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The Economics of Third-Party Financed Litigation

Keith N. Hylton[*]

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Abstract: This paper examines the law and economics of third-party financed litigation. I explore the conditions under which a system of third-party financiers and litigators can enhance social welfare, and the conditions under which it is likely to reduce social welfare.   Among the applications I consider are the sale of legal rights (such as contingent tort claims) to insurers, to patent trolls, and to financiers generally.

I. Introduction

Third-party financing of litigation is a practice in which a financier underwrites a lawsuit in exchange for a share of the final judgment. It is a business that appears to be growing. At least two investment funds exist that are dedicated to financing high-stakes commercial litigation.[1] There are numerous funding sources available for low-stakes litigation.[2]

This is an interesting state of affairs because the legal status of third-party funded litigation is unclear in the U.S. The common law prohibited third-party funding, under doctrines proscribing maintenance and champerty. Maintenance refers to the financial participation of a third party in a lawsuit. Champerty is the practice of funding a lawsuit in exchange for a share of the judgment. At present, the common law prohibitions have been modified or abolished in a majority of American states.[3] Still, even though the law on maintenance and champerty is now a patchwork quilt, there remain several American jurisdictions in which champertous agreements are either illegal or unenforceable.[4] Only a handful of states have abolished the doctrines entirely.[5]

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[1] Juridica Capital Management and Burford Capital Limited are the first litigation funders to raise money through IPOs (on the London Stock Exchange) and aim their investments largely at the U.S. market. Richard Loyd, *The New, New Thing*, AM. LAW., May 17, 2010, http://www.law.com/jsp/tal/ PubArticleTAL.jsp?id=1202457711273. Juridica and Burford focus on large commercial matters. Juridica invests exclusively in business-to-business related claims where the amount in dispute exceeds $25 million. *Juridica Investments Limited*, JURIDICA CAPITAL MANAGEMENT, http://www.juridica.co.uk/ investments.php (last visited June 6, 2011); *Investment Objectives & Policies*, BURFORD CAPITAL LIMITED, http://www.burfordcapital.com/objectivesandpolicies.html (last visited June 6, 2011).

[2] If one types the words "lawsuit loans" into an internet search engine, hundreds of sources for small-scale litigation funding will appear. "Lawsuit Loans" Search, BING, http://www.bing.com/search?q="lawsuit+ loans" (last visited June 6, 2011).

[3] As of this year, at least twenty-eight out of fifty-one American jurisdictions (including the District of Columbia) explicitly permit maintenance and champerty in some form. Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 98-99 & n.162, 107 & n.190 (2011).

[4] Sebok identifies 14 American jurisdictions that explicitly prohibit champerty (i.e. enforce champerty doctrine). *See id.* at 101-02 & n.171.

[5] Massachusetts, New Jersey, and South Carolina have abolished the doctrines entirely. *See* Saladini v. Righellis, 687 N.E.2d 1224, 1224 (Mass. 1997); Schomp v. Schenck, 40 N.J.L. 195, 203-04 (N.J. 1878); Osprey, Inc. v. Cabana Ltd. P'ship, 532 S.E.2d 269, 277 (S.C. 2000). Courts in several other states have declared the common-law prohibitions to be nonexistent, but nevertheless have applied statutory restrictions on champerty. *See, e.g.,* Strahan v. Haynes, 262 P. 995, 997 (Ariz. 1928) (declaring doctrines of champerty and maintenance not to be "in force" in Arizona); *cf. In re* Stewart, 589 P.2d 886, 888 (Ariz. 1979) (statute prohibits champertous agreements between attorneys and clients). *See also* Abbott Ford, Inc. v. Superior Court, 741 P.2d 124, 141 n.26 (Cal. 1987) ("California . . . has never adopted the common law doctrines of champerty and maintenance . . . ."); *cf.* Martin v. Freeman, 31 Cal. Rptr. 217, 219 (1963) (statute prohibits champerty by attorneys). *See also* Fasteau v. Engel, 240 P.2d 1173, 1174 (Colo. 1952) (doctrines "no longer exist in Colorado," yet statutes prohibit maintenance involving barratry and officious intermeddling). Finally, courts in Ohio have not yet applied what appears to be a statutory abolition of the doctrines. *See* OHIO REV. CODE ANN. § 1349.55 (West 2008); Stephen Gillers, *Waiting for Good Dough: Litigation Funding Comes to Law*, 43 AKRON L. REV. 677, 688-89 (2010).

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This paper examines the economics of third-party financed litigation.[6] I explore the conditions under which a system of third-party financiers and litigators can enhance social welfare, and the conditions under which it might reduce social welfare.

I start with a review of the economics of litigation. One fundamental proposition in this literature is that the private and social incentives to litigate diverge.[7] Because of this incentive divergence, parties may bring suit where litigation reduces welfare, and may not pursue their claims even where litigation is socially desirable. However, if transaction costs (i.e., bargaining costs) are low, the incentive divergence problem is unlikely to generate welfare-reducing litigation. The reason is that potential victims and injurers will enter into waiver agreements. Another fundamental proposition, countering the incentive divergence proposition, is that in a low transaction cost setting, parties will sign waiver agreements whenever litigation reduces social welfare.[8]

These fundamental propositions regarding the welfare effects of litigation are used to assess the social benefits and social costs of third-party funding and litigation. I examine the implications of third-party funding in the context of "unmatured" legal claims (i.e., legal rights), and for matured claims. Although markets in unmatured claims are not widespread at present, there are examples such as trade in intellectual property rights (e.g., patent trolls) and subrogation agreements by insurers.

Third-party funding enhances social welfare to the extent it can resolve the incentive divergence problem in the presence of high transaction costs between potential injurers and potential victims. There are two obvious scenarios in which this is beneficial. One is where litigation would be socially desirable but victims do not sue because the cost exceeds the expected award. Third-party funding permits victims to transfer their claims to more efficient litigators, who would then prosecute these claims. The other scenario is where victims bring suit even though litigation is not socially desirable – for example, in a setting in which a no-fault regime would be optimal. If transaction costs prevent waiver agreements from being formed between potential future litigants, the third-party funding mechanism (coupled with third-party control) could achieve the same outcome as waivers. In addition to these benefits, third-party funding can enhance welfare by

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[6] Previous articles on the economics of third-party funding of litigation include Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697 (2005); Robert Cooter, *Towards a Market in Unmatured Tort Claims*, 75 VA. L. REV. 383 (1989); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J. LEGAL STUD. 329 (1987); Paul H. Rubin, *Third Party Financing of Litigation* (Third Party Financing of Litigation Roundtable, Searle Ctr., Nw. Univ. Law Sch. Sept. 24-25, 2009), *available at* www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf; Daniel L. Chen & David S. Abrams, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes*, *available at* http://www.duke.edu/~dlc28/papers/MktJustice.pdf. There are many articles exploring economic aspects of third-party funded litigation. The Abramowicz, Chen-Abrams, Cooter, Rubin, and Shukaitis articles are distinguishable because they explore the economic issues in more depth than most. For a recent reexamination of Cooter's argument, see Stephen Marks, *The Market in Unmatured Tort Claims: Twenty Years Later* (Bos. Univ. Sch. of Law, Working Paper No. 11-14, 2011).
[7] Steven Shavell, *The Social versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982).
[8] Keith N. Hylton, *Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis*, 8 SUP. CT. ECON. REV. 209 (2000).

transferring viable claims to more efficient litigators, reducing the resources tied up in the litigation process.

These benefits provide a justification for third-party funding and suggest that a total ban would reduce society's welfare. However, there are costs associated with third-party funding and litigation. The nature and magnitude of the costs depend on the mechanism by which legal rights or claims are transferred to financiers and to litigators. The value of a particular right or claim may be the private information of the victim, which could be a source of inefficiency in a market in which claims are transferred to third parties. The victim may not know the value of his claim, or be aware of personal costs associated with its enforcement. The type of litigator who will be assigned to the claim may be known by the third-party financier but not known by the victim, another scenario that is a plausible source of market failure. If transaction costs prevent trades between third-party litigators and potential injurers, an expanded market in legal claims could reduce welfare by generating socially undesirable litigation. External costs associated with third-party control of claims could outweigh the benefits from third-party enforcement. Yet another potential source of inefficiency is generated by the fact that third-party enforcers gain as the likelihood of injury increases. Since enforcers would have a direct interest in seeing more injuries, they may have incentives to reduce the rate of enforcement or to generate new injuries.

I also examine a market in which contingent claims are auctioned to a financier who then assigns them to enforcers. The bids offered by the financier reflect the type of litigator (enforcer) to whom the financier will assign the claim. When the auction market is efficient, in the sense that it enhances society's wealth, there are still inefficient transfers of legal rights that could occur. If the auction market is inefficient – e.g., because sellers set the wrong prices for their rights – the problem of inefficient transfers of legal rights is even worse.

My goal is not to say whether third-party funding of litigation is ultimately good or bad for social welfare; that is an empirical question. What I have attempted to do is identify, within a consistent framework, the likely sources of welfare gains and losses in a third-party litigation funding system. Identification of the sources of gains and losses should have implications for empirical research and for regulation. Empirical research on the welfare consequences of third-party litigation funding can be improved by taking advantage of developed frameworks for analyzing potential benefits and costs. The other benefit from a theoretical assessment is its implications for the design of a regulatory system. Since third-party funding of litigation can generate welfare gains a total ban would be difficult to justify. However, since there are costs, an ideal regulatory system would harness the benefits of third-party funding while minimizing the costs. The framework developed here could inform any such effort.

Part II provides a brief background on the legal prohibitions of third-party funding and the theories that have supported those prohibitions. Part III examines the economics of litigation, focusing on the private and social incentives to litigate and to waive the right to litigate. In Part IV I extend the basic economic model of litigation to examine the

welfare consequences of third-party funded litigation. I use the model to identify the sources of social benefit as well as the sources of social cost of third-party funding of litigation.

The key analytical contribution of the model in Part IV is to move beyond the literature that focuses on third-party funding as a method of risk reallocation or of overcoming liquidity constraints.[9] Although I focus on a model in which actors are risk-neutral and legal rights are traded for a lump-sum fee, I also show that the model includes as a special case the scenario in which a third-party funds litigation under a contract that involves an upfront payment plus a damage-sharing agreement. Thus, although the framework below focuses outright purchase and sale of legal rights, its results apply with equal force to the standard third-party finance contract.

In Part V, I extend the model again to apply it to the exchange of realized or "matured" claims. In Part VI I review the implications for welfare effects of third-party funding and discuss regulatory issues.

II. Perspectives on the Prohibitions of Third-Party Funding and Litigation

Conventional third-party funding agreements would fall under the categories of maintenance and champerty, and any business devoted to such funding might be deemed guilty of barratry. Maintenance is simply providing financial or other support to a lawsuit. Champerty is a special type of maintenance in which the third party collects a portion of the judgment. Barratry is the practice of stirring up litigation, and has been described as "a continuing practice of maintenance or champerty".[10] It follows that maintenance, champerty, and barratry are closely related; as if maintenance were a single act polluting the litigation environment, champerty pollution for profit, and barratry a nuisance-like process of continuing offenses.

Of these practices, Blackstone had harsh words:

> Common barretry is the offence of frequently exciting and stirring up suits and quarrels . . . . The punishment for this offence … is by fine and imprisonment: but if the offender . . . belongs to the profession of law, a barretor . . . ought also to be disabled from practicing for the future.
> Maintenance is . . . an officious intermeddling in a suit that no way belongs to one, by maintaining and assisting either party with money or otherwise . . . . This is an offence against public justice, as it keeps alive strife and contention, and perverts the remedial process of the law into an engine of oppression.
> Champerty . . . is a species of maintenance . . . being a bargain with the a plaintiff or defendant . . . to divide the land or other matter sued for between them . . . whereupon the champertor is to carry on the party's

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[9] See Cooter, supra note 6; Shukaitis, supra note 6; Chen and Abrams, supra note 6; Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367 (2009).
[10] *In re* Primus, 436 U.S. 412, 424 n.15 (1978).

suit at his own expense . . . . These pests of civil society, that are
perpetually endeavoring to disturb the repose of their neighbours, and
officiously interfering in other men's quarrels . . . the Roman law . . .
punished by the forfeiture of a third part of their goods, and perpetual
infamy.[11]

But beyond Blackstone's harsh words, repeated in many court opinions, it is hard to find
a competent explanation of the reasons for prohibiting maintenance and champerty. Max
Radin argued that the prohibitions were enacted to put an end to the practice, adopted by
wealthy landowners in Medieval Europe, of funding property lawsuits against their
wealthy competitors for status brought by indigent plaintiffs.[12] Through funding these
lawsuits, in return for a share of the land, a landowner could augment his holdings and
status.[13]

Another explanation was offered by the plaintiff in *Key v. Vattier*,[14] who noted that the
rules prohibiting barratry, maintenance, and champerty were imposed after the Norman
Conquest and the resulting redistribution of land into parcels doled out to knights loyal to
the new government.[15] Statutes became necessary later as land expropriated by force or
assumed by the crown, due to forfeiture and escheat, was given to followers and
favorites. The plaintiff's theory, which was rejected by the court, is that the ancient
prohibitions on third-party funding resulted from the forceful taking of land and the
consequent need to prevent dispossessed victims from seeking redress through the courts.

