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An Empirical Investigation of Third Party Consumer Litigation Funding

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LITIGATION FUNDING

Ronen Avraham and Anthony Sebok***

INTRODUCTION

Third party litigation funding (TPF), where financial corporations support plaintiffs' lawsuits by advancing money as a nonrecourse loan, is attracting both controversy and capital.¹ Media coverage of TPF in connection with lawsuits inspired by the #MeToo movement, and other high profile litigation such as the suit against Gawker Media sponsored by investor Peter Thiel, has thrust the industry out of the shadows of the civil litigation ecosystem and into the limelight.² At the same time, TPF is a fast-growing asset class in the United States, as well as in other nations.³ The 2016 merger of two of the largest funders in the United States, Burford and Gerchen Keller, has created a firm that, by the end of 2017, had \$3.1 billion "invested and available for legal finance".⁴ TPF firms receive a large premium in the event of a successful litigation outcome:

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¹ See, e.g., Mattathias Schwartz, *Should You Be Allowed to Invest in a Lawsuit?*, The New York Times B1, October 22, 2015, at <https://www.nytimes.com/2015/10/25/magazine/should-you-be-allowed-to-invest-in-a-lawsuit.html>, and Joshua Hunt, *What Litigation Finance Is Really About*, The New Yorker, September 1, 2016 at <https://www.newyorker.com/business/currency/what-litigation-finance-is-really-about>.

² See, e.g., Matthew Goldstein & Jessica Silver-Greenberg, *How the Finance Industry Is Trying to Cash In on #MeToo*, The New York Times at B1, January 28, 2018, at <https://www.nytimes.com/2018/01/28/business/metoo-finance-lawsuits-harassment.html> and see Eugene Kontorovich, *Peter Thiel's Funding Of Hulk Hogan-Gawker Litigation Should Not Raise Concerns*, The Washington Post, May 26, 2016 at <https://www.washingtonpost.com/news/volokh-conspiracy/wp/2016/05/26/peter-thiels-funding-of-hulk-hogan-gawker-litigation-should-not-raise-concerns/> and Sam Thielman, *Peter Thiel Has Backed A Startup That Makes It Easier To Sue – And Win*, The Guardian, August 24, 2016 at <https://www.theguardian.com/technology/2016/aug/24/peter-thiel-legalist-startup-gawker-lawsuit>.

³ See, e.g. Drew Hasselback, *The Gavel Gamble: Litigation Emerges As An Asset Class*, Financial Post, April 29, 2016 (In Canada, "[l]awsuits are emerging as a distinct asset class, just like real estate, private equity, precious metals or stocks and bonds.") at <http://business.financialpost.com/legal-post/the-gavel-gamble-litigation-emerges-as-an-asset-class>), and Patrick M. Jones, *Third-Party Litigation Funding In Bankruptcy Cases*, 30 The Bankruptcy Strategist (January 1, 2013) at 3 ("litigation finance is an alternative asset class that has experienced rapid growth in the U.S. in the past decade").

⁴ Burford Capital, 2017 Interim Report at 1.

variously as a portion of the amount recovered, or a multiple of the amount advanced, or a very high fixed interest rate on the amount advanced.

TPF in the United States is divided between the commercial and the consumer sectors.⁵ In the former, funding is provided to a highly sophisticated litigant, usually a corporation, to help pay for the attorneys and their costs in a commercial dispute.⁶ In the latter, funding is provided directly to individuals, most of whom have never engaged previously in litigation. Importantly, consumer TPF allows money to flow directly to the litigant, providing an important source of financial support during the pendency of litigation.⁷ Funding contracts differ in type between the two sectors. Commercial TPF usually pays the funder a percentage of the litigation proceeds upon resolution of the litigation.⁸ In contrast, in consumer TPF the funder receives a payment based on small monthly or semi-annual interest charge determined by the length of time to the resolution of the litigation.⁹

Over the past ten years there has been an explosion of scholarly commentary about TPF, with authors approaching it from positive and normative perspectives.¹⁰ TPF has drawn the attention from certain political quarters as well, with groups associated with

⁵ For a comprehensive review of the TPF market, see Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, Law, Finance, and Capital Markets Program Occasional Paper (2010).

⁶ *Ibid* at 13.

⁷ *Id.* at 9.

⁸ In commercial litigation finance contract “the financier provides immediate capital to prosecute the case in exchange for a percentage of the future recovery.” Joanna M. Shepherd & Judd E. Stone II, *Economic Conundrums in Search of a Solution: The Functions of Third-Party Litigation Finance*, 47 ARIZ. ST. L.J. 919, 937 (2015). But there is no “one size fits all” commercial litigation finance contract. Commercial funding is diverse and includes many different types of products. See, e.g. Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455 (2012) and see Shepherd & Stone, *Economic Conundrums in Search of a Solution* at 941 - 42 (on the use of “first money out” and “waterfall” payment structures).

⁹ See Garber, *supra* note 5 at 9.

¹⁰ See Ronen Avraham & Abraham Wickelgren, *Third Party Litigation Funding - A Signaling Model*, 63 DEPAUL L. REV. 233 (2014), Jeremy Kidd, *To Fund or Not to Fund: The Need for Second-Best Solutions to the Litigation Finance Dilemma*, 8 J. L. ECON. & POL'Y 613 (2012), Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 VT. L. REV. 615 (2007), Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55 (2004), Susan Lorde Martin, *Litigation Financing: Another Subprime Industry that Has a Place in the United States Market*, 53 VILL. L. REV. 83 (2008), Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65 (2010), Marco de Morpurgo, *A Comparative Legal & Economic Approach to Third-Party Litigation Funding*, 19 CARDOZO J. INT'L & COMP. L. 343 (2011), Maya Steinitz, *Whose Claim is this Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268 (2011), Anthony J. Sebok, *Litigation Investment and Legal Ethics: What are the Real Issues?*, 55 CAN. BUS. L.J. 111 (2014), and Anthony J. Sebok, *Should the Law Preserve Party Control? Litigation Investment, Insurance Law and Double Standards*, 56 WM. & MARY L. REV. 837 (2015).

tort reform in the United States publishing studies critical of both commercial and consumer TPF in the United States and Europe.¹¹

One of the main critiques of TPF is that winning plaintiffs often pay usurious interest rates to funders and that this practice often leaves them with almost nothing from the award or settlement.¹² This criticism is directed against consumer TPF for a few reasons. The first is that the population of users of TPF in the commercial market are, by definition, commercial actors, and, while some may be more sophisticated than others, observers think that as a group they do not need the same protections consumers require.¹³ The second is that there is very little publicly available information about the terms of commercial TPF, given that commercial TPF firms do not make their rates available to the public; do not report the details of their business practices to their shareholders (if they are publicly traded); and fight to protect the details of their contracts and contract negotiations from adverse parties in discovery.¹⁴ As a result, the focus on the cost of TPF has been really about the cost of consumer TPF.

Concern over the cost of consumer TPF is not, however, grounded in reliable data. Until this article, academic and policy debate about consumer TPF has been conducted in an environment of anecdote and speculation. A brief review of some academic work

¹¹ See U.S. Chamber Inst. for Legal Reform, *Supporting Safeguards: EU Consumer Attitudes Towards Collective Actions and Litigation Funding* (2017), Lisa Rickard [President, U.S. Chamber Inst. for Legal Reform], *This Is Casino Litigation, Where We All Lose*, *The New York Times*, May 27, 2016, at <https://www.nytimes.com/roomfordebate/2016/05/27/the-ethics-of-investing-in-anothers-lawsuit/this-is-casino-litigation-where-we-all-lose>, U.S. Chamber Inst. For Legal Reform, *Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States* (2009) (hereafter “Selling Lawsuits”), and *Third-Party Litigation Funding*, Inst. For Legal Reform, <https://perma.cc/7SUX-WHXZ> (collecting materials).

¹² See, e.g., Jenna Wims Hashway, *Litigation Loansharks: A History of Litigation Lending and a Proposal to Bring Litigation Advances Within the Protection of Usury Laws*, 17 *Roger Williams U. L. Rev.* 750 (2012).

¹³ See Laurie A. Giordano-Vahey and Alissa M. Valentine, *Advocate’s View: An Update On Non-Recourse Litigation Loans*, *The Daily Record*, October 14, 2015 at <http://nydailyrecord.com/2015/10/14/advocates-view-an-update-on-recourse-litigation-loans/> (“[A] sophisticated corporation’s calculated decision to pay a high fee to a funding company to avoid taking the full risk in litigating a claim does not seem unreasonable [but] . . . from the perspective of an individual plaintiff . . . [should be] subject to higher scrutiny.”).

¹⁴ See *Miller UK Ltd. V. Caterpillar, Inc.*, 17 F. Supp. 3d 711 (N.D. Ill. 2014). Occasionally a commercial TPF firm will describe, in general terms, the content of contract after an investment has been concluded. See, e.g., Burford Capital, *Theory and Practice in Litigation Risk*, 10 – 11 (2015) at <http://www.burfordcapital.com/wp-content/uploads/2015/01/Booklet-Theory-and-Practice.pdf> (describing three investments, including one which in which Burford received “its investment back plus roughly a 2x return on that invested capital”). IMF Bentham, the world’s second largest commercial TPF firm, “generally aims to get its investment back plus two times the invested amount.” See Allison McNeely, *Suing Is Canada’s New Asset Class as Investors Bet on Claims*, *Bloomberg*, January 31, 2018 at <https://www.bloomberg.com/news/articles/2018-01-31/suing-is-canada-s-new-asset-class-as-investors-bet-on-outcomes>.

reflects an extraordinary range of reported rates in the consumer TPF market. In 2004 two articles reported that consumer TPF cost between 180% - 425% per annum.¹⁵ A 2007 law review note reported that rates of 120% - 180% per annum “were not uncommon” in the 1990s, but that rates have decreased since then.¹⁶ The 2010 RAND study noted that “there [was] no systematic empirical information about the sizes of financing fees” for any type of TPF, but reported anecdotal evidence of a range of 24% - 60% per annum.¹⁷ As recently as 2014, a law review article which purported to be a survey of TPF stated that “it is not atypical for a [TPF provider] to charge 80% interest in the first year of a loan and up to 280% of the total loan amount.”¹⁸ A 2015 law review article, which argued that TPF was overcharging its customers, suggested that TPF rates ranged between 30% - 180% per annum, with the typical rate falling, after compounding, at 47% per annum.¹⁹ The 2018 *New York Times* article mentioned at the beginning of this Introduction reported that consumer TPF interest rates of “as high as” 100%.²⁰

It is possible that rates have, on average, declined over the past two decades. On the other hand, it is possible that consumers are at the mercy of a market where rates for similar financial products dramatically differ for no apparent reason. The range which the published reports reflects could mirror an extremely inefficient market, or it could be random noise picked up by scholars, lawyers and journalists encountering a new business model. Without much larger and comprehensive sample, it is impossible to know. This article is the first comprehensive effort to analyze the behavior of the consumer TPF market including providing a measure of the cost of TPF.

