary, which means that she may be more loyal to her clients and have less incentive to arrange a quick settlement or collude with the defendant to settle on suboptimal terms.

Moreover, a litigation-savvy financier could negotiate a better hourly rate and thereby prevent astronomical fees while ensuring that the case is adequately funded.

Were a quick settlement offer generous enough to cover the financier's expenses and provide it with some return on the risk, the financier might push plaintiffs to accept the settlement, but here the billable-hour attorney's self-interest checks the financier's.

If anything, a billable-hour attorney would prefer to prolong the litigation, would advise plaintiffs to wait for a better deal, and would thus counterbalance the investor.

Billing hours also encourages lawyers to spend time counseling their clients about the alternative options available and explain the risks of litigating versus settling, which curtails the effect of contrast biases and uninformed risk preferences.

This arrangement may likewise negate some of the pressure attorneys feel to cram the settlement down on their clients and misallocate settlement funds to payoff holdouts.

When an attorney's payday isn't inherently tied to settling the lawsuit (as is the case when she works on a contingent fee), it alleviates her pressing financial concerns. So, though the attorney's ability to tender finality to the defendant is still vital for achieving a satisfactory settlement, she no longer feels the accompanying financial urgency and self-interest tugs that the current system engenders.

There are hazards involved with this billable-hour option, too. There is some risk that the billable-hour attorney would encourage her clients to accept a settlement that was not in their best interests if it furthers her prospects of doing repeat business with the financier. Thus, the collusion occurs not between plaintiffs' attorneys and defense attorneys, but between plaintiffs' attorneys and funders.

But perhaps the most worrisome aspect of this compensation scheme is whether it would still attract the best and brightest plaintiffs' attorneys.

Although defense attorneys on the billable-hour system make a very nice income, one rarely sees them with their own private

planes and yachts, trappings common for successful mass-tort plaintiffs' attorneys.

While third-party financing would increase competition among the plaintiffs' bar and may thus foster innovation and loyalty, the question remains whether plaintiffs would still receive advocacy of the same quality and creativity and whether trading some ingenuity for greater loyalty is worth the cost.

2. Financiers and plaintiffs' attorneys split a contingent fee

This second option allows attorneys and financiers to split the attorneys' standard contingent fee. The lawyers would receive a reduced award since they are shouldering less financial risk, but the payoff is still potentially momentous.

This option recognizes that contingent fees and their attendant rewards encourage entrepreneurial attorneys to accept monolith cases and thus promote ex post law enforcement.

It likewise accounts for the lingering reputational risks that attorneys must shoulder despite taking on less financial risk.

As noted, most claimants agree to a 33–40 percent contingent fee, though some judges have reduced that fee to between 25–28 percent.

Assuming the initial agreement's range provides ample incentive to accept the litigation's risks, the total percentage allocated to parties other than the plaintiffs should not exceed those parameters. Attorneys and financiers might divide the total by splitting the percentage in some agreed upon fashion.

The trouble is, if both funders and attorneys operated purely on a percentage-of-the-proceeds payment plan, their incentives would overlap with one another, but not necessarily with plaintiffs.

Like the contingent-fee attorney today, both would have some motivation to achieve a higher settlement since it means a greater profit, but the attendant risks of that fee arrangement would plague plaintiffs to an even greater degree.

Both financiers and attorneys may prefer to settle quickly (provided the offer exceeds costs and fees), collude with the defendant if the deal benefits them financially, pressure plaintiffs to accept an offer through questionable means and misallocate settlement funds if it is necessary for achieving the deal's required consensus.

So, while a third-party funder could ensure that litigation is not underfunded and might negotiate a reduced attorneys' fee, the savings would benefit the investor, not the plaintiffs.

... the question remains whether plaintiffs would still receive advocacy of the same quality and creativity and whether trading some ingenuity for greater loyalty is worth the cost.

Having a financier foot the bill actually encourages attorneys to spend time communicating with their clients.

3. Billable hours plus a small percentage of the proceeds

While awarding attorneys a pure percentage of the proceeds would attract creative, entrepreneurial attorneys, the better approach is for the funder to negotiate a billable-hour rate plus a small percentage of the proceeds as a successful litigation bonus.