Jeremy Bentham suggested that the prohibitions were designed to prevent bullying of
courts by feudal barons, which implies that they may have served to reduce corruption.[16]
Writing in 1787, Bentham argued that the rules were no longer necessary.

The different historical theories provide contrasting pictures of the prohibitions'
functions: the traditional view (Radin and Bentham) suggests that they were needed at
one time to put an end to a wasteful form of rent-seeking, while the alternative view
(plaintiff in *Key v. Vattier*) suggests that they were, from the start, instruments of

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[11] 4 WILLIAM BLACKSTONE, COMMENTARIES *134-135.

[12] Max Radin, *Maintenance by Champerty,* 24 CAL. L. REV. 48, 58-66 (1935).

[13] Id. Radin's frequently cited critique viewed it as an effort by feudal landlords to maintain their status,
and as part of a rearguard action against the development of capitalism.

[14] Key v. Vattier, 1 Ohio 132 (1823)

[15] *Id.* at 136-37.

[16] The Works of Jeremy Bentham (Defense of Usury), vol. 3, Bowring ed. 1843, at 19-20. The statutory
prohibitions, sometimes described as declaratory of the common law, began with early laws dating from
1275 to the early 1300s, see George Barker, Third Party Funding in Australia and Europe, conference paper
available at http://www.masonlec.org/wp-content/uploads/2011/07/Revised-Draft-Barker.pdf. Barker notes
that the most important statute (33 Ed. 1, 1305) was part of a suite of laws aimed to suppress corruption in
government. The statutes may have played an important role in the formative period of the common law
system. The relative advantage of English government in suppressing corruption of government offices
may explain the divergence between common law and civil law systems. See Edward L. Glaeser and
Andrei Shleifer, *Legal Origins*, 117 Quarterly J. Econ. 1193 (2002).

oppression.[17] That both theories are plausible indicates the difficulty of making a case for a total ban on third-party funding, or, on the other extreme, a *laissez-faire* approach toward the practice.

The preferable alternative to both extreme positions is a fine-tuned effort to distinguish the types of third-party funding that are likely to be harmful and the types that are likely to be socially beneficial. The common law had adopted this approach in many states,[18] and as a result the prohibitions have been narrowed over time.[19] Still, the courts have not even attempted to identify the benefits and costs of third-party funding within a general assessment of the welfare consequences of litigation.

It should be clear that champerty is closely related to the subject of assignment of potential legal claims, that is, assignment of choses in action. The common law in many states permits the assignment of rights to sue for debt or for property.[20] The key barrier to assignment is observed in the case of personal injury, where the law has traditionally prohibited assignment of a chose in action.[21] Given this, the debate over third-party funding should be understood to concern personal torts largely (such as accidental injury, assault, battery, defamation, false imprisonment).[22] Moreover, the general prohibition of assignment of personal torts has been narrowed, and in some cases repealed in effect, where states have limited or abolished the champerty rule.

III. Economics of Litigation and Waiver

I will provide a simple formal analysis of the economics of third-party litigation finance. The third-party finance system that I will examine initially is one involving the purchase of *unmatured* claims – that is, claims that have not materialized. Thus, a potential victim

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[17] One period in modern American history in which the prohibitions were enforced with an oppressive purpose is that of the civil rights litigation in the 1950s. Several southern states amended their barratry laws in order to obstruct civil rights plaintiffs, *see* Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 Minn. L. Rev. 1268, 1287 (2011).

[18] *See* Osprey, 532 S.E.2d at 274-77.

[19] *See id.* (describing development of law in South Carolina). *See also* Paul Bond, *Making Champerty Work: An Invitation to State Action*, 150 U. PA. L. REV. 1297, 1302-04 (2002). One question that has received little attention in the common law development is the difference between criminal penalties and unenforceability rules. Both rules have applied to varying degrees to champerty. However, one liberalizing approach, observed in recent English law, is to abolish the criminal penalties but leave champertous contracts unenforceable. *See* Andrea Pinna, *Financing Civil Litigation: The Case for the Assignment and Securitization of Liability Claims*, *in* NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE 109, 113-14 (Mark Tuil & Louis Visscher eds., 2010).

[20] *See, e.g.,* Bond, *supra* note 19, at 1299.

[21] *Id*.

[22] Indeed, the controversy over third-party funding of litigation focuses on a novel source of incremental funding that may be relatively unimportant in terms of the overall market for litigation finance. Lawsuits are already funded by lawyers who accept contingent fees, though one could view this as form of self-financing by plaintiffs. There is already a large industry in lending directly to personal injury plaintiffs and to law firms. See Steven Garber, RAND Inst. for Civil Justice, Alternative Litigation Funding in the United States (2010), 9-13 *available at* http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf (describing markets in lending to plaintiffs and to law firms).

would assign all or a subset of his potential tort claims to a third party. The specific arrangement I will consider is one in which claims are sold to a financier, who then assigns or sells the claims to litigators (or enforcers). The sale of an unmatured claim can be considered equivalent to the sale of a legal right.

However, before I discuss third-party finance of litigation, I will begin with an examination of the economics of litigation and of waiver agreements. The basic results on litigation and waiver will be used later in the paper to shed light on the economics of third-party funded litigation.

I start with a simple model of litigation, from Shavell.[23] There are two types of agents: potential victims and potential injurers. For simplicity, I will often refer to the potential victim as "the victim," and the potential injurer as "the injurer". I will also use the term "plaintiff" to refer to the victim at times, and the term "defendant" to refer to the injurer.

An injurer can take care, which is costly, and thereby reduce the likelihood of injuring a victim. If the victim is injured he will bring a lawsuit, provided that his expected recovery exceeds the cost of brining suit. The basic variables in this analysis are as follows:

p = probability of injury if the injurer does not take care.

q = probability of injury if the injurer takes care, $0 < q < p$.

v = loss suffered by the victim if an accident occurs.

x = the cost of care for the injurer.

c_p = cost of litigation for the victim (plaintiff).

c_d = cost of litigation for the injurer (defendant).

In addition to these definitions, I assume that society's costs when injurers fail to take care are greater than society's costs when injurers take care.

$$pv > qv + x. \tag{1}$$

Thus, taking care is socially desirable. It follows that injurers will take care whenever suit is permitted because $pv + pc_d > qv + x + qc_d$. To simplify matters, I will assume that liability is strict and $v > c_p$, so that the victim will always sue when injured. If I assumed that the rule of negligence applied, all of the results of this model would remain with only minor modifications in the arguments.

The assumption that taking care is socially desirable is equivalent to assuming that enforcement of the law is socially desirable. Although I adopt this as a basic premise to

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[23] Shavell, *supra* note 7 at 334-35.

simplify the model's presentation, my analysis of the economics of litigation does not require this assumption.

I will treat all of the parties as risk neutral. This is a simplifying assumption. In many real-world settings the victim and the injurer will be risk averse.[24] I set the issue of risk aversion aside because I want to focus on the incentive consequences of litigation.

A. Private Versus Social Incentive to Litigate

Within this framework, Shavell establishes the following result.

Incentive Divergence Theorem: *Litigation is socially desirable when the deterrence benefit from litigation exceeds the expected cost of litigation. A lawsuit is privately desirable from the plaintiff's perspective when the expected award exceeds the expected cost of litigation to the plaintiff. Thus, the private incentive to litigate diverges from the social incentive.*

The proof of this claim follows from comparing society's costs when litigation is prohibited to its costs when litigation is permitted. When litigation is prohibited, injurers do not take care and the total cost borne by society, on a per capita basis, is pv. When suit is permitted, injurers take care, and society's costs are $qv + qc_d + qc_p + x$. Thus, suit is socially desirable if and only if $qv + qc_d + qc_p + x < pv$ or alternatively

$$(p - q)v - x > q(c_p + c_d) \qquad (2)$$

The left-hand side of this inequality is the social benefit from deterrence. It is equal to the injuries avoided by taking care, less the cost of taking care. The right hand side of the inequality is the expected cost of litigation. Thus, if the deterrence benefit exceeds the expected litigation cost, suit is desirable from society's perspective. The final step in the argument is to note that the private incentive to litigate is simply $v > c_p$, which implies that a plaintiff may have an incentive to file a suit that is not within society's interests. If the inequality in (2) is reversed, so that the deterrence benefit is less than the total cost of litigation, social welfare could be enhanced by prohibiting litigation – even where a plaintiff wishes to sue.

When a plaintiff decides to sue, he thinks only about his own judgment and his own cost of litigating. But the social interest is different, because it depends on whether the deterrence benefit from litigation, which is the difference between the losses avoided by taking care and the cost of taking care, is greater than the expected costs of litigation.

In this framework, conditions are uniform among agents. If litigation is socially desirable, then every lawsuit enhances society's wealth, and if litigation is not socially desirable, then every lawsuit reduces society's wealth. The uniformity assumption makes the analysis simple, but it is not a realistic description of litigation.

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[24] On liability and risk aversion, see Jennifer H. Arlen, *Liability for Physical Injury When Injurers as Well as Victims Suffer Losses*, 8 J.L. ECON. & ORG. 411, 412-15, 422-23 (1992).

If we introduce heterogeneity (for example, in the size of the victim's loss or in the cost of taking care) to this framework, we observe diminishing returns to litigation. The first lawsuit may be worthwhile in terms of the deterrence benefits it brings to society, but the one hundredth lawsuit may be undesirable. Because of diminishing deterrence returns, there is likely to be an optimal number of lawsuits. Moreover, if the total cost of litigation rises as more lawsuits are filed, say because of court congestion, then there may be an optimal number of lawsuits even if the uniformity assumptions regarding care and accident injuries are maintained. The result is depicted in Figure 1, which shows that there is a frequency of litigation (e.g., number of lawsuits per year) where the marginal social benefit from litigation (based on deterrence benefits) is just equal to its marginal social cost (based on litigation expenses).
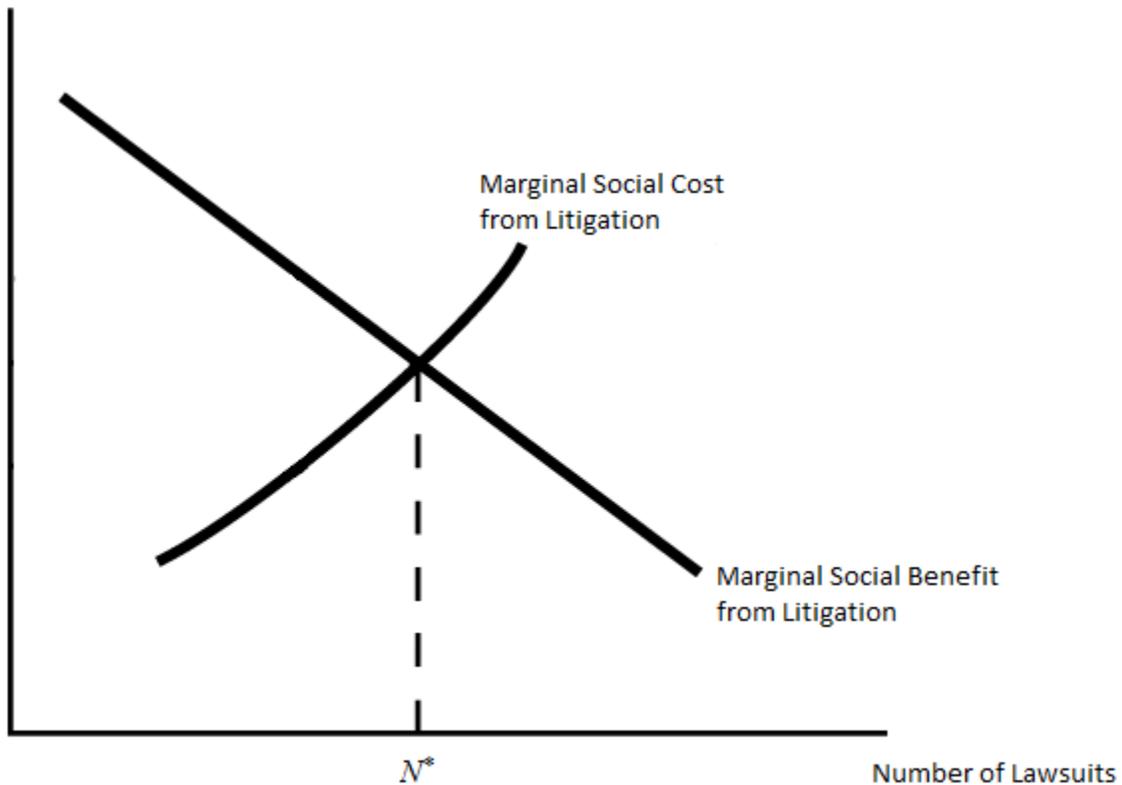
Figure 1: Optimal frequency of lawsuits