Trustworthy data on the consumer TPF market is more important than ever before, given increased attention on the industry. Media coverage of alleged abuses by the TPF industry has increased.²¹ Media coverage both reflects and drives legislative

¹⁵ Yifat Shaltiel and John Cofresi, *Litigation Lending For Personal Needs Act: A Regulatory Framework To Legitimize Third Party Litigation Finance*, 58 CONSUMER FIN. L.Q. REP. 347, 348 (2004) (425%) and Martin, *supra* note 10 at 68 (180%).

¹⁶ Courtney R. Barksdale, *All That Glitters Isn't Gold: Analyzing the Costs and Benefits of Litigation Finance*, 26 REV. LITIG. 707, 729 (2007) (citing the American Legal Finance Association website FAQs).

¹⁷ Garber, *supra* note 5 at 12.

¹⁸ Terrence Cain, *Third Party Funding of Personal Injury Tort Claims: Keep the Baby and Change the Bathwater*, 89 CHI.-KENT L. REV. 11, 13 (2014)

¹⁹ Carol Langford, *Betting on the Client: Alternative Litigation Funding Is an Ethically Risky Proposition for Attorneys and Clients*, 49 U.S.F.L. REV. 237, 239 (2015).

²⁰ See Goldstein & Silver-Greenberg, *supra* note 2.

²¹ See, e.g., Shawn Cohen, *et. al. Inside the Cottage Industry That's Fleecing NYC Taxpayers*, NY Post, January 2, 2018 at <https://nypost.com/2018/01/02/how-firms-are-getting-rich-on-the->

interest.²² Recently, some American states have enacted laws governing TPF. These reforms have followed two streams. One stream, which is supported by the TPF industry, promotes transparency. Maine, Nebraska, Ohio, Oklahoma, and Vermont have enacted laws which explicitly allow TPF funding for consumers with requirements designed to help the consumer decide whether to contract with a funder free of undue pressure.²³ These reforms vary in detail, but they include such typical provisions include notice and disclosure provisions, standardized contract language, a minimum cancellation period after signing, and bans on attorney referral fees. The other stream, which is supported by “tort reform” pressure groups such as the United States Chamber of Commerce, promotes fixed limits on the rate of return paid by a TPF contract (usually linked to the state’s usury laws). Arkansas, Indiana, and Tennessee have passed laws that cap the premium charged to a consumer for an advance at a multiple of an annual rate.²⁴ To date, the former is unlikely to reduce the interest rates and fees plaintiffs pay, while the latter is likely to drive TPF providers out of that state’s consumer market, as was recently illustrated in the case of Tennessee.²⁵

While scholarship about litigation financing is still growing, there is almost no empirical research on the industry world-wide and no empirical research whatsoever about the American system.²⁶

surest-money-grab-in-nyc/ and Alison Frankel, *NFL Concussion Case: Can MDL Judges Police Plaintiffs’ Funding Deals?*, Reuters, November 30, 2017 at <https://www.reuters.com/article/legal-us-otc-nfl/nfl-concussion-case-can-mdl-judges-police-plaintiffs-funding-deals-idUSKBN1DK2IE>.

²² Compare Post Editorial Board, *Crack Down On New York’s Legal Sharks*, NY Post, January 3, 2018 at <https://nypost.com/2018/01/03/crack-down-on-new-yorks-legal-sharks/> with Bruce Golding, *Lawmakers Square Off Over Profitable Cottage Industry*, NY Post, January 15, 2018 at <https://nypost.com/2018/01/15/lawmakers-push-back-against-profitable-cottage-industry>.

²³ See Maine Rev. Stat. Ann. tit. 9-A, § 12-101 (effective Jan. 1, 2008); Neb. Rev. Stat. § 25-3302(1), (4) (effective Apr. 13, 2010); Ohio Rev. Code § 1349.55(A)(1) (effective Aug. 27, 2008); Okla. Stat. § 14A-3-801(6) (effective May 29, 2013) and 8 Vt. Stat. Ann. §§ 2251 – 2260 (effective July 1, 2016).

²⁴ See Ark. SB 882 (2015) (to be codified at Ark. Code § 4-57-109(a)(2)) (effective April 1, 2015) (maximum rate of 17% per annum); Indiana Code 24-4.5-3-202 (effective July 1, 2016) (maximum rate of 36%) and Tenn. Code Ann. § 47-51-101 et seq. (effective July 1, 2014) (maximum rate of 10%).

²⁵ See Andrew G. Simpson, *Litigation Financing Firm Exits Tennessee As New Law Goes Into Effect*, Insurance Journal, July 3, 2014, at <http://www.insurancejournal.com/news/southeast/2014/07/03/333772.htm>.

²⁶ David Abrams & Daniel Chen, *A Market for Justice: A First Empirical Look at Third Party Litigation Funding*, 15 U. PENN. J. BUS. L. 1075, (2013) and Daniel Chen, *Can Markets Stimulate Rights? On the Alienability of Legal Claims*, 46 RAND JOURNAL OF ECONOMICS 23 (2015) are the only published empirical studies about the industry and they both use data from Australia and only about 113 funded cases). See also Jean Y. Xiao, *An Empirical Examination of Consumer Litigation Funding* (Ph.D. dissertation, Vanderbilt University, 2017, Chapter 3 (“Consumer Litigation Funding and The Financier-Law Firm Relationship”))

This research project is the first large-scale empirical analysis of the pre- and post- contract underwriting behavior of the consumer TPF market. Starting from the common-sense premise that policymakers cannot begin to regulate a financial instrument without first understanding the operation of the market, this research is the first to carry out a comprehensive empirical investigation into how the consumer TPF system operates in the U.S.

We have received from one of the largest consumer litigation financing firm in the United States a unique dataset which has about 200,000 funded and unfunded American cases over a period of ten years. The litigation funding firm has provided us with access to *all* their applications for litigation funding, which are retained electronically. Thus, we have access to the equally large groups of funded and unfunded cases.

The data is very rich. It contains, among other things, the name and address of the party seeking funding, the name of the lawyer representing them (if there is an attorney), where the applicant's suit has been filed, a brief description of the case, and the amount requested by the applicant. More information is gathered on applications that are seriously considered for funding. For example, the company may obtain police, hospital, and insurance reports on the incident at the center of the claim; it may conduct independent legal research to determine the likelihood of success and the potential damage award; and the company may also seek details concerning any liens on an award the plaintiff might receive, or historical data concerning, for example, whether the plaintiff has ever filed for bankruptcy. In addition, the data contains data on the amount funded, the monthly interest rate, the length of the case, the amount owed when the case settles, and the amount eventually collected.

In this paper we provide the first comprehensive analysis of funders' modus operandi. Our main findings are, first, that the underwriting procedures adopted by the funders are robust, in that only approximately half of the funding applications are approved. We cannot yet tell whether the robustness of the selection process is driven by the ability of the funders to identify stronger cases – cases more likely to have positive outcomes – rather than features of the applications exogenous to the case presented, but the finding suggests that funding may serve as a second layer of case selection

(examination of 4,403 consumer litigation finance contracts resolved between 2002 – 13) (hereafter, "Xiao 2017").

(after the initial layer of the plaintiff attorney's own decision whether to take a case).

Second, funders are cautious about investing too deeply into a case. The ratio between average case valuation and average funding amounts is extremely large. Funders invest about 7% of the estimated case value. This may be an artifact of the fact that the funder's internal case valuations may not truly reflect settlement value, but even so, the large difference indicated suggests that funded plaintiffs still have a very strong interest in the outcome of their case, even after funding, which is a rational investment strategy for the funder. One of the criticisms of consumer litigation finance is that it leaves the consumer with an inconsequential recovery after the conclusion of her litigation; the data we have collected cuts against this claim.²⁷

Third, the data suggests that 12% of the consumers who received funding pay nothing for the advances they receive, either because they pay nothing to the funder at the resolution of their cases, i.e. a complete default (10%) or they pay only an amount that reflects all or some of the original advance.²⁸

Fourth, while the data suggests that the median amount due to the funder reflects costs of about 101%, the median actual annual cost is approximately 44% of the amount funded, once one takes into account fees, defaults and haircuts. Our data is the first comprehensive measurement of the cost of consumer litigation finance. The results we have produced about the embedded interest rate, as high as they might seem, are significantly lower than some of the speculations introduced by critics of consumer litigation finance in debates over reform and regulation.²⁹ The embedded interest rate that we have identified -- 44% per annum -- is close to the statutory rate cap that some members of the consumer litigation

²⁷ See, e.g., Cain, *supra* note 18 at 12 (“On the other hand, if [the consumer] does recover something from her lawsuit, she could very well end up owing . . . as much as 280% more than what she borrowed. If she recovers less than what she owes the LFC, she will have to turn her entire recovery over to the LFC, leaving her with nothing.”). This claim has been repeated in popular media coverage of consumer TPF. See NY Post, *Crack Down On New York's Legal Sharks*, *supra* note 22 (“plaintiffs whose cases would do well in any court — 9/11 first-responders; brain-injured ex-NFL pros — can wind up with pennies on the dollar”).

²⁸ 12% is less than some funders have reported. See Memorandum from William N. Lund, Superintendent, Bureau of Consumer Credit Protection, Department of Professional and Financial Regulation, State of Maine, to Senator Peter Bowman, Senate Chair Representative Sharon Anglin Treat, House Chair Joint Standing Committee on Insurance and Financial Services, March 1, 2009 (“According to officials from the 3 companies currently registered to do business in Maine, between 20% and 30% of all cases result in no funds to the plaintiff, and therefore in those cases, no funds are received by the funding provider.”). (Hereafter “2009 Report to Maine I & FS Committee”.)

²⁹ See text accompanying nn.15 – 20 *supra*.

finance industry accepted in negotiation with industry critics in Indiana – that is, 36% per annum plus approximately 10% in additional fees.³⁰

Fifth, the data suggests that there is significant *ex post* adjustment of the portion of the litigation proceeds recovered by the funder. A little bit more than half of the transactions between the funder and the consumer were subject to what we call a “haircut” – where the funder was repaid its advance but then repaid a lower return on its investment than it was contractually obliged to receive. The frequency and the size of the haircuts explain why observers have reported very high rates of return in the consumer funding industry and we observed much lower rates of return – because there often a dynamic repricing of the investment after the resolution of the consumer’s case. This result, in turn, suggests further avenues of inquiry, including, for example, (i) why do some consumers receive a haircut from the funder, and (ii) to the extent that the haircut is a product of negotiation between the consumer’s lawyer and the funder, what ethical obligations, if any, does the lawyer assume with regard to securing (or attempting to secure) the haircut?

Although we do not take a position in this paper on whether consumer rates should be regulated, the data we have provided is important for any policy discussion. Further, we think that our results support reforms designed to make pricing transparent by removing complex pricing mechanisms such as “investment buckets” and minimum investment periods described below.

I. DATA ANALYSIS

A. General

The data originally contained 203,307 funding requests filed by 113,298 different individuals involved in 120,230 different cases.