Providing a bonus and having a sophisticated financier oversee the billable hours allays at least some of the traditional objections to having a billable-hour system.

These objections include that billable hours encourage lawyers to duplicate their efforts and not communicate effectively with their clients, fail to provide predictable client costs and penalize efficient and productive lawyers.

Having a financier foot the bill actually encourages attorneys to spend time communicating with their clients. And bonuses reward efficiency and productivity while helping to counteract any tendency to unduly prolong the litigation or duplicate effort.

Granted, there is still some risk that attorneys might cherry pick certain cases for continued litigation (and the billable hours that accompany them).

Yet, the attorney's reputation among the financiers might serve as a failsafe. If the attorney hopes to gain repeat business from financiers while maintaining her reputation as a faithful agent to her clients, then she may continue to litigate only where it best serves her client's interests.

By injecting a sophisticated financier into the lawsuit and making it the largest stakeholder, this arrangement improves the status quo.

First, financiers enable plaintiffs' law firms with less monetary capital to litigate high stakes, resource intensive cases, which increases competition within the private bar. Once a market for funding aggregate litigation emerges, it is also likely to spur competition among financiers, which could, in turn, mean that they would accept a lower percentage of the proceeds for stronger cases.

Second, this proposal incentivizes financiers to monitor the attorneys, while reducing the need for monitoring in the first place.

The demand for oversight swelled from bundling financial risk with the attorney's duty of loyalty to clients: self-interest in avoiding financial strain tempted attorneys to engage in self-dealing, overbearing – if not unethical – settlement practices.

But uncoupling these divergent interests permits the financier to negotiate a competitively priced fee and to monitor the monthly costs.

With the lawyer's financial wellbeing secured by the financier's nonrecourse investment in the litigation's proceeds, she can faithfully and loyally represent her clients' best interests as well as counterbalance any undue settlement pressure the financier exerts.

MAKING THIRD-PARTY FINANCING WORK

As one might imagine, shifting the status quo from contingent-fee arrangements to litigation-funding agreements necessitates reexamining historical bans on maintenance and champerty as well as contemplating how a financier may affect the attorney-client privilege, work-product doctrine and attorney confidentiality.

First, if financiers take a more active role in funding aggregate litigation, they need to be able to independently evaluate the claim's merits and communicate with both the plaintiffs and the attorneys without waiving plaintiffs' attorney-client privilege or losing objections based on the work-product doctrine.

Although some financiers rely principally on publicly filed pleadings and memoranda and thus do not need privileged information, it seems that a financier considering whether to invest millions of dollars into funding aggregate litigation would need more information.

Sharing privileged information requires plaintiffs' informed consent to satisfy attorneys' ethical duties of confidentiality, but it also entails considering the attorney-client privilege and the work-product doctrine.

Because lawyers generally waive the work-product doctrine only when they make disclosures that substantially increase the likelihood of putting documents in their adversary's hands, it raises fewer concerns than the attorney-client privilege.

One possibility for addressing the attorney-client privilege is to extend the common-interest doctrine to include financiers who invest in the lawsuit as well as those who considered investing. Covering the latter category of investors encourages price competition among financiers without jeopardizing plaintiffs' confidential information.

The common-interest doctrine evolved from situations where two clients retained the same attorney to pursue their common interest and has long been used by insurance companies, in joint defense strategies (such as by asbestos and tobacco defendants), and by plaintiffs involved in group litigation.

In these contexts, the doctrine extends to "two or more clients with a common interest in a litigated or nonlitigated matter" who are represented by the same or separate lawyers to encourage full and efficient case preparation.²

Although the third-party financier seems to fit neatly under this common-interest umbrella, there is one critical matter worth clarifying: the financier and the plaintiff cannot be considered joint clients of the plaintiff's attorney.

If that were the case, the lawyers would have duties of loyalty to the financier, not just her client. That would undermine the disaggregated incentive structure that promotes loyalty to plaintiffs.