Any proponent of an expansion in litigation should consider whether the rate of litigation is below or above N^*, the optimal frequency of lawsuits. The prospect that an expansion of third-party funded litigation could bring forth more lawsuits does not tell us whether social welfare would be enhanced by such a change. Indeed, Rubin has argued that the litigation in America is probably beyond the optimal frequency, given the widespread

acceptance of contingency fee arrangements and of class action lawsuits.[25] This is an empirical question that I will not attempt to answer here. My focus is on identifying the reasons third-party finance may or may not enhance social welfare.

B. Low Transaction Costs

The Incentive Divergence Theorem discussed in Part A does not take into account the possibility of litigation waivers. A litigation waiver is an agreement between a potential victim and a potential injurer in which the victim agrees not to bring suit if he is injured by the injurer. If transaction costs (i.e., the costs of bargaining over and reaching an agreement) are low, potential victims and potential injurers may be able to enter into waiver agreements.

The failure of the Incentive Divergence Theorem to take such waivers into account may be defensible under certain conditions. There are settings in which potential victims and potential injurers cannot identify each other ex ante – i.e., before the accident. In those settings it would be impossible for litigation waiver agreements to be exchanged ex ante; transaction costs are too high. However, there are also settings where potential litigants have opportunities to exchange litigation waivers; consider, for example, places where buyers and sellers of services constantly interact, such as the workplace. In such low transaction cost settings, litigation waivers may be observed. Alternatively, consider a firm's decision to sell a patent to its potential infringer, or to someone who is unlikely to enforce the patent; such a sale would be equivalent to waiving the right to sue for patent infringement.

If transaction costs are sufficiently low that litigation waivers are easy to exchange, the Incentive Divergence Theorem will no longer hold. The reason is that litigation waivers will be traded whenever the social benefit from a lawsuit is less than its social cost.

To see this, return to the model described earlier. Suppose the victim can sell his right to sue to the injurer. What price will he set on that right?

If he sells the right to the injurer, the injurer will no longer take care. Thus, the victim can expect to suffer the harm pv after selling the right. However, selling the right permits him to forgo the expense of suing, which is worth qc_p. He also forgoes the compensation he would receive for any injuries that occurred when he possessed the right to sue, but that compensation merely offsets the injuries suffered by accidents. This implies that the minimum price asked by the victim to waive his right to sue is

$$pv - qc_p. \tag{3}$$

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[25] Rubin, *supra* note 6, at 8-9. One important factor weighing in favor of Rubin's argument is that class actions and third-party enforcement cases will often involve claims that would be unprofitable for the victim to assert. In the American litigation environment, those claims are brought forward today under the class action device. Introducing third-party funding and enforcement would not be necessary to bring such claims into court. Indeed, lawyers might prefer to use the class action device rather than purchase claims in order to enforce vicariously.

What is the maximum offer price that the injurer will pay for the waiver? By purchasing the waiver, the injurer avoids the cost of taking care, in addition to the cost of litigation and compensation. It follows that the maximum price the injurer will offer for a litigation waiver is

$$x + qv + qc_d . \tag{4}$$

The injurer and victim will therefore sign a litigation waiver agreement when and only when $pv - qc_p < x + qv + qc_d$, which is equivalent to $(p - q)v - x < qc_d + qc_p$, the same condition under which litigation is socially undesirable (2).[26] The efficiency gain from waiving litigation is $q(c_d + c_p) + x - (p - q)v > 0$. This proves the following proposition:[27]

Litigation Waiver Theorem: *Litigation waivers will be exchanged when and only when the deterrence benefit from litigation is less than the expected total cost of litigation. Thus, if transaction costs are low, socially undesirable litigation will not be observed.*

The Litigation Waiver Theorem has implications for arbitration agreements as well as waiver agreements. In some circumstances an arbitration agreement may serve the same purpose, or have the same effect, as a waiver agreement. Suppose, for example, that the victim agrees to resolve all disputes with the injurer in an arbitration forum that is obviously biased in favor of the injurer. In this case the arbitration agreement operates in effect as a waiver. Waiver and arbitration agreements can enhance society's wealth by reducing the frequency of wealth-reducing litigation. Moreover, the Litigation Waiver Theorem implies that such agreements are likely to be observed in those settings in which litigation reduces society's welfare.[28]

There are issues of information and disclosure that could stand in the way of the efficiency implications of the Litigation Waiver Theorem. For example, a potential

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[26] Recall that I have assumed that a strict liability rule applies, in order to simplify the analysis. If the negligence rule applies, the analysis changes a bit, but the conclusion remains the same. Under negligence, if the potential victim agrees to a waiver, he knows that the potential injurer will not take care, so the expected cost to the potential victim is pv. If the victim did not agree to a waiver, then his expected cost is equal to $qv + qc_p$ – this reflects the assumption that the victim would sue the injurer and lose, because the injurer, having taken care, would not be found negligent. Under these assumptions, the injurer would be willing to pay a maximum of $x + qc_d$ for a waiver. Waivers will therefore be exchanged when the potential legal claim is inefficient. If I assume, instead, that the victim observes the injurer's care level, and decides not to sue under negligence, then there would be no litigation costs to consider in this analysis.

[27] Hylton, *supra* note 8, at 221.

[28] I have not considered the case of dormant legal rights – that is, the case where $v < c_p$. When litigation would be unprofitable, the victim will not sue. Given this, the injurer would not have an incentive to take care. In the zero transaction cost setting, the victim would be willing to pay $(p - q)v$ for the injurer to take care. The injurer loses only x by taking care. Thus, whenever $(p - q)v > x$, a contract will be arranged in which the potential victim purchases care from the potential injurer. Indeed, if transaction costs are zero, the victim and injurer will contract for optimal care and litigation will not be necessary in any event. I am assuming in this framework that transaction costs can be sufficiently low for a waiver agreement to be formed, and at the same time too high for the parties to contract directly over the level of care.

victim might sign a waiver agreement without realizing its scope. Alternatively, a potential victim might sign an arbitration agreement without realizing that it is effectively a waiver agreement. These features could lead to inefficient waivers. However, these are general issues of contract acceptance. They do not, without more, present a justification for a ban on waiver or arbitration agreements. However, they do justify an effort on the part of courts to distinguish genuine agreements from agreements based on fraudulent representations.

C. Example

The framework described so far can be summarized with an example that illustrates its applicability as well as some of its limits. Suppose a ski resort has a choice whether to adopt additional precautions to reduce the risk of injury to skiers, or to offer them an option to waive tort liability in exchange for a reduction in the price of a season ticket. The precautions will cost the resort $40 per skier in a season.[29] If the ski resort takes no steps to enhance safety, the likelihood of an injury during the season to the typical skier is ¾. If the resort adopts precautions, the likelihood of an injury is ¼. The expected harm from an injury is $100. Suppose, in addition, that the cost of litigation (taking settlement rates into account) is $60 for the skier (victim) and for the ski resort (injurer). If a skier is injured, he would have an incentive to sue the resort, because he would net $40 from the lawsuit. What is the minimum amount by which the season ticket would have to be discounted to get the skier to accept a tort litigation waiver? How much would the ski resort be willing to discount the season ticket price in exchange for a waiver?

Litigation would be inefficient in this example, because the deterrence benefit is less than the expected total cost of litigation. On the other hand, the threat of litigation would, in the absence of any waivers, induce the ski resort to pay for additional precautions.

The skier would be willing to waive his potential tort claims against the resort if the resort discounted the entrance price by $(¾)(\$100) – (¼)(\$60) = \$60$. The resort would be willing to discount the season ticket price by the amount it saves from avoiding tort suits, which includes the savings from not paying for additional precautions. The maximum amount that the resort would be willing to discount the ticket price by is equal to the sum of the per-skier season precaution cost ($40) and the cost of a tort suit $((¼)(\$100 + \$60))$; thus, the maximum discount is $80. Since the resort gains $80 from the waiver, and the skier loses $60 from the waiver, there is room for a welfare-enhancing litigation waiver provision in the season ticket contract. In view of the savings from the inclusion of a waiver provision, competition would cause ski resorts to include such a provision as the default.

Because the cost of transacting is low in this example, the waiver agreement enables the parties to avoid inefficient litigation. However, some cases will raise questions whether the injury is the type that should be understood to have been covered by the waiver

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[29] To avoid issues generated by the public-good nature of care, I will assume in this example that the precautions can be limited to an individual skier. If precaution is a public good, in the sense that providing it for one means that it is effectively provided for all, then it is possible to have socially inefficient waivers.

clause. Some injured skiers will argue that they never understood or even noticed the waiver clause. In light of these issues, some courts may refuse to enforce the waiver agreement.[30]

IV. Third-Party Finance of Litigation

The type of third-party finance I will examine initially is the purchase of unmatured legal claims. An example would be a third party who purchases a potential victim's right to sue before any claim arises. Under such an agreement, the third party would have the right to sue on behalf of the real victim and collect all or some share of the damages awarded to the victim. The third party would also have the right to waive the victim's future legal claims.[31]

To offer a concrete example, suppose the third party enforcer is an insurance company, as Cooter proposes.[32] Under a system in which unmatured claims are transferable, the insurance company could purchase the potential claims and then prosecute them when an injury occurs (as insurance companies do already in subrogation actions), or waive them immediately in exchange for a payment from the potential injurer (or the potential injurer's liability insurer). In a setting in which lawsuits are extremely costly and have a negligible deterrence effect, numerous waivers would be observed.

Since the third-party enforcer will acquire the contingent legal claim of a victim, the contract between the victim and the third party will typically specify some combination of upfront payment for the legal claim and perhaps some portion of the damage award that will be shared between the enforcer and victim. The upfront payment need not be positive; the contract could involve the victim paying the enforcer to take control of his future claims. The size of the upfront payment will depend on the litigation expenses that will be borne by the enforcer and the share of damages passed on to the victim.

There are four parties in this analysis: the potential victim, the potential injurer, the claim purchaser (or financier), and the claim litigator or enforcer. I have separated the financier from the enforcer to isolate their potentially different functions in a third-party finance scheme. However, for the most part I will treat the third-party financier and enforcer as a single entity; references to one can be taken generally as references to the other. Where it is important to separate their different functions I will do so.

The first step in analyzing third-party litigation finance is to use the analysis of waiver agreements to discover its implications for third-party agreements. At first, the two types of agreement may seem to be entirely different. A waiver involves discarding legal claims in exchange for compensation from the potential defendant. Third-party financing

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[30] See, e.g., Dalury v. S-K-I Ltd., 670 A.2d 795 (Vt. 1995).
[31] One could imagine an alternative system in which third parties gain ownership of potential claims, but without control. In such a system, third-party funding would be just a system of risk reallocation. A securitization market in which financiers were unable to exercise control over the allocation of rights of action would serve this function. The benefits of risk reallocation as a justification for third-party funding have been thoroughly explored in the literature, though without formalization.
[32] Cooter, supra note 6, at 385.

of litigation, in the context of unmatured claims, involves selling legal claims to be enforced at the discretion of a third party.