³⁰ See Indiana Code 24-4.5-3-202:

A provider is permitted to charge the following for each transaction: a 36% per annum fee of the amount; a fee not exceeding an annual rate of 36% of the funded amount; a servicing charge not exceeding an annual rate of 7% of the funded amount; and a one-time document fee not to exceed \$250 for the transaction with a funded amount of less than \$5,000 or not to exceed \$500 for a funded amount of at least \$5,000.

One consumer litigation funding trade organization, the Alliance for Responsible Consumer Legal Funding (“ARC”) supported the Indiana law. See *Landmark Legal Funding Laws in Vermont and Indiana Set the Standard for Consumer Protection*, June 21, 2016 at <http://www.prnewswire.com/news-releases/landmark-legal-funding-laws-in-vermont-and-indiana-set-the-standard-for-consumer-protection-300290234.html>.

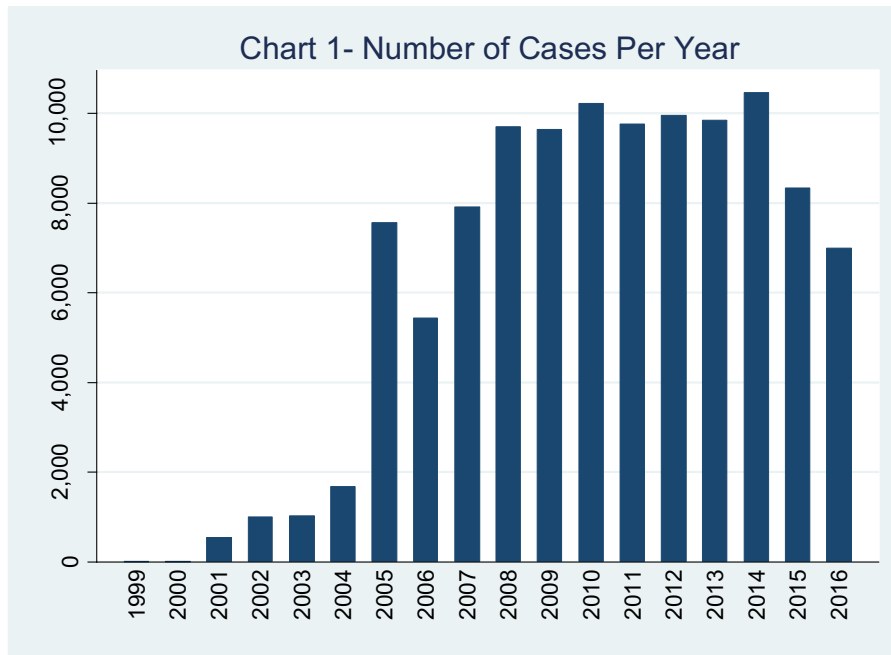
After masking and cleaning it we ended up having 191,144 funding requests filed by 106,800 individuals involved in 111,982 different cases.³¹

The vast majority of individuals in our dataset (102,383 individuals, (96%)) brought just one case. 3815 (3.5%) individuals brought two different cases. The remaining 0.5% brought on average about 3.5 different case.

When a client brings a case, she sometimes files for more than one funding request. For example, of the 96% of clients who brought just one cases, 75% filed one funding requests, 13% filed two funding requests, and another 12% filed on average 5.3 requests. To keep things simple, we combined those requests and work at the case level. Therefore, we were left with 111,982 pre-settlement consumer funding cases coming from 106,800 different consumers. Funding requests come from clients whose average age is 42 years. They live in every single state in the U.S. Thirty-two percent of funding cases come from New York. Other significant origin states include Florida and New Jersey, about 9 percent each, as well as California, Georgia, Pennsylvania and Texas, about four to five percent each.

Chart 1 presents the distribution of cases per year. It shows that the number of cases has peaked around 10,000 cases per year.

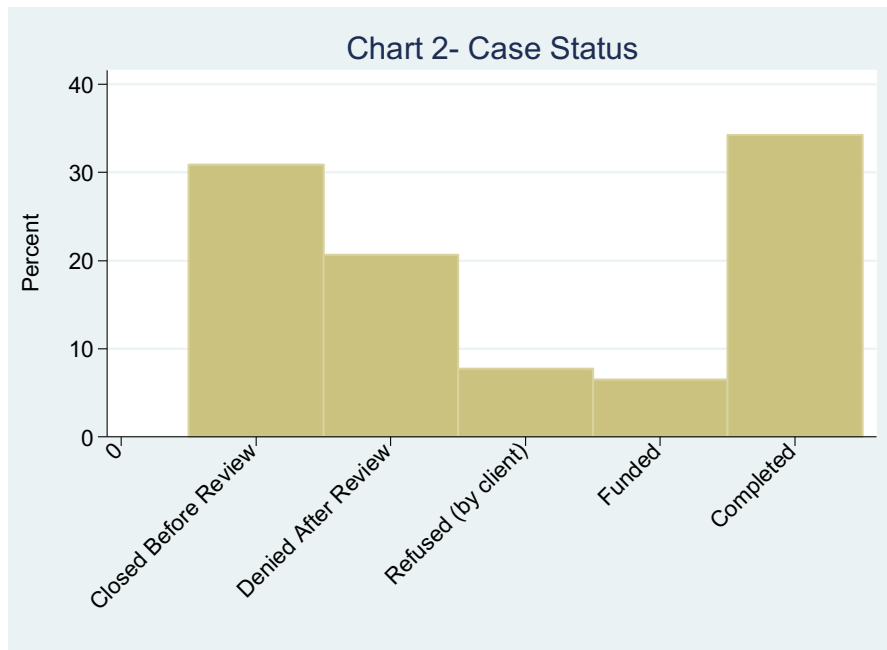
³¹ We excluded cases where funding was extended to lawyers. These cases are fundamentally different both in terms of the amount funded and interest rate charged from cases brought by regular clients. Therefore, we dropped 455 lawyer-clients with 1471 cases and 1677 funding requests. For consumer-clients, there are three types of business lines. The most important one is called “pre-settlement.” These funding requests come from clients who request funding before their case was settled. There are 195,602 such requests. Next, there are 6,028 “post-settlement” requests. These requests come from clients who have secured a settlement or a verdict in their favor and, while waiting for the money to arrive, they need some funding. Next, there are 4458 requests where the funder bought older receivables from other funders. Because buying old receivables and post-settlements funding seem to us to be different types of business lines, we dropped both types of these requests. We also dropped 264 pending cases and 325 cases which were withdrawn by the client before the funder completed processing it.



Each funding request must undergo a multi-stage process. Possible statuses in our dataset for such requests include: Completed, Funded, Refused, Closed Before Review and Denied After Review.³² Generally, about a little bit more than one-in-two cases (52%) are not funded, of which about 60% are denied outright and the remainder are denied after an underwriting process.

³² In the funder’s dataset Completed is coded as Settled. However, that is confusing when we start talking about the underlying case being settled. We therefore used Completed. In addition, there are two other statuses: Withdrawn, and still In Review, but these were too few to matter so we ignore them.

Chart 2 presents these results:



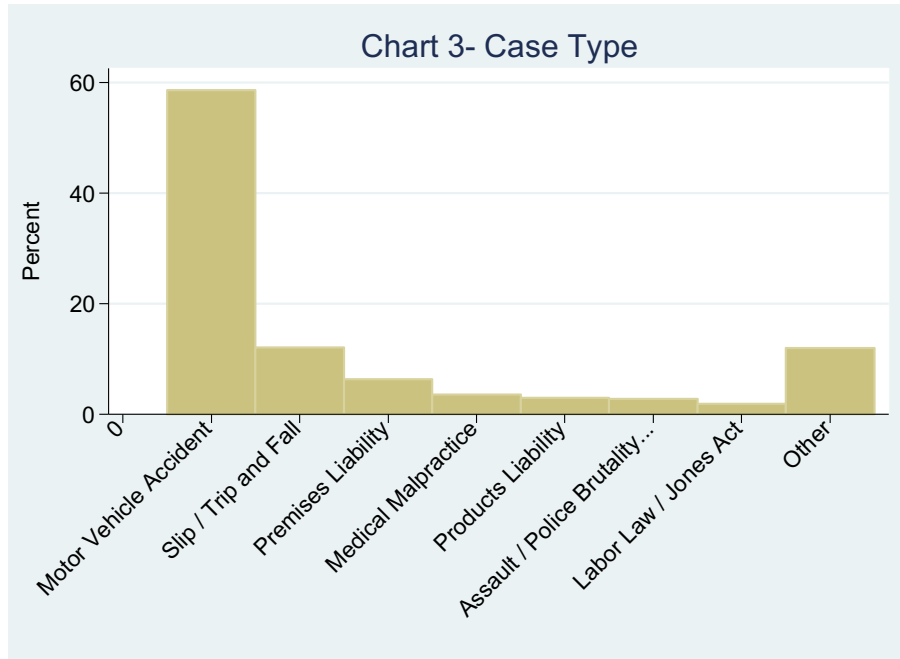
More specifically, in our pre-settlement dataset, 38,318 (34%) of the cases are ‘completed,’ meaning that they underwent a full underwriting process, the client was actually funded, the underlying lawsuit ultimately settled, and funder was paid. Then, 7,302 (6%) of the cases were “funded,” meaning that the requests went through a full underwriting process, money was offered to the client, and the client has agreed to the terms and accepted the funds, but the underlying lawsuit has not yet settled and the obligation to the funder is still outstanding. Next, in 8,637 (8%) cases the funding was “refused by the client” meaning that the request went through a full underwriting process, was approved and money was offered to the client, but the client refused to take the funding.³³

Next, 34,575 (31%) cases were “closed before review,” meaning that the application did not go through a full underwriting process and was denied outright. Lastly, are 23,150 (21%) cases that were “denied after review,” meaning that the application underwent a full underwriting process and funding was eventually not approved by the funder.³⁴

³³ The data provided by the funder did not give any further information about whether these consumers received funding from another funder or whether they simply decided not to receive funding at all. The former suggests that there is price competition in consumer funding among funders. In any case, even if all of the consumers belonged to the latter group, their behavior offers an insight into the funder’s practice of charging a “processing fee” paid only by the other 38% of the applicants whose applications were accepted and who proceeded with the funding – they are the only applicants from whom the funder could practically charge and collect a fee.

³⁴ The difference between claims that were denied after review, closed before review and refused is that the first and the second options do not contain data about any specific terms of the offer that was made to the client (because such offer was not actually made) while the refused cases do contain such data, such as the monthly rate and amount funded.

The underlying cases vary in subject matter. Specifically, 65,638 cases (59%) involved car accidents, 13,480 cases (12%) featured suits for general negligence, 7,047 cases (6%) were categorized as premises liability, and 13,452 cases (12%) were labelled “other.”³⁵ Chart 3 categorizes these cases by subject matter.