Second, states should continue to lift the historical prohibition on champerty such that the enforceability of a financing agreement does not hinge on a particular state's laws or an ad-hoc balancing approach to conflict of laws, both of which provide further impetus for forum shopping.

One recent survey showed that 26 of 51 jurisdictions (including the District of Columbia) permit champerty to some degree so long as the financier does not promote clearly frivolous litigation, participate in "malice champerty" ("meritorious litigation employed for an improper end") or "intermeddling" (controlling trial strategy or settlement).

Further, as Anthony Sebok has argued in detail, the arguments against assignment and maintenance are "not currently persuasive from either a historical or jurisprudential perspective."³

And most studies about champerty predict that lifting this ban will be beneficial by increasing access to justice and improving the likelihood that settlements will reflect the claim's merit as opposed to economic pressures.

The trouble is that attorneys are likely the ones referring clients to a financier. And attorneys' preferred financiers may depend more on the hourly rate and percentage of the proceeds the financier will pay them than the clients' best interests.

This brings us back to the potential for collusion between the financier and attorney. Unlike clients, who are typically one-shot players, financiers and lawyers are both repeat players; their relationship is more enduring.

This potentially powerful bond between financiers and attorneys suggests that judges must play a mitigating role.

But two things must happen before they can do so.

First, they must know that an alternative-financing arrangement exists. Accordingly, in multidistrict litigation, there should be mandatory, in camera disclosure of financing agreements.

Currently, financing agreements contain confidentiality provisions and financiers regularly require plaintiffs to sign additional non-disclosure agreements.

Although these measures keep the defendant from exploiting this information, submitting the funding agreement to the judge in camera allows the judge not only to learn of its existence and ensure its terms are not unconscionable, but to recuse herself if she has a disqualifying relationship with the financier.

Moreover, should it become necessary, this enables the judge to report unethical behavior between attorneys and financiers to the relevant bar authorities.

Second, as Congress has done in similar areas of consumer concern, it, or perhaps the newly minted Bureau for Consumer

Financial Protection, should prohibit arbitration in consumer-financing agreements.

This would ensure some transparency in the funding process through enforcement challenges, allow consumers to vindicate their contractual rights in a convenient forum and, through judicial adjudication, outline the permissible bounds of litigation-funding agreements.

Potential judicial enforcement also deters collusive behavior between the financier and the plaintiffs' attorneys; when the two know that the agreement is not shrouded in arbitration's confidentiality and could land before a judge (and in publicly filed documents), they are far less likely to engage in clandestine behavior.

CONCLUSION

Alternative litigation financing, if properly engineered, could help alleviate the financial pressure on the attorney-client relationship and thereby encourage ethical behavior in litigating and settling aggregate litigation.

Presently, attorneys who specialize in large-scale litigation bear the crushing burden of funding it, a practice that prevents lawyers with less capital from entering the field and tempts those who do to prefer their own financial self-interest over their clients' best interests.

If financial risk is no longer an integral part of an attorney's relationship with her clients, it opens the door to several new possibilities.

First, financiers might bankroll talented attorneys who could not otherwise afford to initiate aggregate litigation.

Second, new entrants could intensify competition among the plaintiffs' bar that could encourage innovation and drive down fees.

Finally, given the increased costs and risks associated with multidistrict litigation as opposed to class actions, allowing financiers to enter the picture ensures that meritorious suits will not wither alongside the class action.

To be sure, adding an intermediary can introduce competing incentives and is thus not a cure-all for principal-agent problems.

Rather, third-party financiers offer one means for managing some of these problems in aggregate litigation.

END NOTES

1 Alison Frankel, *Helping Underfunded Plaintiffs Lawyers—At a Price*, LAW.COM (Feb. 13, 2006), <http://www.law.com/jsp/law/international/LawArticleFriendlyIntl.jsp?id=900005547685>.

2 Restatement (Third) of the Law Governing Lawyers § 75 (2000).

3 Anthony J. Sebok, *The Inauthentic Claim*, 64 Vand. L. Rev. 61, 133 (2011) (surveying state laws on champerty and maintenance).