A closer look, however, reveals the similarity between waiver and third-party funded litigation. A waiver involves a sale of a legal right to the potential injurer. A third-party finance agreement covering an unmatured claim involves the sale of a legal right to a third party. The third-party purchaser could be the alter ego of the potential injurer, in which case a litigation finance agreement operates effectively as a waiver. Alternatively, the third-party purchaser could act with the same interest and zeal as the victim himself. These two cases – sale to the alter ego of the injurer and sale to the alter ego of the victim – represent two endpoints on the spectrum of outcomes that could be observed in a third-party litigation finance system.

A. Asking Prices for Legal Rights

Consider the incentives of a potential victim to sell his unmatured claim to a third party. If the potential victim sells to the alter ego of the potential injurer, the victim will demand the same price that he would ask of the injurer, that is, $pv - qc_p$. The reason is that the victim knows that if he sells his claim to the alter ego of the potential injurer, the injurer will no longer take care, so the victim will suffer the same costs as if he had relinquished his potential legal claims to the injurer.

If the potential victim sells his claims to someone who enforces with the same zeal as the victim would – that is, to the victim's own alter ego – the result would be that the potential injurer would take care, and there would be no increase in the risk of harm to the victim. The key gain to the victim would be avoiding future litigation costs – because those costs would be borne by his alter ego enforcer. Given this, there is room for the alter ego to profit from such an exchange if the alter ego's litigation expenses are lower than the victim's.

This description of the victim's price-setting incentive is arguably incomplete because it does not take into account the damage-sharing arrangement that might be demanded by the third-party financier. The third-party financier may offer a contract in which he takes part of the damage award in exchange for a smaller upfront transfer.[33] However, I will

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[33] One important feature of this arrangement is that the risk preferences of the victim and of the financier will determine the optimal levels of the upfront payment and the division of the damage award. If the victim is the more risk-averse party, the contract will generate a relatively larger upfront payment and relatively small amount of damages. Although my focus in the text is on the incentive effects of third-party funding, it is important to note that the financing arrangement alone can provide efficiency gains to society. Traditional litigation markets involve standardized award-splitting arrangements under contingency fee contracts. The third-party financing system permits the financier to structure a contract that allocates risk optimally as between the parties. Shukaitis, *supra* note 6, at 339-41, notes that risk can be allocated in a superior manner through the sale of tort claims. *See also* Cooter, *supra* note 6, at 385, 387. Since most victims are likely to be risk-averse in comparison to the financier, most contracts should specify a relatively large upfront payment and a correspondingly small amount of damages shared. For a proposal for third-party financing limited to the sharing of the risk associated with matured legal claims, see Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI-KENT L. REV. 625 (1995).

assume that the contracts involve only an upfront payment for the victim's legal right, with the financier taking the entire damage payment.

The model could be made more complicated by allowing for a damage-sharing arrangement, which I do in the Appendix, but the additional complications do not change the fundamental results of this model. Incentives to trade legal rights, in this model, are unaffected by the financing arrangement – i.e., whether it is an upfront payment or the combination of an upfront payment plus damage sharing. For this reason it is appropriate in this model to treat the third-party finance contract (which typically involves a combination of an upfront payment plus damage sharing) as a special case of a contract that trades a legal right.

The most obvious real-world example of an alter ego enforcer is the insurance company. If we view the insurance company as the victim's alter ego in litigation, then one can understand why potential victims would purchase insurance even if they are not risk-averse. Consider, for example, a health insurance firm. When the victim is injured, the insurance firm pays off the victim's medical expenses, and then brings a subrogation action against the injurer. In the subrogation action, the health insurance firm serves as the third-party enforcer for the victim.[34] The insurance firm combines the services of insurance and litigation. Another real-world alter ego enforcer is the patent troll. Patent owners transfer their rights to trolls because trolls are more efficient enforcers.

These two extreme cases (injurer alter ego and victim alter ego) suggest there is a way to formally analyze the incentives to sell to a third party. Assume the victim can sell his legal claim to either the alter ego of the injurer or to his own alter ego. Let δ represent the probability that the victim sells to the alter ego of the injurer, and $1 - \delta$ the probability that the victim sells to his own alter ego.

With these terms in mind, the price a victim would demand in order to sell his legal right (or claim) to a third party is

$$\text{Asking price} = \delta pv + (1 - \delta)qv - qc_p \tag{5}$$

Consider first the case where the legal right is offered to the alter ego of the injurer. In the *injurer-alter-ego* case ($\delta = 1$), the *asking price* is

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[34] The analogy is not perfect. The insurer can sue only for the medical expenses it has incurred, not for the total injury to the victim, which may be greater than the medical expenses. Substantial efficiency gains in litigation, as well as enhancements in deterrence, could be secured through permitting medical insurers to contract with their customers to bring subrogation actions for the entire damage award. See Kenneth S. Reinker and David Rosenberg, *Unlimited Subrogation: Improving Medical Malpractice Liability by Allowing Insurers to Take Charge*, 36 J. LEGAL STUD. 261 (2007). Another difference between the "unlimited subrogation" system of Reinker and Rosenberg and a system of complete third-party control is that in the latter system a third-party who owns a set of claims could choose to waive them. Thus, a medical insurer could act as an intermediary that provides insurance to the customer and, if conditions indicate, waives their potential legal claims. The medical insurer could offer customers a choice to either have their claims litigated in a future subrogation action, or waived upfront. If waiver is the efficient option, the medical insurer would offer the lowest price for insurance to customers who choose to waive their potential tort claims.

$$pv - qc_p \qquad (6)$$

If the asking price is positive the victim will demand a payment from the injurer-alter-ego enforcer in order to sell off his potential claim. In the case of a negative asking price, the victim will be willing to pay the financier to take control of his future legal claim.

Now consider the other extreme, where the third-party financier-enforcer is the alter ego of the victim. In the *victim-alter-ego* case ($\delta = 0$), the *asking price* is

$$qv - qc_p \qquad (7)$$

The alter ego of the victim threatens the injurer with a lawsuit if the injurer causes an injury to the victim. Given this, the injurer takes care and the frequency of injury is consistent with caretaking rather than carelessness.

B. Offer Prices for Legal Rights: Incentives of Third-Party Financier-Litigators

How much will a third-party enforcer pay for a legal claim? As the foregoing discussion indicates, the offer price of the enforcer will depend on his incentives – specifically, whether the enforcer will act with the same zeal as the victim (sue for damages) or pursue the same goals as the injurer (drop the claim). If the third-party enforcer behaves in the victim's interest, the price he will offer for the victim's claim will depend largely on the degree to which he is a more efficient enforcer than is the victim. Since the victim gains in this case by unloading enforcement costs onto the third-party enforcer, the enforcer gains only if he is a more efficient enforcer.

The opposite extreme to consider is where the third-party enforcer pursues the same goals as the injurer. In this case, the third-party enforcer may be willing to pay a premium that reflects the precaution and litigation cost savings that will accrue to the injurer. However, this is a more complicated case to consider than the opposite extreme where the third-party enforcer is the alter ego of the victim.

I will start with the simpler case, where the enforcer is the alter ego of the victim and the victim knows this. Let c_e be the litigation cost of the third-party enforcer. The enforcer's offer price will be less than or equal to the profit the enforcer earns from holding the claim; thus, *the offer price when the enforcer is the alter ego of the victim* is

$$qv - qc_e \ .$$

Now consider the third-party enforcer who is the alter ego of the injurer. The third-party enforcer's acquisition of the legal right means that the claim will be dropped and the injurer will not have an incentive to take care. Since the third-party enforcer is the alter ego of the injurer, he benefits as much as the injurer by not having to pay damages. Thus, *the offer price set by the alter ego of the injurer* is

$$x + qv + qc_d \, .$$

C. A Spot Market in Legal Rights: Low Transaction Cost Case

To examine the properties of a market in contingent legal claims where third parties fund litigation by purchasing rights, I will start with the simplest type of market to examine, one in which victims know precisely the type of enforcer to whom they are selling their claim. Another way of putting this is to say that there are no transaction costs in the market for exchange of legal rights.

In terms of the model, the low transaction cost assumption implies that each victim knows whether the probability that he is facing an injurer-alter-ego is equal to zero or equal to one. In examining the sale of legal claims, I will continue to treat victims as homogeneous and to assume that the potential injuries they might suffer, as well as the relevant probabilities of the injury occurring, are observable by the enforcer.

1. Selling Legal Rights to Third Parties

First, consider the sale of a legal right to the alter ego of the victim. Since the victim is assumed to know that $\delta = 0$, and the profit earned by the third-party enforcer is $qv - qc_e$, an arrangement in which the third-party enforcer purchases the victim's unmatured claim will occur when

$$qv - qc_p \; < \; qv - qc_e \, ,$$

or, equivalently, when $c_e < c_p$. Thus, *when the third-party acts as the alter ego of the victim, victims will sell their legal claims to the third parties when and only when the third parties are more efficient litigators than is the victim. Such transfers will enhance social welfare by permitting legal rights to be enforced more cheaply*.

Third-party enforcers could be more efficient litigators for several reasons. First, they may have superior skill in detecting legal violations and in gathering evidence of violations. Second, they may be superior monitors and managers of attorneys, because they are repeat players in litigation. Third, third-party enforcement may offer superior alignment of interests between litigators and victims (i.e., lower agency costs). As owner of the victim's claim, the third-party enforcer has optimal incentives to invest in litigation. Risk aversion and liquidity constraints, two problems that constrain ordinary plaintiffs from pursuing claims, can be eliminated as factors by transferring ownership of potential claims.

The insurance company, as a third-party enforcer, employs the skills that it develops in the course of identifying and evaluating compensable claims in determining the cause and the severity of injury for litigation purposes.[35] The insurance company, as a repeat player

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[35] For example, a medical insurer is likely to be far better at detecting and procuring evidence of medical malpractice than is the typical plaintiff's attorney, see Reinker & Rosenberg, supra note 34, at 272. The medical insurer will also have an advantage in assessing the severity of loss in connection to malpractice.

in litigation, is also likely to be a better monitor and manager of plaintiffs' attorneys than the typical accident victim.[36] The patent troll has an advantage over the typical patent holder in monitoring for instances of possible infringement, responding with credible threats of litigation,[37] and managing attorneys. These advantages make it possible for a substantial market to exist in which victim-alter-egos acquire and enforce legal rights.

Next, consider the sale of legal rights to the alter ego of the injurer, where the victim knows that this is the case ($\delta = 1$). The third-party enforcer's acquisition of the legal right means that the claim will be dropped, and the injurer will not have an incentive to take care. Since the third-party enforcer is the alter ego of the injurer, he benefits as much as the injurer by not having to pay damages. The victim will sell to the third-party enforcer when

$$pv - qc_p < x + qv + qc_d$$

which is the condition under which the Litigation Waiver Theorem holds. *Thus, when the third party acts as the alter ego of the injurer, the victim will sell his potential claim to the third party when and only when litigation would be socially undesirable.*

Suppose the victim-alter-ego and the injurer-alter-ego both are in the market for legal rights at the same time. If the victim-alter-ego purchases the victim's claim, would he then turn around and sell it to the injurer-alter-ego? Only if the claim is inefficient, in the sense that the deterrence benefit from enforcement is less than total litigation cost. To see this, note that if the victim-alter-ego were to sell to the injurer-alter-ego, he would have to set the price at a level that reflects the fact that the injurer would not take care after the claim was transferred to the injurer-alter-ego. This implies that the victim-alter-ego would set an asking price of $pv - qc_e$. Now, a mutually beneficial exchange between the victim-alter-ego and the injurer-alter-ego occurs only if

$$pv - qc_e < x + qv + qc_d.$$

Thus, the victim-alter-ego enforcer would sell his potential claim to the injurer-alter-ego enforcer only if enforcement (litigation) would be inefficient.