B. The Underwriting Process

In our dataset, funding requests in 45,620 different cases (40%) were “executed,” meaning they went through the underwriting process (they were not denied, or closed before review), money was offered to the client and she accepted it (the funding was not refused).³⁶ Of these cases, 16% were still being litigated at the end of the period, or there has not been a settlement at the end of the period (these as coded as “Funded”). The remaining 38,318 cases (83%) had been “completed” and money was paid back to the funder. Most of our analysis below will focus on these completed cases.

We start by inquiring about the number of days between the completed cases’ various milestones. For the completed cases, the median number of days from the date of the accident to the date the client first contacted the company is 308. The median number of days between that date and the date of first funding is 10 (future funding requests for the same case were processed much faster as the details about the case were already known). During the 10 days in which the funder processes the first funding request he collects

³⁵ The ‘other’ refers not only to funding request, which the company label under other, but also funding request, which include several of types under 200.

³⁶ Recall the difference between cases and requests, as more than one requests can be funded in a single case.

information about the client, the lawyer representing her, the court where the case is handled, and basic facts about the underlying case. For example, if the case involves a car accident the funder documents a short description of facts surrounding the incident. The funder also records the injuries the client suffered, including whether he suffered fractures or needed any surgeries, the length of the medical treatment it went through, and time the client was out of work. Following this preliminary investigation, the funder then collects data on the defendant’s insurance carrier, its rating, and the scope of coverage the defendant holds. Lastly, the funder estimates the underlying case value including the lost wages and medical expenses involved. In our dataset, we have case evaluation for 84% of the cases in which requests were funded or completed. The median (average) case valuation is \$36,000 (\$183,000).³⁷

Once the funds are extended to clients, it takes another 417 days (median) for the case to be completed. Table 1 summarizes the results.

Table 1– Stages of Funding

Time between:	Median # of Days:
Accident to contact	308 days
Contact to 1 st funding	10 days
1 st funding to completion	417 days

C. The Return on the Investment

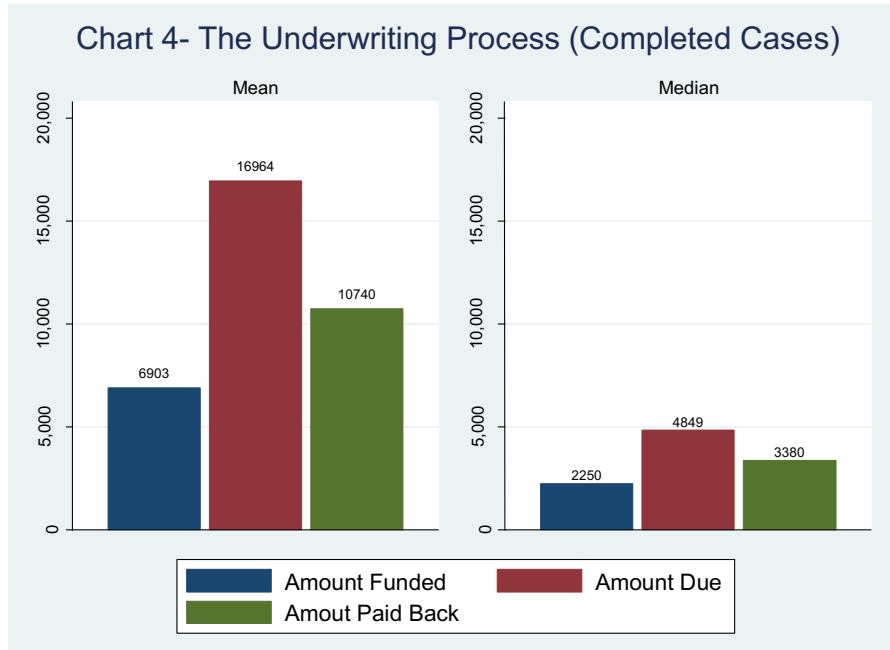
The total amount of money funded by the funder also varied from case to case. The average total amount funded for the 38,318 cases that were completed in our dataset was \$6,903, and the median was \$2,250. The “Amount Due” is the amount owed to the funder when the case settles. The average amount due for the 38,318 cases that were completed was \$16,964 and the median was \$4,849. These numbers reflect a markup of 145% and 115%, respectively.³⁸ However, the Amount Due was not – for various reasons discussed below -- always paid back in full. The “Amount Paid Back” is the amount which the client actually paid back to the funder.³⁹ The

³⁷ It is a limitation of the data set that the funder does not record the gross proceeds recovered by those clients with completed cases who recovered something (which comprise 91% of all completed cases – see Table 8.) There is no way, therefore, to evaluate the accuracy of the case valuations. By way of comparison, a recent study of New York City tort litigation disclosed that average the proceeds paid in both settled cases and adjudicated cases was about \$90,000. See Eric Helland, Daniel M. Klerman, Brenda Dowling, and Alexander Kappner, *Contingent Fee Litigation in New York City* (July 26, 2017) available at SSRN: <https://ssrn.com/abstract=3009453>.

³⁸ We calculated markup in the following way: (amt due/amt funded)-1.

³⁹ As noted above, the funder records only the amount paid by the consumer to the funder—and not the gross or net proceeds in the underlying case. As a result, it is not possible to know,

average Amount Paid Back to the funder is \$10,740 and the median is \$3,380. These numbers reflect a markup of 56% and 50%, respectively. Chart 4 summarizes:



Because the distribution of the amounts funded, due and paid back is skewed by a relatively small number of unusually high outlying amounts (potentially miscoding’s), we will work with the medians as we believe they better reflect the general story we tell in this paper. As Chart 4 shows, had the clients paid back all the money they owed (including the fees), the funder would have had a markup on the median case of 115% for the funding period (417 days-median). However, the amount actually paid back is much smaller, bringing it to a median markup of 50% for the funding period, or 44% per annum. The difference between the amount owed and the amount paid back is because some clients did not pay anything back, and many of them received a haircut on their balances.

We will return to the amount paid back later. For now, we would like to focus on the amount due. Specifically, one would wonder how the funder could be owed extra 115 cents on the dollar in a little more than one year. This is puzzling as the median posted monthly interest rate is 3% in our dataset. So, one would reasonably assume that the yearly interest rate should be 36% and for the length of the funding—42%, as the median length is about 14 months. In other words, the average consumer who might not look carefully at the fine print of the funding contract might reasonably *expect* the cost of funding to be 36% per annum, and, if she knew that the average length of a case to resolution after funding was 14

on average, the percentage of the consumer’s recovery that went to the funder, and the percentage that went to the consumer (and her lawyer).

months, that the total cost of her funding would be 1.42 times her advance. We call this the *expected interest rate*. But the expected interest rate is not the same as the interest rate that the consumer commits herself to pay upon contracting with the funder. There is a puzzling difference between the actual (or embedded) interest rate in the contract and the expected interest rate.

To resolve this puzzle the next section explains the under-the-hood of the funding transactions. It starts by explaining the exact way the interest rates are calculated. Then, it describes various novel features used by funders such as minimum-interest-period and interest buckets. Lastly, it covers the way the fees work in these funding requests.

D. The Determinants of the Effective Interest Rate

1. Compounding

There are three types of interest rates offered to the clients. The most basic one is called “simple” and has no compounding elements in it. If a client received \$1000 with a 3% interest rate, it means that after a year – or 12 months – he owes 36% which translates to \$360 and therefore to a total debt of \$1360. Similarly, after 14 months (which is the median time a case in is completed) he would owe 42% which translates to a total of \$1420. We refer to the 42% interest rate as the expected interest rate. However, less than about 4% of the completed cases were funded with a ‘simple’ interest rate. In 8% of the completed cases the interest rate was compounded annually, meaning that at the end of the year the interest is added to the principal before the next monthly interest rate applies. Thus, in our example above, after a year the client will still owe \$1,360, and yet after 14 months she would owe \$1,443. However, by far the most prevalent type of funding is one where the interest rate is compounded on a monthly basis. Indeed, in about 88% of the completed cases, the interest is compounded on a monthly basis. This means that in our example above after one year our client will owe \$1426 and after 14 months she will owe \$1,513.

This means that disclosure of the compounding type is crucial for client’s welfare. Clients that do not understand that their funding is compounded monthly, as might well be the case, will end up paying not the 42% expected interest on a 14 months funding, but rather 51%. Table 2 summarizes:

Table 2- Hypothetical Amount Due on a \$1000 funding, per type of interest				
Type of Interest	% of Completed Cases Funded in This Way	Amt. Due After 12 Months	Amt. Due After 14 Months	Total Interest Rate per Funding Period
Simple	4%	\$1,360	\$1,420	42% (The Expected Interest Rate)
Compounded Annually	8%	\$1,360	\$1,443	44%
Compounded Monthly	88%	\$1,425.70	\$1,513	51%

As a side note we observe that in our example, we assumed all types of funding come at a 3% monthly interest rate. However, the average monthly interest is not identical between the types but rather varies by type. Cases compounded monthly are charged on average the highest interest rate -- 3.18%; those compounded annually -- 2.50%; and those not compounded at all -- 2.16%.

2. Minimum Interest Period and Interest Buckets

Most cases feature a minimum number of months for which interest will be charged, regardless of the actual length of the funding. For example, a Minimum Interest Period (MIP) of three months means that monthly interest will be charged for the *first* three months even if the money has been paid back within two months. In addition, most cases have another very similar feature called: Interest Buckets (IB), which represents the intervals (in months) beyond the MIP for which interest will be charged, even if the money was paid back at some point during the interval. For example, an IB of three months means that money paid back within 10 months will still be charged interest as if it were paid back after 12 months. Often our dataset features an MIP that equals zero and then a positive IB. In that case the IB starts from day one. Thus, MIP is interesting in and of itself only when it is different from zero and is not equal to the IB. Otherwise, these two features converge to one. Overall only about 10% of our completed cases do not feature one or both of these. Observe that these two features are similar to

early payment penalties: clients pay an extra fee for not paying back at the IB exit stations. We will come back to this point below.

For the monthly compounding, the median MIP is 3 months, and every other IB is also 3 months; For the annual compounding, it is 6 and 6, and for the no compounding it is 3 and 1 months, respectively. Chart 5 presents the results.