Given both the victim-alter-ego and the injurer-alter-ego are in the market for legal claims, who would bid the highest? The assumption here is that the victim knows the type of enforcer who seeks to purchase his claim. Thus, the victim will set one price for the victim-alter-ego and another price for the injurer-alter-ego. Given that the victim sets different prices, he will be tempted to sell to the enforcer who offers the greatest surplus over his minimum asking price. The surplus offered by the victim-alter-ego enforcer is

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[36] Reinker & Rosenberg, supra note 34, at 273-274.

[37] The supply of a credible threat of litigation is probably the most important function of the patent troll, see, e.g., James F. McDonough, *The Myth of the Patent Troll: An Alternative View of the Function of Patent Dealers in an Idea Economy*, 56 Emory L. J. 189 (2006). In the absence of a credible threat of litigation, no one has an incentive to respect a patent. Patent holders – especially individual inventors – are unlikely to present credible threats to potential infringers.

the potential litigation-cost efficiency gain, $q(c_p - c_e)$. The surplus offered by the injurer-alter-ego enforcement is equal to the efficiency gain from waiving litigation, $q(c_d + c_p) + x - (p - q)v$. It follows that *the injurer-alter-ego will outbid the victim-alter-ego for ownership of the victim's legal right if (and only if) the efficiency gain from waiving litigation exceeds the efficiency gain from cheaper litigation.* In terms of the model, this means that

$$q(c_p - c_e) \;<\; q(c_d + c_p) + x - (p - q)v \,.$$

These results have immediate implications for dormant legal rights – that is, rights that are unlikely to be enforced. In the model examined in the previous parts I assumed victims would assert their legal claims, but this assumption may not be true. Some legal rights are dormant because the cost of litigation for the right exceeds the likely value of the judgment ($v < c_p$).[38] In the full information market examined here, those rights may be traded to third-party enforcers, who are more efficient litigators. When enforcement is inefficient, the third-party enforcers will sell their claims to potential injurers.[39]

The conditions under which dormant legal rights will be traded and enforced are as follows:

$$c_e \;<\; v < c_p$$

$$(p - q)v - x > q(c_d + c_e)$$

These conditions imply that the claim is unprofitable to the victim, but profitable to the third-party enforcer. In addition, suit by the third-party enforcer would be efficient.

This discussion implies that in the one-on-one spot market in which legal rights are sold to third-party enforcers, such rights will be sold either to real enforcers (alter egos of victims) or to the alter egos of the injurers. If enforcement of rights is socially desirable, the victim-alter-ego enforcers (e.g., insurance company, patent troll) will be the highest bidders. If enforcement of rights is inefficient, the injurer-alter-egos will be the highest bidders, as long as the efficiency gain from waiving is greater than that from cheaper litigation. When injurer-alter-ego enforcers acquire victim rights, they will extinguish them.

I have assumed that victims are all the same in this discussion. If victims differ, so that litigation would be efficient for some of them but inefficient for others, the implications of this analysis remain intact. Suppose, for example, half of the potential victims will suffer such small injuries that litigation would be inefficient. Victims in the other half

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[38] Suit may be unprofitable to the victim for several reasons. First, the monetary expenses of litigation may exceed the award. Second, the award may be so far delayed that the victim is led to discount the value of the award to a small amount. This is equivalent to increasing the cost of prosecuting a claim. Third, the victim may be risk averse, which effectively increases the cost of litigation. Shukaitis, supra note 6, relies on these factors to support his argument in favor of selling rights of action to third parties.

[39] On the divergence of private and social incentives to litigate, see Shavell, *supra* note 7.

suffer large injuries, so that litigation would be efficient. In the efficient spot market examined here, the low-injury victims would sell their claims to injurer-alter-ego enforcers and the high-injury victims would sell their claims to victim-alter-ego enforcers.

2. Examples

Medical Insurer Example: Return to the ski resort hypothetical (Part III.C). The skier has a medical insurer that charges an actuarially fair price for insurance. If the insurer's administrative cost amounts to $1 per ski season, the actuarially fair price for a season of insurance is $26, assuming all of the potential injury losses are medical expenses. Suppose the cost of litigation for the insurer is $20, only a third of the cost of litigation for the skier ($60). How much will the medical insurer discount the price of insurance if it subrogates the skier's potential tort claim? How much will the medical insurer discount the price of insurance if it sells the potential claim to the ski resort?

By subrogating the skier's potential tort claim, the medical insurer gets a benefit of ($\frac{1}{4}$)($100 – $20) = $20. Thus, the medical insurer, if it chooses to subrogate, should be willing to discount the price of a season of insurance by as much as $20. A competitive market for medical insurance should drive the per-season price down to $6.

However, litigation is still inefficient in this scenario. The deterrence benefit from litigation is ($\frac{3}{4}$ – $\frac{1}{4}$)($100) – $40 = $10. The expected total cost of litigation, under the subrogation agreement, is ($\frac{1}{4}$)($60 + $20) = $20. Since the expected total cost exceeds the deterrence benefit, welfare can be enhanced by selling the skier's potential tort claim to the resort.

The resort is willing to purchase the skier's potential tort claim for $80. The medical insurer would sell the skier's potential claim for $20. If the medical insurer sells the tort claim to the resort for more than $50 it would be able to offer free medical insurance to the skier and still make a profit. Moreover, questions concerning the scope of the waiver are more likely to be addressed at the contracting stage in this scenario than in the case where the skier enters into a waiver agreement directly with the ski resort.

Patent Troll Example: Suppose an inventor has a patent on an invention that potentially guarantees an income of $100 through use or licensing. A corporation happens to be developing a functionally equivalent invention. The corporation has a choice whether to invest $40 in searching prior patents to ensure that it does not infringe the inventor's patent. If the corporation does not search, the probability it will infringe the patent is $\frac{3}{4}$. If the corporation searches, the probability of infringement is $\frac{1}{4}$. Suppose the cost of litigation for both the inventor and the corporation is $120 each.

Although the inventor has a patent, he will not sue to enforce because the damage award is at most $100 and the cost of litigation is $120. This is a plausible and probably common scenario because part of the cost of litigation for the inventor is the opportunity cost of his time, which could be devoted to working in his laboratory rather than pursuing

infringers in court. Indeed, the social cost of the inventor's time may far exceed the out-of-pocket expenses of litigation.

If the inventor could credibly threaten to enforce, the corporation would conduct a search. The reason is that the cost to the corporation if it searches is $40 + (¼)($100 + 120) = $95, and the expected liability to the corporation if it does not search is (¾)($100 + $120) = $165. But in the absence of a credible threat to enforce, the corporation will not search among the previous patents. Unlike the ski resort example, the injurer in this case has no incentive to take care (i.e., search), even though care is socially desirable. Since the inventor cannot credibly threaten to sue, the value of the patent to him is equal to the potential income discounted by the probability of infringement, $25.

Suppose a patent troll approaches the inventor, and the troll's cost of litigation is $20. Since the troll's threat to litigate would be credible, the troll would be willing to pay as much as (¼)($100 – $20) = $20 for the inventor's potential infringement claim. In a sense, the troll would subrogate the owner's infringement claim. The inventor would be willing to sell the right to sue for infringement for any positive price, since it is worthless to him in the absence of a credible threat to litigate.

Once gaining ownership of the infringement suit right, the troll could hold on to it, or sell the potential claim to the potentially infringing corporation. The corporation would be willing to pay as much as $95 for the potential claim. The efficient outcome is the one in which the troll sells the claim to the corporation. This is a transaction that would be unavailable to the inventor because his threat to litigate is not credible.

An alternative contract between the inventor and the troll could involve the inventor selling the patent entirely to the troll, which is probably more common in reality. I examined a more limited contract in which the inventor sells only his potential infringement claim primarily because that is easily compared to the ski resort example considered earlier. However, in many real world settings, the litigation rights connected to the patent constitute the most valuable feature of the patent. Given this, my initial assumption that the troll purchases only the litigation rights from the inventor may accurately capture the essential features of transactions among inventors and trolls in many real world instances.

If the inventor sells the entire patent to the troll, he would demand a price of at least $25. The value of the patent to the troll is equal the associated income stream discounted by the probability of infringement (given credibility of enforcement) plus the value of the tort claim in the event of infringement: (¾)($100) + (¼)($100 – $20) = $95. Since the patent is more valuable in the hands of the troll than in the inventor's hands, the troll may choose to purchase the patent from the inventor rather than purchase the right to sue for infringement.

D. Transaction Costs

The efficient market examined in the previous part may not be observed if transaction costs make it difficult to arrange trades. I will assume here that third-party enforcers cannot sell rights directly to injurers. In other words, victims cannot exchange rights with injurer-alter-ego enforcers who would waive them on behalf of injurers.

If claims cannot be sold to injurer-alter-ego enforcers, then they will all end up in the hands of victim-alter-ego enforcers – for example, insurance companies. As a result, all claims will be enforced, even those whose enforcement is not socially desirable.[40] In addition, since claims will be transferred from victims to more efficient enforcers, some dormant rights will also be transferred and enforced.

This is a plausible and important type of market failure for several reasons. First, once a third-party enforcer acquires a victim's rights, he may have difficulty finding the potential injurer or negotiating a waiver agreement. For example, the medical insurer may not be able to identify the potential injurer (or the potential injurer's insurer) if the potential injury is a traffic accident. Alternatively, even if the third-party enforcer can identify the potential injurer, they may be unable to negotiate an efficient waiver agreement – say because of externalities among affected parties, or because of informational asymmetry.

Second, there may be informational gaps between the victim and the enforcer that result in divergent enforcement incentives. If the victim could negotiate directly with the injurer, he may choose to waive his right. But the enforcer may have incentives that differ from those of the victim, and would choose to enforce the right even when enforcement is inefficient.

When transaction costs prevent third-party enforcers from transferring potential claims to injurers, enforcement will be socially excessive. Dormant legal rights will be purchased and enforced by third-party enforcers, perhaps to the point of eliminating instances in which rights that could be efficiently enforced remained dormant. But rights that would be inefficient to enforce could not be extinguished by contract.

Patent Troll Example: Return to the example of Part IV.C.2. The value of the right to sue for infringement, for the inventor, is equal to zero, because the anticipated damage judgment would be less than the inventor's cost of litigation. Hence, the inventor would not sue, and any threat on his part to sue would not be credible. The value of the right to sue for infringement, for the patent troll, is $(¼)(\$100 – \$20) = \$20$. The potentially infringing corporation would purchase the right from the patent troll for any price less than $95. Since the potential infringer could easily buy out the troll's potential claim, litigation in this setting is inefficient. But if transaction costs prevent such a transfer from taking place the troll will sue for infringement, and litigation will occur.

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[40] The following conditions describe this scenario: $(p - q)v - x < q(c_p + c_d)$ (victim's potential claim inefficient), $qv - qc_e > 0$ (claim profitable to enforcer), $(p - q)v - x < q(c_d + c_e)$ (enforcer's suit inefficient).

Social welfare could be enhanced by a rule barring the inventor from selling his potential claim to the troll.[41] However, this conclusion relies in part on this framework's focus on the welfare consequences of litigation. A broader perspective would consider the innovation incentives provided by patents. If the inventor were prevented from contracting with the troll, the value of his patent would be $25. If the inventor were permitted to contract with the troll, the value of his patent would rise to as much as $95 (the sum of $75 and the value extracted from selling the infringement suit right to the troll). Even though litigation by the troll would be inefficient, the inventor's payoff from innovation would be greater. The innovation benefits from transacting with trolls could outweigh the welfare losses generated by their litigation.

E. Mistaken Beliefs

In addition to transaction costs, another source of inefficiency is mistaken beliefs. Victims might mistakenly believe that all claims would be allocated to real enforcers (rather than to the injurers) and therefore sell their claims too cheaply.[42]

Suppose victims assume that their claims will be allocated by a third-party financier to a real enforcer or to an injurer in accordance with their shares of the population of enforcers, but the claims are allocated only to injurers. Now exchange would occur when

$$\delta pv + (1 - \delta)qv - qc_p \ < \ x + qv + qc_d$$

which is equivalent to

$$\delta(p - q)v \ < \ x + qc_d + qc_p \ .$$

Thus, there may be instances in which victims who would not sell to injurers (because their asking prices exceed the offer prices of injurers) choose to do so because they mistakenly assume that the rights will be allocated to a real enforcer. In this setting, the market in legal rights could reduce social welfare because some rights are inefficiently extinguished.

F. Sham Enforcement and Agency Costs Generally

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[41] This example could explain the empirical findings of the Bessen, Ford and Meurer study of patent trolls, Bessen, James E., Meurer, Michael J. and Ford, Jennifer, The Private and Social Costs of Patent Trolls, Boston Univ. School of Law, Law and Economics Research Paper No. 11-45, available at http://ssrn.com/abstract=1930272.

[42] This strikes me to be a more plausible assumption about informational asymmetry than the assumption that victims know more about their claims than do third party financier-litigators. For this reason I have not emphasized the lemons problem discussed by Abramowicz, *supra* note 6. Most victims know very little about the value of their claims. Shukaitis, *supra* note 6, at 348, worries that unsophisticated victims would be taken advantage of by financiers. Indeed, one argument in favor of third-party financing is that it will enable victims to get information on the value of their claims from financiers. Rubin makes the related point that a contingency fee arrangement reveals information about the value of the claim. *See* Rubin, *supra* note 6, at 4-5.

I will continue to consider the case in which rights are transferred to third-party enforcers, and transaction costs prevent those enforcers from transferring rights to injurers. As a result, legal rights are transferred only to third-party enforcers. In this part I will assume that some third-party enforcers choose not to enforce rights promptly; they engage in sham enforcement.

The key feature of sham enforcement is that it is not done with sufficient vigor to induce injurers to take care. Injurers understand that the threat of liability from sham enforcers is not strong enough to give them an incentive to take care.

Why might sham enforcement be observed? Once the third-party enforcer owns the victim's legal rights, he may prefer to see more injuries rather than less, because his revenue increases as the rate of injury increases. It may be profitable for an enforcer to purchase claims, and then reduce his level of enforcement to the point that the injurer no longer has an incentive to take care.

To see the sham enforcement problem in terms of the model, let θ represent the frequency with which the sham enforcer brings an action against an injurer. The revenue for the sham enforcer is

$$p\theta(v - c_e) \ .$$

The revenue for the victim-alter-ego enforcer is $q(v - c_e)$. If the rate of enforcement is such that $p\theta > q$ then the enforcer might profit by purchasing victims' claims and enforcing less diligently.

Since the sham enforcer's threat of action will not induce the injurer to take care, the expected cost to the injurer if he does not take care must be less than the expected cost if he does take care:

$$p\theta(v + c_d) < x + q\theta(v + c_d)$$

This means that even with the threat of a lawsuit from the sham enforcer, the injurer will still choose not to take care, because it is cheaper in expectation to pay off the damage claims than to take care.

As long as care is socially desirable, sham enforcement reduces welfare relative to real enforcement. To see this, note that the under sham enforcement, society's costs are

$$pv + p\theta(c_d + c_e) \ .$$

Under real enforcement, society's costs are

$$x + qv + q(c_d + c_e) \ .$$

Real enforcement is preferable to sham enforcement if

$$(p - q)v - x > (q - p\theta)(c_d + c_e) \, ,$$

which is true as long as care is socially desirable. Thus, sham enforcement may be profitable to third-party enforcers while harmful to social welfare. This is valid even if real enforcement is inefficient relative to no enforcement. It should be clear that sham enforcement is inefficient relative to no enforcement, because sham enforcement involves spending resources on enforcement with nothing to show for it in terms of deterrence.[43]

Under what conditions would a patent troll have an incentive to engage in sham enforcement under the assumptions of the example of Part IV.C.2? If the troll sets his rate of enforcement at 35 percent, he will profit from sham enforcement. The value of the infringement suit right under real enforcement is (¼)($100 - $20) = $20. The value of the infringement suit right under sham enforcement is (¾)(.35)($100 - $20) = $21. Thus, the troll who intends to engage in sham enforcement will outbid the troll who intends to really enforce the inventor's rights. Moreover, if the troll sets his rate of enforcement at 35 percent, then if the corporation does not search its liability will be equal to (¾)(.35)($100 + $125) = $57.75; and if the corporation searches its cost will be $40 + (.35)(¼)($100 + $120) = $59.25. Hence, the corporation will not search among prior patents. Since sham troll enforcers would earn greater profits than real enforcers, sham enforcers would enter the market more frequently and displace real enforcers. The tendency to engage in sham enforcement is probably dampened by the practice of trolls owning the patent rather than merely the enforcement right.

Sham enforcement is just a special case of "agency costs" in enforcement. Third-party litigators may have interests that differ from those of victims, and those interests may lead the third parties to engage in conduct that reduces the welfare of victims or of society in general. Third-party enforcers may choose to trade off the deterrence or compensation interest in exchange for enhancing the value of damage claims, gaining favorable precedent, biasing courts by influencing judicial appointments and elections, or outright bribery of judges.

G. Externalities from Enforcement

Closely related to the problem of agency costs is that of external effects from enforcement. If enforcement of the victim's legal right by a third party imposes a cost on another party, then third-party enforcement could easily be socially undesirable. Suppose, for example, that the third-party enforcer gets a private benefit from enforcement because it allows him to impose costs on a rival. In this scenario, relatively high-cost enforcers could outbid low-cost enforcers and drive inefficient litigation through the courts.

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[43] An alternative version of sham enforcement is where the enforcer surreptitiously inflates damages, through fraud or through manipulation of the courts. In the first period, the injurer has no incentive to take care given the expected level of damages and the observed rate of enforcement. In an enforcement action in a later period, damages far exceed actual losses as a result of the enforcer's distortion of the court's processes.

Return to the patent example of IV.C.2. Suppose there are two corporations potentially affected by the inventor's work; an "entrant" corporation that is in the process of developing an infringing invention, and an "incumbent-monopolist" corporation that could protect its monopoly in a specific market by gaining control over the inventor's invention. The incumbent-monopolist would bid on the inventor's right for the purpose of obstructing entry by the entrant corporation. By gaining ownership of the inventor's invention, the incumbent-monopolist can threaten infringement litigation and demand excessive royalties in order to block entry into its market by the entrant corporation. Let the benefit the incumbent gets from obstructing entry be $200. Then, if the incumbent's litigation cost is $80, the incumbent would bid as much as $200 + (¼)($100 – $80) = $205 for the inventor's infringement suit right. The incumbent would prevail in a bidding war for the patent and would vigorously enforce it against the entrant corporation. Assuming that the $200 gain to the rival corporation largely reflects a transfer from consumers, the resulting litigation would reduce society's welfare.

H. Exchange in a Securitization Market

I examined (in Part C) a market in which victims, third-party financiers, and injurers were able to enter into fully-informed agreements for the exchange of legal rights. Under these conditions, an efficient market in legal rights would be observed. Such a market enhances society's wealth by enabling the enforcement of legal rights whose enforcement is socially desirable, and facilitating the waiver of rights whose enforcement is not socially desirable.

But a real market in legal rights may not be characterized by full information and low transaction costs. Suppose, for example, victims cannot distinguish injurer-alter-ego enforcers from victim-alter-ego enforcers. A victim comes to the market and offers to sell his legal right. What price would he set? Since the victim knows there is a risk that the purchaser could be the injurer-alter-ego, he will set a high price, and the only purchaser would be the injurer-alter-ego. No rational victim would set a low price, because his right would be snapped up right away by an injurer-alter-ego. In this scenario, the only rights exchanges that would be observed would be waivers. Moreover, if there is heterogeneity in the potential injuries of victims, then there could be a process of adverse selection in which the market collapses. Only the most severe injurer types and their representatives would enter the market to purchase legal rights. Only the victims with the highest asking prices would offer to sell their rights.

Given the difficulties that arise as soon as we step away from the full information market examined earlier, I will examine a simple securitization market here. In this part I consider a market in which claims are transferred and pooled into a security. In some respects this is an ideal setting in which to examine the potential gains from a market in legal claims. If legal barriers to third-party funding of litigation are removed, and commerce in legal claims continues to expand, the market could operate in a manner

equivalent to other established securitization markets, such as the mortgage-backed securities market.[44]

Consider the case in which legal claims are pooled into a security, auctioned off to a third-party financier, and then allocated by the financier in equal shares among enforcers. This is equivalent to the mandatory exchange market suggested by Abramowicz.[45] It is an ideal market to consider because it would not be distorted by adverse selection. The mandatory exchange market is equivalent to one in which matches between victims and enforcer types occur randomly.

Under the mandatory sale and random allocation system, offer prices will be determined by the average valuations among the two types of enforcer. The victim would not know whether the person purchasing his claim is his own alter ego, or an injurer. Similarly, third-party enforcers – consisting of victim-alter-egos and injurers – would acquire claims in proportion to their representation among enforcers.

Under the securitization arrangement, the maximum bid for a claim would be

$$\delta(x + qv + qc_d) + (1 - \delta)q(v - c_e). \tag{8}$$

The claims would be traded in this market as long as the maximum bid exceeds the offer price, which means that

$$\delta pv + (1 - \delta)qv - qc_p < \delta(x + qv + qc_d) + (1 - \delta)q(v - c_e)$$

This implies, in turn, that legal claims will be traded in the securitization market if

$$\delta[(p - q)v - x - q(c_d + c_p)] < (1 - \delta)q(c_p - c_e). \tag{9}$$

Thus, there are two reasons securitized claims will be exchanged: the existence of claims that would be inefficient to enforce and the existence of more efficient enforcers than the original victims. If litigation is welfare-reducing, the left-hand side of (9) would be negative, because the deterrence benefit would be less than the cost of litigation (see (2), though reversed). If third-party enforcers are especially efficient litigators, as assumed earlier, the right-hand side of (9) would be positive. Thus, the less efficient litigation is in general, and the more efficient third-party enforcers are relative to original victims, the greater the potential wealth created by the market in legal claims.

One implication of this analysis is that even if litigation is efficient (waivers would reduce social welfare), the exchange of legal claims could enhance wealth if the relative efficiency advantage of third-party enforcers is sufficiently great. The auction regime in which this would be observed is one in which the efficiency gain from third-party enforcement is so great that it swamps the welfare loss from inefficient waivers. In more practical terms, some victims would have their potential claims forfeited under conditions

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[44] See, e.g., Cooter, supra note 6, at 383.
[45] See Abramowicz, supra note 6, at 757.

that reduce society's welfare, while other victims would have their claims enforced at much lower cost by a real enforcer.

The other possible extreme case of an efficient market in claims is where litigation is inefficient and third-party enforcers are also relatively inefficient. However, the inefficiency of litigation is so great that the welfare gain from extinguishing some potential claims exceeds the loss from permitting more costly enforcement of non-extinguished claims.

Although I have offered this model as a hypothetical device to use to examine the likely results of third-party funding with securitization, one might ask whether there are any real markets in existence that this model might describe. One example is the purchase of patents, or of patent portfolios, or the securitization of royalties from patents or other types of intellectual property. A patent can be purchased by the likely infringer, which is equivalent to waiving the patent holder's right. If a third-party financier were to purchase a security based on a patent (or patents) he would have to consider the probability that the patent would be sold to the likely infringer in evaluating its price.

V. Exchange of Matured Claims

The analysis of the previous parts applies to the sale of matured legal claims, with some modifications.[46] In this setting, the transfer of rights is assumed to have no affect on the decision to take care, because it occurs after the injury happens. Of course, if the victim and injurer knew beforehand that the claim would be transferred, there might be an impact on the decision to take care, but I will assume that the parties cannot predict ex ante whether the claim will be transferred.

Let P_p be the plaintiff's prediction of the likelihood of a verdict in his favor, and P_d be the defendant's prediction of the same probability. Suppose the third-party enforcer has a different prediction of the likelihood of plaintiff victory, $\tilde{P}_p$. The third-party enforcer and the victim will arrange a mutually beneficial exchange of the matured claim if $P_p v - c_p < \tilde{P}_p v - c_e$, or equivalently

$$(P_p - \tilde{P}_p)v < c_p - c_e \qquad (10)$$

Thus, the two factors driving the purchase of matured claims are the third party enforcer's greater likely success in litigation, and the third party's cost advantage in litigation. Note that the third-party enforcer does not need to have both a cost advantage in litigation and a greater likelihood of success for a claim to be purchased – an advantage on one score can offset a disadvantage on the other.