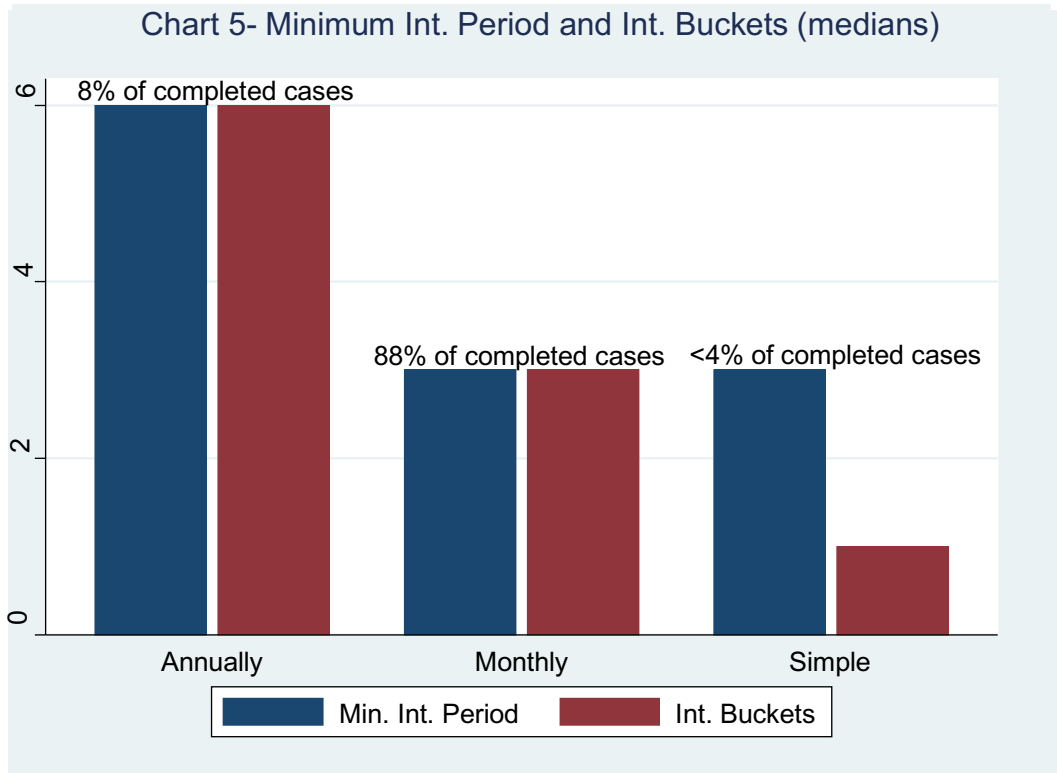


Chart 5 shows for simple interest (which only less than 4% of the completed cases were funded this way) the median MIP was 3 months and the median IB was 1 month. For the annually compounded funding (only 8% of the dataset was funded this way), the median MIP and IB were both 6 months long. Lastly, for the monthly compounded funding, which 88% of the cases were funded this way the median MIP and IB was 3 months.

To demonstrate the impact of the buckets (MIP and IB) on the amount due we present in Table 6 the impact of two representative IBs (3 months and 6 months) on the amount due for a \$1000 funding over a period of 14 months.⁴⁰

Table 3- The Impact of Interest Buckets on Hypothetical Amount Due (Assuming: \$1000 funding, 3% monthly rate, 14 months length)						
Type of Interest	With No IB		With IB=3		With IB=6	
	Amt. Due	Total Int. Rate	Amt. Due	Total Int. Rate	Amt. Due	Total Int. Rate
Simple	\$1,420	42%	\$1,450	45%	\$1,540	54%
Annual	\$1,443	44%	\$1,486	49%	\$1,624	62%
Compounded Monthly	\$1,510	51%	\$1,558	56%	\$1,702	70%

In Table 3 above we suggested that clients who do not understand the difference between simple interest and monthly compounding will be surprised to learn that they will pay 51% instead of the expected 42% on a 14 months \$1,000 funding with 3% interest rate. Table 4 below shows that not understanding in addition the meaning of a 6 months bucket (which is the most prevalent type of bucket for both the monthly and annually compounded funding) might surprise the client even more for she would have to pay 70% on that same funding, 30% more than the

⁴⁰ To make the calculation easier we assume that the MIP is either identical to IB or is equal zero. This assumption allows us to use just the IB.

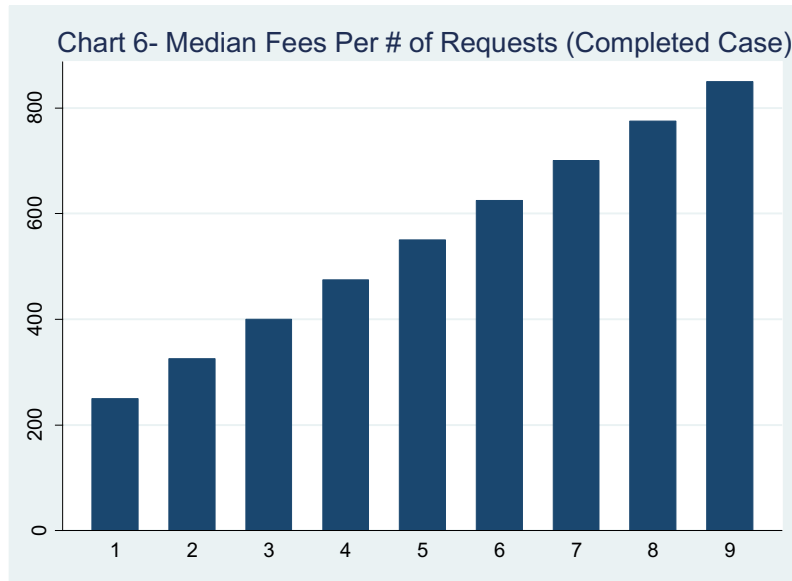
expected interest rate she would have paid with simple interest and no buckets – 54%.

3. Fees

Another way in which clients pay funders is through fees. The fee is a contingent one, paid if and when the client pays money back to the funder. Thus, in effect, the fee amount is added to original amount funded, only that the client never receives this amount – it stays with the funder. As was noted above, the putative rationale for a fee is that the funder has to spend money up front to determine whether to fund a case. Why this is not simply counted as overhead is unclear, but there are other consumer finance industries, such as the residential mortgage industry, that charge fees in a similar way. Unlike the residential mortgage industry, however, only a subset of the applicants whose applications are processed pay the processing fee, since the fee is paid *ex post*. The only applicants who actually pay the funder a fee are those applicants whose cases are funded *and* produce a recovery larger than the amount funded. In effect, the funder absorbs the cost of fully or partially vetting applicants it rejects as well as applicants it accepts but whose cases yield no return, as overhead.

In other words, only “winners” pay the fee, while “losers” get their fee waived. Further, since the fees are not “paid” until after a client knows she is a winner, they are treated as an advance, and the cost of the advance is compounded at the same terms the original funding is compounded.⁴¹ The most frequent fee for the *first* funding request in a completed case is \$250, 54% of the completed cases were charged this fee. A fee of \$350 follows this (24% were charged this fee). Then, a fee of \$150 (18% were charged this fee). Recall however that many cases have more than one funding request. In these cases, any additional request for funding is usually accompanied by a \$75 charge. Chart 6 presents the average total fee paid in completed cases per the number of requests.

⁴¹ There is another type of fee, which is not compounded. This fee covers actual small costs (such as FedEx, etc.), which the funder paid external entities for their services. This fee is not included in the analysis.



All in all, in the completed cases in our dataset the average fee paid was \$308 on an average of \$6,919 amount funded, which is about 4.5%. The median fee was \$250, which amounts to 11% of the \$2,250 median amount funded. But both the 4.5% and the 11% are misleading. In practice, the fee varies by the size of the amount funded. Thus, when we calculate the ratio of the fee to amount funded in every single case, we find that the median (average) ratio of the total fees to the amount funded is an astonishing 12.5% (15%).

This fee, recall, is compounded with the rest of the amount funded. Therefore, we can translate it to an effective interest rate. Table 4 demonstrates the impact of this fee on the interest rate the client would have ended up paying had the funder charged him higher interest rate instead of a fee. To make it tractable we present the results just for cases that were compounded on a *monthly* basis, which is the most prevalent type of compounding. Table 4 thus copies the last line from Table 3 and adds 12.5% fee to the amount funded.

Table 4- The Impact of Fees on Hypothetical Amount Due (Assuming: \$1000 funding, 3% monthly rate, 14 months length, \$150 fee)							
Type of Interest	Fees	With No IB		With IB=3		With IB=6	
		Amt. Due	Total Int. Rate	Amt. Due	Total Int. Rate	Amt. Due	Total Int. Rate
Compounded Monthly	None	\$1,510	51%	\$1,558	56%	\$1,702	70%
Compounded Monthly	15%	\$1698.75	70%	\$1,753	75%	\$1,914	91%

Recall that with a simple interest the expected interest rate paid on a 14 months funding with no buckets was 42%. Table 4 shows that once fees are added to the calculation the median case with a six months bucket is effectively charged 91%, which is 2.16 times the simple interest rate of 42%.

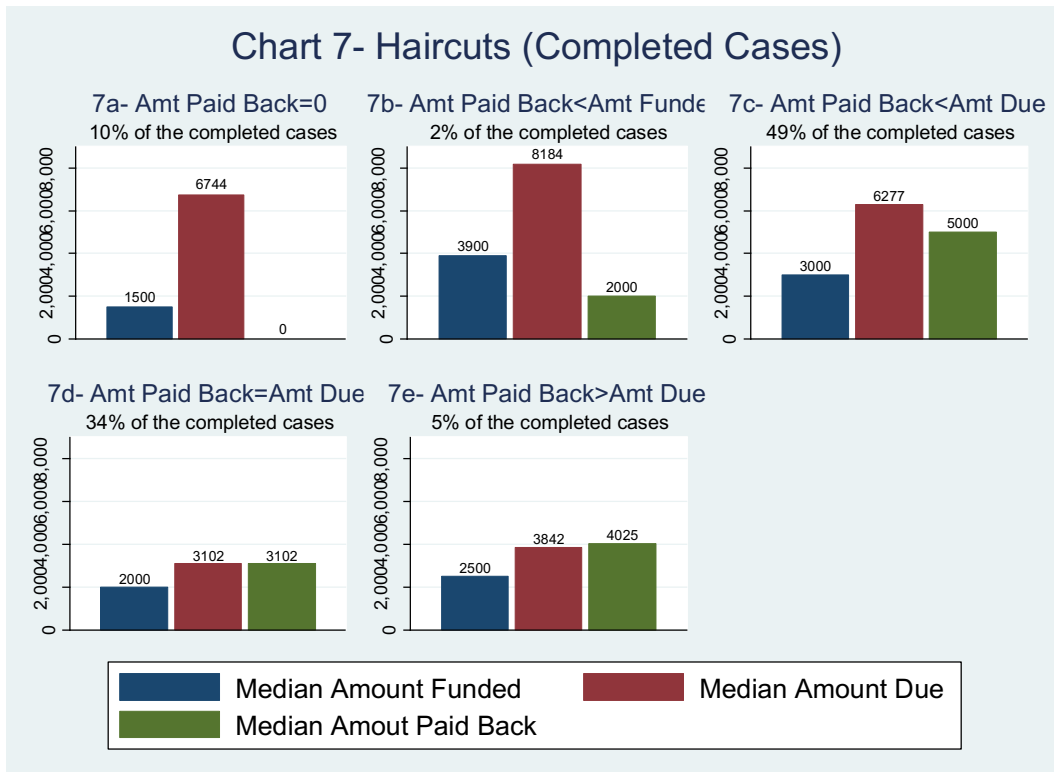
Lastly, recall that we started this section with the puzzling question of why there is a markup of 115%. In this section we were able to explain how one might get to 91% over the median period. The remaining difference is probably due to averaging and rounding error in the various steps we have taken. For example, we have used a monthly interest rate of 3%. Had we used the median interest rate in our dataset which is 3.2%, we would have gotten to 99% instead of the 91% mentioned in Table 4.