The plaintiff would settle his claim if $P_p v - c_p < P_d v + c_d$, or equivalently $(P_p - P_d)v < c_p + c_d$, which is the well known Landes-Posner-Gould settlement condition. The third-party enforcer who purchases the plaintiff's claim would settle if

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[46] For an insightful discussion of markets in matured legal claims, see Peter Charles Choharis, *A Comprehensive Market Strategy for Tort Reform*, 12 Yale J. on Reg. 435 (1995).

$$(\tilde{P}_p - P_d)v < c_e + c_d \,, \tag{11}$$

assuming that the defendant's prediction of the likelihood of plaintiff success remains the same after the claim is transferred to the third-party enforcer. If the third-party enforcer is a more successful litigant ($\tilde{P}_p > P_p$), he will wish to pursue litigation when the victim would prefer to settle; in addition when the third-party enforcer is a more efficient enforcer, he will prefer to litigate when the victim would choose to settle the claim. It follows from (11) that either one or both of these conditions will be satisfied whenever the third party enforcer acquires the victim's claim in a mutually beneficial exchange, which implies the following proposition (see Appendix for proof).

Whenever a matured legal claim is sold to a third-party enforcer, the third party enforcer will be more likely to litigate (less likely to settle) than is the victim, provided that the transfer does not affect the defendant's prediction of the likelihood of plaintiff victory.

If the defendant's prediction of the likelihood of success changes as a result of the transfer, the conclusion that third-party litigation necessarily reduces the likelihood of settlement no longer holds. Suppose, after the claim is transferred, that the defendant's estimate of the likelihood of plaintiff success changes to $\tilde{P}_d$, where $\tilde{P}_d > P_d$. The reason this might occur is that the defendant may realize that the third-party funded litigator has a greater likelihood of success.[47] Under this assumption, settlement would occur if

$$(\tilde{P}_p - \tilde{P}_d)v < c_e + c_d \,. \tag{12}$$

In this case it is unclear whether settlement is less likely to occur under third-party litigation. The gap between expected judgments may shrink after the defendant adjusts his expectation, which would enhance the probability of settlement. *Thus, if the transfer of the matured claim alters the defendant's prediction of the likelihood of plaintiff victory, the probability of settlement may or may not increase under third-party enforcement.*

Some of the case law and commentary on third-party financing have focused on the possible existence of different litigation incentives for third-party enforcers and original victims, and have suggested that this possibility presents a reason for prohibiting the transfer of legal claims. In particular, one critique of third-party enforcement is that it will reduce the rate of settlement.[48] As this analysis shows, third-party funding of matured legal claims, along with third-party control over litigation, will reduce the rate of settlement if defendants' trial-outcome expectations are not affected by it; and otherwise the effect on settlement frequency is ambiguous.

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[47] The plaintiff may disclose the third-party funding arrangement in order to persuade the defendant that it has a valid claim, *see* Garber, *supra* note 22, at 15.

[48] *See* Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 220 (Ohio 2003); Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 U.C.L.A. L. REV. 571, 576, 595-99 (2010).

Given that third-party funding is likely to increase the frequency with which matured claims are litigated, the more important question is whether such a change would enhance social welfare. A reduction in the rate at which disputes settle, considered alone, tells us little about the welfare implications of third-party funding. The welfare implications depend on the extent to which the deterrence benefit from litigation exceeds the total cost of litigation. This is an empirical question, and its answer will depend on the specifics of the environment in which litigation may arise.

If the sale of a matured claim is foreseeable to victims and injurers, then the price-setting incentives examined in the previous parts of this paper would affect the terms of any contracts between potential victims and potential injurers. For example, suppose employees know that any matured tort claims against their employer would be assigned to injurer-alter-ego enforcers. The employees would demand compensation, in their employment contracts, for waiving their tort claims against the employer. The issues examined previously would apply fully to the case of matured claims.

VI. Discussion and Implications

In the preceding parts of this paper I have identified the benefits and costs of third-party financed litigation. The benefits are easier to see if they are considered in light of the circumstances in which litigation is (or is not) socially desirable.

The potential social benefits of third-party finance and litigation can be traced to several sources. First, to the extent third-party enforcers are more efficient litigators than are original victims, social welfare can be enhanced through a reduction in the resources devoted to litigation. Second, third-party enforcers, because of their superior efficiency in litigation, may be willing to enforce socially efficient rights (i.e., potential claims for which the deterrence benefit from enforcement is greater than the total cost of litigation) that would otherwise not be enforced. The third source of welfare gain is, perhaps counterintuitively, from waiving potential claims. If victims cannot waive legal rights easily, sale to third parties may facilitate waiver,[49] which would be socially desirable in the case of inefficient legal rights.

The settings in which more vigorous enforcement would be observed are those in which the cost of litigation, for the plaintiff, is likely to exceed the expected value of the award. A third party enforcer who can litigate more cheaply would have an incentive to purchase potential claims of this sort. For example, the vast majority of instances of medical negligence do not result in litigation,[50] probably because most victims of adverse medical events do not have the time, money, or inclination to sue their doctors. The settings in which third party litigators would purchase potential claims and then waive them are

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[49] Bond, *supra* note 19, at 1322, proposes allowing defendants to purchase claim without noting that it would be equivalent to permitting waivers. The purchase of matured claims by injurers would be equivalent to settlement.

[50] A. Russell Localio, et al.,The Relation Between Malpractice Claims and Adverse Events due to Negligence: Results of the Harvard Medical Practice Study III, 325 New England Journal of Medicine 245-251 (1991).

generally those in which the expected injuries are small relative to the cost of avoiding them. Cooter suggested the example of a privately arranged no-fault automobile insurance regime.[51] A third party litigator, in this case an insurance company, would purchase potential tort claims for traffic accidents and waive them. Since fault liability does not seem to affect driver care greatly,[52] the dominant effect of waiving probably would be a reduction in transaction and litigation costs.

One could argue that the benefit from enhancing enforcement of socially efficient rights that would otherwise not be enforced (because they are unprofitable) is limited today because the class action device already allows many of these claims to be brought to court.[53] But the class action device probably does not capture all of the potential claims that are both efficient and unprofitable. In addition, the third-party enforcement system provides the advantage of guaranteed compensation to original victims, which enhances the likelihood that only efficient claims of class harm will be pursued.[54]

A fourth source of welfare gain, not explicitly incorporated into the model of this paper, is the reallocation of risk.[55] The original victim may be risk averse and the financier spreads risk across a portfolio of investments. When the victim sells his claim to the financier, social welfare is enhanced by the reallocation of risk from a risk-averse party to a risk-neutral party.

A fifth potential gain is the prospect of greater alignment between the interests of attorneys and those of plaintiffs.[56] Third-party financiers, because they are likely to know more about the strengths and weaknesses of litigators than will ordinary victims, will have incentives to channel lawsuits to the most effective litigators, and to monitor those litigators. A litigation funder, such as Juridica Investments, can validate the quality of a claim for investors without raising the suspicions that lawyers might raise under the same conditions, because the litigation funder is likely to have incentives that are closely aligned with those of investors, and of plaintiffs.[57] In class litigation settings, the requirement that potential or actual claims be purchased would eliminate the worst features of class action and derivative litigation, such as races to the courthouse and

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[51] Cooter, supra note 6, at 385.

[52] Studies on the effects of no-fault have been mixed, and suggest a modest effect at most. For a thorough review of the empirical literature, see Marco, Alan C. and Salvietti, Casey, What Does Tort Law Deter? Precaution and Activity Levels in No-Fault Automobile Insurance, pp. 7-10 (November 2007), 2nd Annual Conference on Empirical Legal Studies Paper, available at http://ssrn.com/abstract=998741.

[53] Rubin, *supra* note 6, at 8.

[54] If third-party enforcers did not have to compensate victims in full, there is a significant risk that those enforcers would "sell out" their claims. On such collusive settlements, see Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 VA. L. REV. 1051, 1111-15 (1996).

[55] Shukaitis, *supra* note 6, at 334; Molot, supra note 9. Although risk allocation is not incorporated into the model examined in this paper, one could view the litigation efficiency gain from third-party enforcement as arising from the risk allocation advantage.

[56] *See, e.g.*, Max Schanzenbach & David Dana, *How Would Third Party Financing Change the Face of American Tort Litigation?* (Third Party Financing of Litigation Roundtable, Searle Ctr., Nw. Univ. Law Sch. Sept. 24-25, 2009), *available at* http://www.law.northwestern.edu/searlecenter/papers/ Schanzenbach_Agency%20Costs.pdf.

[57] *See, e.g.*, Garber, *supra* note 22, at 15.

collusive settlements. If class action attorneys had to gain the consent of each victim to sue on his behalf, races to the courthouse would not be observed.[58] The problems of collusive settlements could be greatly reduced if class action lawyers had to purchase the claims of victims (an opt-in system).[59]

But there are also costs that would be associated with a third-party finance and enforcement system. Although I will focus here on implications of the analysis of markets in unmatured claims, the points are also applicable to the sales of matured legal claims.

A. Leakage

In any system in which the control of legal rights is shifted to a third party, there is a risk of leakage: control will fall into the hands of the actors responsible for the injuries underlying the potential claims. Rights that fall into the hands of potential injurers will be effectively waived, since the injurers are not going to sue themselves.

How could leakage occur? If a third party offers to finance the claims of a potential victim, the same third party could be controlled by another party who is likely to be the source of the victim's injury claims. Suppose, for example, firm *A* purchases potential legal claims of employees of firm *B*. If firm *A* is the wholly owned subsidiary of firm *B*, then employees will have effectively waived their claims by selling them to firm *A*. Such a transparent case of leakage may be unlikely, but a market in which potential legal claims are sold could result in complicated transactions and ownership structures. Within such a market, leakage might occur without being obvious.

Of course, leakage could be efficient.[60] If the underlying potential claim is inefficient, then a transfer to the injuring party enhances social welfare. However, an opaque or complicated transfer mechanism (e.g., securitization) might lead to contingent claims going to a combination of genuine enforcers and injurers. In such a market, it is possible, depending on how the transfer mechanism is arranged, for contingent claims to be transferred with the result being harmful to social welfare.

B. Prosecution of Inefficient Claims

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[58] The race to the courthouse famously observed in class action and shareholder derivative litigation is an effort to gain ownership of claims. If a litigator gained ownership directly, he could take the time to develop and research his case rather than running directly to the courthouse with a shoddily researched complaint.

[59] If class action lawyers had to pay each victim a non-trivial amount of money to gain control over his legal claim, then the lawyers would need to earn a substantial judgment in order to make a profit on the class action lawsuit. At present, civil procedure rules permit class action lawyers to take effective ownership of claims, giving victims an opt-out right. An alternative to the "taking" of control over claims by class action lawyers would be an auction system as proposed in Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chicago L. Rev. 1 (1991).

[60] For the argument that leakage should be prevented under a system in which potential claims are assignable, see Marks, *supra* note 6.

Third-party enforcement may lead to more frequent prosecution of inefficient claims. I considered examples in which this occurs because transaction costs prevent third-party enforcers from transferring claims to injurers. Also, third-party enforcers may have constraints and interests that differ from those of the original victims, and these differences could lead to the prosecution of inefficient claims. Such differences are likely for several reasons: the inability of the original victim to foresee future costs associated with litigation, informational asymmetry, and a special, perhaps idiosyncratic, gain to the third-party enforcer.

Take the employment setting as an example. A potential victim might sell his unmatured legal claims to a third-party financier/enforcer without having a clear sense of exactly what those claims might be. In a later period, the third-party enforcer discovers evidence that he could use to bring a successful discrimination claim against the victim's employer. Suppose, for example, the enforcer discovers that the employer has promoted several individuals whose credentials are less than those of the victim's. The victim, asked whether to pursue the discrimination claim, might decline because he expects to leave his current employer and would rather not enter the job market under the cloud of a discrimination lawsuit. The enforcer, however, has different payoffs and may find it profitable to pursue the claim. If the victim had foreseen the possibility of this type of claim, he would have sold his legal rights for a higher fee, or perhaps not have sold them at all. But after the rights are sold, he has relinquished the right to control the lawsuit.