However, recall from Table 3 that the amount paid back was much lower than the amount due. Whereas the median amount due was 115% higher than the median amount funded, the median amount paid back was about 50% higher. This large haircut is explained in more detail in the next section.

4. *Haircuts*

Of the 38,318 cases completed in the dataset, in 10% of the cases the client paid nothing. The reasons for a \$0 payment to the funder are various. The client may have lost the case or accepted a voluntary dismissal. Or, the money she received from the defendants was insufficient to cover outstanding liens against her, including her own attorney's liens for costs and expenses.⁴² In an additional 2% of the cases the funder received a positive amount but which is only equal or lower than the amount funded. In these cases, there is a positive recovery (either a judgment or settlement) but, for reasons not disclosed in the data (e.g. liens, etc.) there is nothing left to pay the premium component of the return based on the embedded interest rate. In contrast, in the remaining 88% of the cases, the client paid back more than the amount she was funded, which means the funder made some profit. In a little more than half of those cases the funder recovered less than the amount due, whereas in a little bit less than half it recovered the amount due or even more. Chart 7 provides more details.

⁴² As was noted in the *2009 Report to Maine I & FS Committee, supra* note 28 at 3, "large competing liens and debts owed by the consumer (such as medical provider liens, back child support, back taxes or separate civil judgments against the plaintiff) that must also be paid out of any recovery and that have priority status over the lien of the legal funding advance."



As Chart 7a shows in 10% of the cases there was a complete default, the funder lost 100% of its investment. Chart 7b shows that in 2% of the cases the funder got some money back. Funder in those cases lost almost half of its investment.

Of the 88% of the completed cases where the funder made some profit, as Chart 7c shows, in almost one in every two completed case which paid back more than the principal the client got a haircut and did not pay back the entire amount due. In those cases, the funder earned an interest rate of 66% profit. Next, as chart 7d shows, about one-third of the clients pay exactly the amount due. In those cases, the funder earned an interest rate of 55%. Lastly, about 5% paid back even more than the amount due. In those cases, the funder earned an interest rate of 61%.⁴³ There is an interesting irony reflected in the results in Chart 7c and 7d. The funder made more money on those cases where it agreed to take a haircut than those where it took no haircut (66% v. 55%). In fact, the irony is double, since the embedded interest rate for the cases in chart 7c

⁴³ This is roughly consistent with some anecdotal reporting by industry actors. See Martin Merzer, *Cash-Now Promise of Lawsuit Loans Under Fire*, Fox Business (Apr. 19, 2013) (quoting Eric Schuller, director of government affairs for Oasis Legal Finance: “in 47% of the cases we fund, we get less than our contracted amount. 22% of the time, we get less than the principal back, and 10% of the time, we get zero back”) at <http://www.foxbusiness.com/personal-finance/2013/03/29/cash-now-promise-lawsuit-loans-under-fire/>.

(the haircut cases) is almost double the embedded interest rate for the cases in chart 7d (the full payment cases).⁴⁴

In table 4 we saw that due to compounded interest, buckets, and fees the amount due by the client in an average case translates to an annual interest rate of 78%, which, given the median length of a funding in our dataset (14 months), would yield a return on each of the funder's investments of 91%. However, as chart 7c shows, even though the funder makes some profit 88% of the time, in almost half (49%) of the overall number cases the funder receives less than it was entitled to receive per the funding agreement.

We could not tell from the data why the funder accepted less than they were contractually owed by the client in these cases. It may have been because, although the client's case was settled for a positive amount – large enough to cover the repayment of the advance and some of the amount due – it was not large enough to cover all of the amount due. Another likely explanation is that, although the client received sufficient net proceeds from the resolution of her case to cover the amount due, the proceeds were less than she and her lawyer anticipated and therefore the funder agreed voluntarily to forego its legal right to full payment of the amount due. This is what we have called the haircuts to the amount due.

The cumulative effect of these haircuts is significant: Recall from Chart 4 that after accounting for the risk of a complete default and no return on investment at all, the funder makes an average of 50% on the median case, whereas had the funder been able to receive the amount due in all the cases where the client fulfilled her agreement with the funder (the embedded interest rate), the funder would have received 115% in the median case.

This means that those clients who do not receive any haircut (39% of the clients) cross-subsidize the clients who default (10% of all clients), pay no premium for their advance (2% of all clients), or receive the haircuts (49% of the successful clients). Those who pay “full freight” generate the cross-subsidy via the features of compounded interest, buckets and fees) so that in effect the funder earns interest rate of 50%, after accounting for defaults and haircuts—in 14 months.

The number 50% is interesting because it is so close to the expected simple interest rate of 45%. The posted median interest rate of 3.2% monthly translates to a 38% annual simple interest rate, which, given the median length of a funding in our dataset (14 months), would yield (assuming no compounding, buckets, fees, etc.) an average return on each of the funder's investments of 45%.

⁴⁴ Perhaps the haircuts are nothing more than proof of the adage, “if something looks too good to be true, it probably is.”

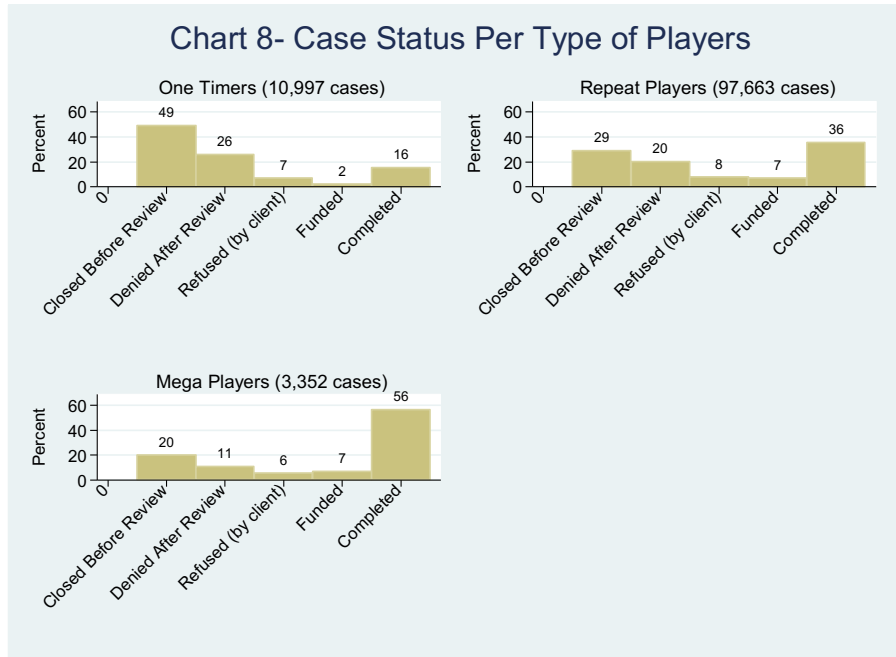
In other words, through a very complicated and circuitous process the funder ends up with a return on its capital that is higher than in a regime in which every client took out a recourse loan at a simple 3.2% per month without any compounding, minimum interest periods, interest buckets, or fees.⁴⁵ It also represents an annual cost of capital (44%) to the consumer that is higher than most forms of borrowing available to consumers, although it is still relatively less expensive than other forms of non-recourse consumer lending, such as payday lending.

E. Law Firms

There are 20,125 different law firms in our dataset. Of those, 10,997 law firms (55%) brought just one case. The rest are repeat players who brought more than one case. Specifically, 16% brought two cases, 8% brought three cases, 4% brought four cases, etc. Overall, 90% of the law firms brought less than 10 cases. At the other end of the distribution we found that one law firm brought 2,317 cases; another firm brought 1,035 cases; six more firms that brought between 500 to 1000 cases; and 123 firms brought between 100 to 500 cases.

We were interested to study whether the repeat players are different from one-timers. To do that we compared the 10,997 law firms that brought only one case, the 9,126 firms that brought between 2 – 1000 cases, and the two “mega repeaters” that brought over 1000 cases each to the funder. We called the first group the “one-timers,” the second group the “repeat players,” and the third group the “mega-players”. The result are in Chart 8.

⁴⁵ Our findings are consistent with the results drawn from a much smaller study. See Xiao 2017 *supra* note 26. That study found that funders encountered a default rate of approximately 8% and took haircuts in 47% of all completed cases – rates almost identical to our results. Xiao’s results differ from ours in certain aspects. The average duration of the cases in her study was 11.4 months and the average gain relative to the amount funded, net defaults and haircuts, was 58%. Our results for the median case are 14 months and 50%. It is striking, however, that despite the difference in the average length of time of the advance extended by funders, the net average gain for funders in both studies is almost identical.



As Chart 8 shows, the funding applications submitted by clients of repeat players were more likely to be approved than the applications of one-timers. Whereas 25% of the roughly 11,000 cases brought by client of one-timers were accepted, 51% of the roughly 98,000 cases brought by the repeat players were accepted, and 69% of the roughly 3,400 cases brought by the mega-players were accepted. At the end of the day, only 18% of the clients of the one-timers received funding, 43% of the repeat players’ clients received funding and, 63% of the mega-players’ clients received funding. Recall that, by comparison, the median approval rate for all 111,000 cases was 48% and the median percentage of applicants who received funding was 40%.

Another interesting question is whether the characteristics of the *completed* cases differ between clients of one timers, the repeat players, and the mega-players. Chart 9a presents the funding terms clients of each type of player are getting.

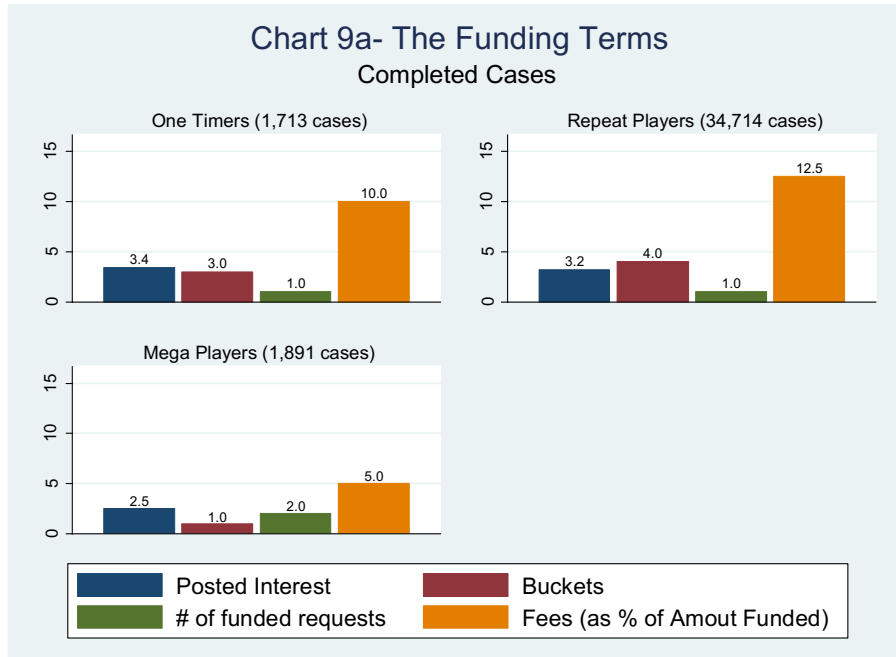
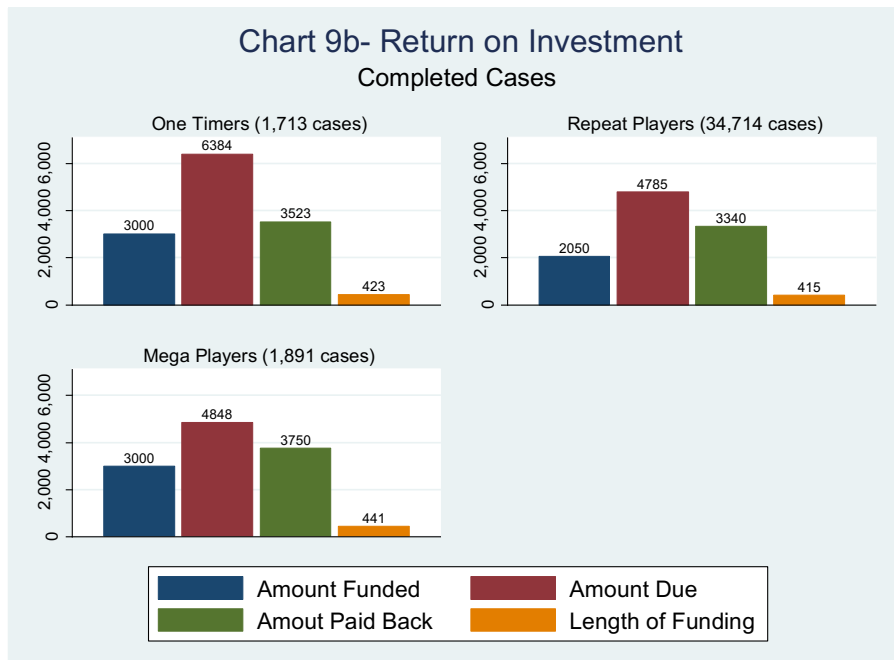


Chart 9a shows that cases brought by clients of the mega-players get better *ex-ante* terms than either the one-timers or the repeat players in various ways. First, the median posted monthly interest rate is smaller -- 2.5% instead of 3.4% for the one-timers and 3.2% for the repeat players. The median length of the buckets is 1 month instead of 3 months for the one-timers and 4 months for the repeat players. The mega-players get an extra funded request per case than either the one-timers or the players. Finally, the median percentage fee (relative to the amount funded) their clients pay is half of the one-timers' clients' median percentage fee -- 5% instead of 10%, and less than half of the fee paid by the rest of the clients, who, as we saw above in Section D.3., pay a median fee of 12.5% of the amount funded.

Interestingly, we found no difference in the type of compounding: clients of one-timers, repeat players and mega players get primarily interest rate that is compounded monthly.

One would expect that the better terms that clients of the mega-players get will translate to lower paybacks to the funder. Surprisingly, this is not the case. Chart 9b presents the return on the investment to the funder.



We first observe that the median amount funded is identical for the one-timers and the mega-players—\$3,000—and is lower for the repeat players (\$2,050). Next, we observe that the embedded rate (median amount paid back to median amount funded) is much lower for the mega-players’ clients (62%) than the clients for either the one-timers (113%) or the repeat players (133%). This makes sense given the results in Chart 9a – the mega-players’ clients got much better terms *ex ante* than any other client whose case was funded.

What is striking, however, is the variation of the embedded and effective rates among the clients of the three types of firms we examined. The one-timers’ clients paid an effective interest rate (median amount paid back to median amount funded) of 17%, compared to an embedded interest rate of 113% based on their amount due. The repeat players’ clients paid an effective interest rate of 63%, compared to an embedded interest rate of 133% based on their amount due. The mega-players’ clients paid an effective interest rate of 25%, compared to an embedded interest rate of 62% based on their amount due.

Each of these groups of clients got a reprieve from the funder; these are the haircuts identified in Section D.4. It is plausible that the mega-firms negotiated relatively good deals *ex ante* for their clients – the embedded rates secured by these clients are half of the rates obtained by all the other clients represented by the other firms. As a result, the mega-players’ clients could only get so much of a rate reduction before it reached zero. But the mega-firms’ clients still got haircuts more often than clients represented by the repeat players or the one-timers. As Table 5 illustrates, the mega-players’ clients got haircuts in 59% of their completed cases, compared to 48% for all the other firms’ clients.

Table 5- Defaults and Haircuts by Law Firm Type (38,318 Complete Cases)			
	One Timers	Players	Mega-Players
Complete Default	15%	10%	8%
Amount Funded Not recovered	3%	2%	2%
Amount Due not recovered	48%	48%	59%
Amount Due recovered	29%	34%	25%
More than 100% Recovered	5%	5%	5%

Recall that in Chart 4 we reported that for all cases, the median effective rate was 50%, and the embedded rate was 115%. Not surprisingly, the repeat players’ clients, who made up 88% of the cases in Chart 4, resembles the median case in many respects. We observe, however, that the cases brought by the clients of one-timers and the mega-players behaved very differently than the median or the repeat players’ clients’ cases. First, the one-timers’ cases turned out to be poor performers for the funder. The gap between the expected return – the amount due – and the actual return – the amount paid back was huge (113% vs. 17%). This was the result of two factors. First, a relatively large number of defaults (and negative capital recoveries), and second, large haircuts, frequently given. The mega-players also did not generate high effective rates for the funder, either – only 25%. But the funder probably saw these cases as good performers. The default rate (and negative capital recoveries) for the clients of the mega-players was almost half that of the clients of the one-timers. And, although haircuts were given generously (59% of all completed cases) the funder still got much of what it had expected, since the gap between the embedded rate and the effective rate (62% vs. 25%) was relatively narrow compared to the clients of the one-timers.

The analysis above leads us to hypothesize that a poor outcome for a first-time client turns some lawyers into one-timers. The funder may not want to deal with a lawyer who had brought it a case that defaulted or needed a large haircut. It is also possible that a lawyer whose funded client defaulted or who needed a large haircut might shy away from encouraging other clients to pursue

funding. Mega-players are the flip-side of the one-timers. The funder had such a good experience with the mega-firms' clients that they offer multiple benefits to their clients. First, the mega-players' clients are significantly more likely to be approved for funding; second, they receive significantly better terms *ex ante*, and third, they are significantly more likely to receive a haircut once they complete a case. The cases the mega-firms bring are good enough, in fact, that the funder finds it profitable to give their clients a large discount on the price of funding compared to the rest of the cases they fund.

Xiao (2017) hypothesizes that “a longer financier-law firm relationship duration is associated with a lower absolute return, a lower return ratio, and a lower interest rate” than the default rate of cases brought by one-timers.⁴⁶ Our result is consistent with this hypothesis, since it is likely that the mega-players have a long-term relationship with the funder. It is possible that repetitious, routinized interactions between law firms and funders create higher degrees of trust that are reflected in higher approval rates. It is equally likely that repeat interactions result in lower screening costs and long-term relationship incentives that allow funders to lower the cost of funding *ex ante*.⁴⁷

II. A REVIEW OF THE RESULTS

This paper provides numerous insights into the practice of consumer litigation funding that answers a few questions and may help shape future policy debate.

First, we show that consumer litigating funding is based on underwriting criteria which result in a significant number of applications screened out and rejected. While these results do not, in themselves, indicate that the cases accepted by TPF funders are meritorious, they indicate that funders are exercising a certain degree of discrimination in the underwriting/selection process. As other commentators, have noted, TPF providers “focus on basic information about the lawsuit” and “the strength of the consumer’s case” when deciding whether to reject the application.⁴⁸ As a matter of economics it would make sense for a funder to take steps to screen potential lawsuit investments in favor of those they reasonably believe are stronger, both from the perspective of portfolio theory and in order to credibly signal to adverse parties that the lawsuit they face is credible.⁴⁹ The fact that in order sample set the funder

⁴⁶ Xiao 2017 *supra* note 26 at 124.

⁴⁷ *Ibid* at 114 (discussing research on relationship lending that suggests that duration is correlated with reduced interest costs).

⁴⁸ Paige Marta Skiba and Jean Xiao, *Consumer Litigation Funding: Just Another Form of Payday Lending?*, 80 LAW & CONTEMP. PROB. 117, 123 (2017) (“The financier assesses the strength of the consumer’s case by looking at factors such as potential damages.”).

⁴⁹ See Avraham & Wickelgren, *supra* note 10.

rejected more than half of the cases presented to it is consistent with this prediction.

Tort reform groups and some scholars have argued that TPF will fuel frivolous litigation.⁵⁰ The tort reform argument has not held up well under serious academic scrutiny.⁵¹ This article does not directly engage this debate, although our results do provide additional reasons to be skeptical of the tort reformers' claim. The putative incentive driving a consumer to bring a frivolous claim she would not otherwise have brought is very weak. Recall that we found that funders rejected slightly more cases than they accepted. Given all the other, much more significant steps that precede the point in time when a funding application is evaluated – finding a lawyer, retaining a lawyer, and then submitting an application to a funder – it is unclear whether a 50% chance at funding would comprise a salient incentive for a party choosing whether to file a lawsuit.⁵² In fact, there could also be the opposite effects – rejection by the funder might serve as a negative signal to the plaintiff or her lawyers and this in return might cause them to drop the case or agree to a low-ball offer.

Second, we show that consumer litigation funding pricing is complex and opaque. The final amount due to the funder upon contract is based on a number of variables, including the advertised interest rate, the type of compounding, the inclusion of interest buckets and minimum interest periods, and the addition of non-recourse fees, which are advanced and treated as contingent costs paid only by clients that paid back their amount due. The implications of this finding are potentially quite significant. It suggests that consumers seeking litigation funding may benefit from less opaque contracts terms even in states that have called for full disclosure of the interest rate.

Others have already noted that TPF contracts are *more* opaque than payday loan contracts, a form of subprime lending to which TPF has been compared.⁵³ Skiba and Xiao observe that the contingent nature of the outcome – the very thing that justifies the relatively high price paid by the consumer for the advance she receives, and which separates it from a loan, makes it much harder

⁵⁰ See Sasha Nichols, Access to Cash, *Access to Court: Unlocking the Courtroom Doors with Third-Party Litigation Finance*, 5 U.C. IRVINE L. REV. 197, 228 (2015) (“[Businesses fear that] giving potential plaintiffs and litigators more money will ‘permit[] [them] to offload risk’ and encourage plaintiffs and attorneys to file more lawsuits, many of which would be frivolous.”) citing U.S. Chamber, *Selling Lawsuits*, supra note 11 at 5, and see Jeremy Kidd, *Modelling the Likely Effects of Litigation Financing*, 47 LOYOLA U. CHI. L.J. 1239 (2016).