There are plenty of examples today of lawsuits that have a negative payoff for the victim and positive payoff for the attorney. Koniak and Cohen criticize class action settlements in which class victims receive coupons, or other seemingly trivial awards, while plaintiffs' attorneys receive legal fees in the millions of dollars.[61] These are negative payoffs when victims receive worthless awards and lose the ability to sue for real injuries that have been compensated in theory by the class award. Another setting in which negative payoffs may be observed is where members of the class suffer different amounts of harm, and the attorney's fee arrangement imposes a fixed charge on each victim.[62] The examples from Koniak and Cohen suggest that class action attorneys already have incentives that diverge from those of at least some of the victims they represent. Class action attorneys are, in effect, third party litigators – the significant difference is they do not have to purchase their claims from victims.

Yet another scenario in which socially inefficient rights are likely to be pursued by third-party enforcers is where the enforcer gets a special gain from pursuing the injurer in

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[61] Koniak & Cohen, *supra* note 54, at 1053-55. Coupons have been criticized because they are often ignored by consumers. However, coupons as a remedy in antitrust cases may be efficient, *see* Polinsky, A. Mitchell and Rubinfeld, Daniel L., A Damage-Revelation Rationale for Coupon Remedies (October 2007). Journal of Law, Economics, & Organization, Vol. 23, Issue 3, pp. 653-661, 2007.

[62] Koniak and Cohen describe the settlement in a class action lawsuit brought on behalf of more than 300,000 customers against BancBoston for allegedly requiring its customers to keep more money in their mortgage escrow accounts than it had a right to demand, *see* Koniak & Cohen, *supra* note 54, at 1058, 1061. In at least one case, attorney's fees were allegedly more than 4,000% of the recovery amount. Koniak & Cohen, *supra* note 54, at 1067. The case is Hoffman v. BancBoston Mortgage Corp, No. 91-1880 (Ala. Cir. Ct. Jan. 24, 1994).

court. Suppose the financier purchases potential claims against its main competitor in the product market – for example, Coke purchases the potential legal claims of Pepsi employees. Welfare gains would be observed when Coke pursues efficient employment-related rights against Pepsi that would otherwise not be pursued by Pepsi employees. However, there is a clear risk that Coke would pursue inefficient potential claims solely for the purpose of damaging its rival.

Competition would spur firms to purchase claims against their market rivals. A firm that refused to purchase such claims would find itself at a competitive disadvantage relative to rivals who had purchased claims against it. As this process continues, the reputation of courts would suffer.

Patent auctions provide concrete examples of the incentive for third-party financiers to purchase claims against rivals for anticompetitive purposes. Technology firms have incentives to bid aggressively for the patent portfolios of firms in their sectors, in order to use those patents to threaten litigation against upstart rivals that hold thin patent portfolios. Even if the efficient allocation of rights would involve the potential infringer acquiring a particular patent, and thereby obtaining a waiver, a competitor might outbid the potential infringer because of the benefit it gains from deterring entry.[63]

C. Informational Disparities

Informational disparities combine with the factors just mentioned (leakage, inefficient potential claims) to create numerous opportunities for welfare-reducing litigation. Take the employment example just considered. The third-party enforcer may be in a better position to foresee the possible future discrimination claim at the time he purchases the rights from the employee. The employee, unaware of the possibility of such a claim, would choose a price that is well below the level that would compensate him for the harms that might arise in the future after selling the claim.

The information problems present difficulties in any effort to construct an efficient market for the securitization of potential legal claims. In a market for legal rights, victims are likely to be the least informed parties about the value of their rights. Financiers are likely to have an informational advantage because they are likely to know more about the characteristics of enforcers than do the victims.

Although informational disparities can be a source of inefficiency in the market, competition serves a mitigating force. If financiers compete for ownership of rights, they will bid away all informational rents. The often-mentioned concern that financiers would take advantage of victims by purchasing their claims too cheaply would not be observed in a competitive market for legal rights. However, even though informational rents

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[63] The best known recent example of this is the auction of Nortel's patent portfolio, which was awarded to a consortium of wireless communications firms that bid $4.5 billion. The one firm that was outside of the consortium was Google, which led to speculation that the consortium intended to use the patent portfolio to launch infringement suits against Google's Android software, see John Letzing, *Google: Rivals Are Ganging Up*, Wall St. J., Aug. 4, 2011, at B4.

would be bid away a competitive market, informational disparities would still result in inefficient waivers as well as inefficient litigation.

D. Perverse Enforcement Incentives

One feature I have tried to formalize is that the enforcer, after acquiring the rights of victims, profits when the probability of harm to the victims increases. This provides enforcers with incentives to enforce opportunistically or to generate additional injuries – that is to act as sham enforcers. Patent trolls are often associated with this activity. But the incentive to engage in sham enforcement is a general characteristic of third-party litigation.

One obvious example is where the enforcer purchases the potential claims and then observes opportunities for making them more valuable. Suppose the enforcer purchases the potential tort and discrimination claims of a group of employees. After gaining ownership of the claims, the enforcer would have incentives to generate an environment for claiming as well as new theories of injury in order to enhance the value of his stock of potential claims.[64] In addition, the enforcer may have an incentive to ferret out or even to fabricate claims that most ordinary people would not consider bringing to court.

Where the claims have been realized (matured claims) the enforcer would have an incentive to fraudulently assert a greater level of injury than has actually occurred. For example, numerous instances of fraud have been discovered in the asbestos and silicosis class actions, where plaintiffs' lawyers have arranged for mass screenings of potential victims.[65] The incentives for fraud would be at least as strong in the setting where third-party financiers own claims.

Another general opportunity for sham enforcement involves injuries that are trivial impositions and do not lead to any serious loss to the victim. Suppose, for example, that the injuries under consideration are common insults. Care would not be socially desirable because the cost of care exceeds the losses to be avoided. However, the sham enforcer may have an incentive to encourage and to pursue these claims in court, especially in a regime of strict liability or where the negligence standard may be applied erroneously.[66] Consider, for example, an item-pricing law that requires grocery stores to stamp a price sticker on every single item stocked in the store's shelves. Many stores might choose not to comply with the law because of its high supply-side costs and meager consumer benefits. Indeed, it would be nearly impossible to comply perfectly in a market with rapidly changing prices. A third-party litigator would have an incentive to

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[64] Lawyers can enhance the value of potential claims by lobbying to influence legislation affecting those claims, or supporting the campaigns of legislators or of judges who would favor rules that enhance the value of potential claims. The American Association for Justice (formerly Association of Trial Lawyers of America) spends millions each year in lobbying legislatures and supporting candidates for office, *see, e.g.*, http://www.opensecrets.org/orgs/summary.php?id=D000000065.

[65] Lester Brickman, Disparities Between Asbestos and Silicosis Claims Generated by Litigation Screenings and Clinical Studies, 29 Cardozo L. Rev. 513 (2007).

[66] This may be a reflection of the underlying strict liability model. If the standard were negligence, the court would reject many of these claims.

gain ownership of claims from customers allegedly harmed by failures to comply, and to encourage additional complaints. If a third party owned some of the potential claims of customers, he may have no incentive to see the store comply with the law, or reach an efficient agreement with customers directly.[67]

The incentive to enhance the value of a portfolio of claims could lead litigation financiers to bribe courts to modify decisions or to change the law. Again, this is an incentive that already exists, but lawyers are officers of the courts while financiers are independent of the courts. The combination of judges on public-sector salaries and richly compensated finance workers would set the stage for corruption in courts that are vulnerable because of lax selection criteria and low compensation of judges.[68]

The possibility of sham enforcement would require some mechanism for controlling agency costs in enforcement. In the absence of such a mechanism, a market in claims could be damaged by excessive entry of sham enforcers. Adverse selection would appear in the form of sham enforcers outbidding real enforcers, and a type of moral hazard would be observed in the phenomenon of real enforcers switching to sham enforcement after gaining ownership of claims.

V. Conclusion

This is not the first paper to suggest that the ancient prohibitions on third-party funding of litigation should be replaced with a more fine-tuned set of rules that distinguish socially beneficial from socially harmful instances of such funding. Moreover, the common law has already adopted the fine-tuning approach. Many courts have narrowed the scope of the prohibitions in order to permit third-party funding of litigation where no foreseeable harm was likely to result from the particular arrangement observed by the court.

The key contribution of this paper is to identify the potential sources of welfare gains and losses associated with a system of third-party litigation funding. While previous studies have discussed the risk-sharing benefits of a market in claims, I have suggested that the social gains should be understood in light of the economics of litigation – specifically the divergence between private and social incentives to litigate, and the market mechanisms for correcting this divergence. But this perspective also points to some important sources of social cost, such as socially undesirable waivers, socially undesirable litigation, and the entry of litigators who have a stake in the generation and continuance of injuries. Any empirical assessment of the welfare consequences of expanded third-party funding will have to take these costs into account.

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[67] This is a case where the optimal arrangement would involve the third party waiving the potential claims. But if he does not own all of the claims, he may have weak incentives to waive. This is another case where transaction costs may stand in the way of an optimal arrangement.

[68] Perhaps third-party litigation finance would force legislators to raise the compensation of judges, or institute more rigorous selection criteria, in order to reduce the risk of corruption. Of course, simply raising pay not be enough to reduce corruption. Back-loading compensation for judges would be a more efficient method of reducing corruption. On compensation and corruption of public law enforcement officials, see Gary S. Becker & George J. Stigler, *Law, Enforcement, Malfeasance, and the Compensation of Enforcers*, 3 J. Legal Stud. 1 (1974).

Appendix

In this part I consider a contract between a victim and financier that consists of two important terms: the upfront payment and the share of damages that will be given to the victim.

Unmatured Claims

Consider the case of a waiver agreement between the potential victim and the potential injurer which includes a damage sharing provision. Under this agreement, the victim would waive his tort claims, but the defendant would also agree to pay part of the damages suffered by the victim in the event of an accident.

Assume that the injurer has no incentive to take care after signing the waiver. Under such an agreement, the victim's asking price for the waiver would be

$$p(1 - \pi)v - qc_p - q\pi v \qquad (A1)$$

This expression reflects the loss that will be imposed on the victim when the injurer stops taking care, but it also subtracts off the litigation costs the victim would have had to pay in litigation (if there were no waiver agreement) and also subtracts off the damage portion the victim would have if the potential injurer had taken care.

The maximum price from the potential injurer would be

$$x + q(1 - \pi)v + qc_d - p\pi v \qquad (A2)$$

which reflects the savings the injurer would get from no longer taking care, and the release from a portion of the victim's damages as well as litigation costs. However, it subtracts off the damage payment that the injurer would have to make under the damage sharing agreement.

Using these expressions, a waiver agreement will be entered into if

$$p(1 - \pi)v - qc_p - q\pi v < x + q(1 - \pi)v + qc_d - p\pi v \qquad (A3)$$

which is equivalent to $pv - qc_p < x + qv + qc_d$. Thus, in the case of the damage sharing agreement, the incentive to waive will be the same as in the case without such an agreement. Given this, I have simplified the analysis in the text by focusing on the simpler contract without a damage sharing agreement.

Matured Claims

The discussion in the text of matured claims is easily modified for the case of a damage-sharing agreement. The third-party enforcer and the victim will arrange a mutually beneficial exchange of the matured claim if $P_p v - c_p < \tilde{P}_p(1 - \pi)v - c_e$, or equivalently

$$(P_p - \tilde{P}_p(1 - \pi))v < c_p - c_e \qquad (A4)$$

Thus, the two factors driving the purchase of matured claims are the third party's greater likely success in litigation, which must be greater still as the proportion of damages shared with the victim increases, and the third party's efficiency advantage in litigation.

The third-party enforcer who purchases the plaintiff's claim would settle if

$$(\tilde{P}_p(1 - \pi) - P_d)v < c_e + c_d. \qquad (A5)$$

Proposition: *Whenever a matured legal claim is sold to a third-party enforcer, the third party enforcer will be more likely to litigate (less likely to settle) than the victim.*

Proof: Suppose the third-party enforcer would settle the claim, which implies (A5). If the claim was obtained in a mutually beneficial trade, then (A4) holds, which implies $c_e < c_p + \tilde{P}_p(1 - \pi)v - P_p v$. Substituting this into (A5), yields $(P_p - P_d)v < c_p + c_d$. Thus, any legal claim that the third-party enforcer would settle, the victim would settle too. Now suppose the victim would litigate the claim, which implies $(P_p - P_d)v > c_p + c_d$. Substituting (A4) yields $(\tilde{P}_p(1 - \pi) - P_d)v > c_e + c_d$. Thus, if the victim would litigate the claim, the third-party enforcer would litigate.