⁵¹ See Shepherd & Stone, supra note 8 at 950 (the claim “that financing encourages frivolous litigation . . . is easy to dispatch”).

⁵² In addition, funding could only be an incentive if it plays a factor in the decision to file a lawsuit. We know that a median case generates a funding application 308 days after the (putative) injury. See Table 1. If the lawsuit upon which the funding application is based was filed much earlier than the funding application, the claim that the availability of funding drives claiming of any sort – much less frivolous claiming – would be still weaker.

⁵³ Skiba and Xiao, supra note 48 at 127 – 28.

for the consumer to comprehend and compare to a loan.⁵⁴ We would add to this that a further source of potential consumer confusion is the specific way that these contingent contracts have been drafted. The employment of interest buckets and minimum interest periods, and the addition of fees takes a consumer who is already unlikely to rationally evaluate the cost of the advance and increases her potential misunderstanding.⁵⁵

The comparison with payday lending raises interesting questions about the evolution of the TPF industry, which has, generally speaking, followed different contract models in its commercial and consumer branches. As noted in the Introduction, a commercial TPF advance typically entitles the funder to a portion of the client's net recovery or, more typically, a multiple of the initial advance.⁵⁶ Although no legal impediment exists, commercial TPF providers simply do not employ the "loan-like" model universally employed by consumer TPF providers, and vice versa. This may be a result of historical accident and path-dependency, as well as other contingent factors such as the fact that commercial TPF arose out of the efforts to treat litigation rights like securities.⁵⁷ Commercial and consumer TPF share, the same legal DNA – they are both the sale of a general intangible, as the UCC would describe it.⁵⁸ But commercial TPF looks like, and behaves like, venture capital or some other form of investment vehicle, while consumer TPF looks like, and behaves like, a sub-prime debt product.⁵⁹

⁵⁴ *Ibid* ("funding's relationship to lawsuits hides its impact on consumers' cash flow due to the effects of salience, differential mental accounting, and lack of the pain of payment").

⁵⁵ Many people lack an understanding of numeracy (that is, "the capacity to do a simple calculation related to compounding of interest rates"), inflation, and risk diversification. See Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 52 J. ECON. LITERATURE 5, 10 - 12 (2014) (summarizing studies in which consumers did not understand compounding interest).

⁵⁶ "In fact, the funder often calculates its rate of return as a multiple of the amount invested rather than a percentage of the amount recovered." Victoria A. Shannon, *Harmonizing Third-Party Litigation Funding Regulation*, 36 CARDOZO L. REV. 861, 894 (2015).

⁵⁷ The earliest attempt at modern commercial TPF may be the 1976 attempt by an attorney to raise funds for an antitrust suit by selling shares in the suit to investors. See Daniel C. Cox, *Lawsuit Syndication: An Investment Opportunity in Legal Grievances*, 35 ST. LOUIS U. L.J. 153, 154-55 (1990). See also Donald L. Abraham, Note, *Investor-Financed Lawsuits: A Proposal to Remove Two Barriers to an Alternative Form of Litigation Financing*, 43 SYRACUSE L. REV. 1297 (1992) (describing efforts in the 1980's at lawsuit syndication).

⁵⁸ "General intangibles" are defined in Article 9 of the UCC as 'any personal property, including things in action, other than accounts.' UCC 9-102(a)(42) (emphasis added). The official commentary further makes clear that "general intangible" is a residual category intended to serve as a catchall for various types of collateral which are not otherwise specifically defined in Article 9. UCC § 9-102, cmt. 5(d)." *U.S. Claims, Inc. v. Flomenhaft*, 519 F. Supp. 2d 515, 528 (E.D. Pa. 2007). TPF contracts are simply contracts to purchase contingent proceeds arising from choses in action. See *Devon IT v. IBM Corp.*, 2013 U.S. Dist. LEXIS 184278 at *15 - *16 (E.D. Pa. Nov. 21, 2013) (discussing commercial TPF contract). While some courts have held that consumer TPF contracts create consumer debt, this view is widely rejected. See Victoria Shannon Sahani, *Reshaping Third-Party Funding*, 91 TUL. L. REV. 405, 411 ("The vast majority of states that regulate third-party funding do not characterize third-party funding as a loan, but Colorado provides a notable exception.") (citing *Oasis Legal Fin. Grp., LLC v. Coffman*, 361 P.3d 400 (Colo. 2015)).

⁵⁹ Compare Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455 (2012) (commercial TPF as venture capital) with Hashway, *Litigation Loansharks*, *supra* note 12 (consumer TPF as usurious lending).

The results of this study suggest that, although the actual cost of capital to consumers is less than many critics believe, the design of the TPF contract is different from the design of commercial litigation contracts in ways which are hard to explain or justify. For example, why, if consumer TPF is essentially the same “product” as commercial TPF, is the former priced like a loan and the latter priced like a contingent property interest? This question is especially pointed given that the consumer shopping for TPF already has had direct experience with one form of contingent property contract – the contingent fee agreement she (presumably) already signed before, and in order, to secure her TPF. We cannot prejudge whether consumer TPF contracts should resemble commercial TPF contracts in price.⁶⁰ We want to suggest that, rather than focus entirely on the price of consumer TPF, reformers should focus on why the industry has collectively added to their basic price additional cost-generating features such as non-recourse application fees, various types of compounding, minimums interest periods, and buckets – features found in neither commercial TPF nor the standard contingent fee offered by lawyers to their clients.⁶¹

We observe the buckets function similar to early penalties which is a feature known in mortgage lending and cellphone contracts. However, whereas in mortgage lending and cellphone contracts one can provide economic justification for such practice, in TPF we could not find one. In cell phone contracts the early penalty enables the provider to offer a free device to its consumers. This “free” device is being paid by consumers throughout the length of the contract. In a world without early penalties consumers will not be able to get the benefit of a new device. The economic rationale for early penalties in mortgage lending is different. In the mortgage lending world, the reason for the early penalties stems from the advantage the borrower has over the lender vis-à-vis changes in interest rates. Because clients have always the option to refinance, lenders worry about adverse selection (or de-selection). Specifically, lenders worry that borrowers refinance whenever the interest rate goes down, whereas lenders does not have a symmetric option to force a refinance when interest rates go up. The early penalty fee provides a share to the lender from the profits borrowers make when interest rates go down and they refinance.

⁶⁰ It is clear from the few publicly available reports we have seen that, on average, commercial TPF rates exceed the actual rates paid by consumers in our survey.

⁶¹ Contingent fees are controversial in their own right and have been the subject of debate for decades. It is possible that the conventional price for plaintiff’s legal representation for consumers – between 30% and 40% of net recovery -- is, in effect, much higher than the real cost of consumer TPF reported in this study (56% of every dollar advanced). That is not the point. The point is to ask why consumer TPF is priced so differently than a lawyer’s contingent fee, given that the two products offer overlapping (but not identical) services. See Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 653 (1995) (discussing the various products “bundled” into a contingent fee, which include, among other things, consumer credit).

Third, we show that the pricing of consumer litigation funding is dynamic *after the initial price is set, at the end of the life-cycle of the funding relationship*. After the resolution of the consumer's case, there is a widespread practice of underpayment by the consumer to the funder. See Chart 7. More than half of the consumers who receive funding pay less than the amount due agreed at contract. There is a significant gap between the amount that funder gets the consumer to promise to pay upon contracting (the embedded rate) and the amount the funder receives upon resolution of the consumer's case (the effective rate). The embedded rate may indeed be 101% per annum in the median case, while the effective rate is closer to 44% per annum.

Fourth, we show that lawyers matter in the formation and execution of the consumer TPF contract. Lawyers' experiences with consumer TPF is correlated with the likelihood that their clients will have their cases approved for funding; the terms of their funding *ex ante*; and the actual markup earned by the funder from the funding contract *ex post*. Certain lawyers, who have formed very strong relationships with the funder, appear to be able to provide the funder with portfolios of cases in exchange for lower funding costs to their clients *ex ante*, while others, who have less experience with the funder, achieve savings for their clients by securing cost reductions *ex post*.

III. IMPLICATIONS FOR POLICY

These four insights into the behavior of the consumer TPF contract from initial contact between consumer and funder to the conclusion of their relationship raises two areas of further inquiry.

A. Consumer Protection

As already mentioned above, the controversy surrounding consumer litigation funding includes calls for various types of consumer protection. The two leading approaches are (a) to insist on greater clarity in the contracts or (b) to place caps on the maximum amount that a funder may charge as a per annum interest against the advance. Our research suggests a third form of consumer protection: The prohibition of contract terms that are likely to conceal the embedded interest rate from the consumer. The embedded interest rate is a result of four features that may present jointly or severally, in the funding contract: monthly and annual compounding, investment buckets, minimum interest periods, and fees advanced on a non-recourse basis. Together, these produce an opaque pricing system that converts what seems to be a simple expected premium of 42% for the typical advance for 14 months to an embedded rate of 115% in the median case.

B. Legal Ethics

This article demonstrates that the effective interest rate *paid* by consumers in completed cases is very different from the interest rate embedded in the contract before those cases are completed. We know more about the process that generated the median embedded interest rate than the effective interest rate, since every consumer within our study had to receive terms from the funder (although we do not know how many of those consumers dickered over those terms).⁶² We know less about the process that generated the effective rate because not every consumer received a haircut. Of the 32,781 consumers who paid the funder back at least the advance they received, 18,799 – more than half – got haircuts of varying degrees (*see* Chart 7c). We assume that the funder did not offer the concession without a rational motivation. The most likely motivation is that the consumer balked at paying the full price to which she had agreed. Perhaps some consumers balked because they received a lower net recovery (after paying their lawyers and liens) than they had expected, and wanted to increase their own net recovery at the funder's expense.

It is very hard to imagine the consumer negotiating directly with the funder with any success. The prevalence of the haircuts and their role in bringing the actual interest rate down to the levels we have demonstrated seems to point to an important and hidden role of the consumer's lawyer in the funding relationship after the funding contract had been negotiated and signed by the consumer. This study has already pointed to strong circumstantial evidence that the funder cared about the identity of the lawyer connected to the cases it funded; as seen in Section I.E., the funder treated clients of one-timers, repeat players, or mega-players very differently at every stage of the funding process. This section assumes that differential treatment, when it occurs, is not the result of unilateral decision-making by the funder, but of bilateral negotiation between the funder and the lawyer on behalf of her client. This section asks, to the extent that the lawyer is playing an active role in securing advantageous treatment for her client, what, if any, are the lawyer's obligations to that client and to call her other clients similarly situated?

Various ethics opinions have considered whether a lawyer can assist her client in applying for or receiving funding.⁶³ All have assumed that the question of a lawyer's obligations to a client arise at the point where the client is pursuing TPF or is in the midst of litigation. None deal with the question of whether the lawyer has a

⁶² We know, for example, that there seems to be a correlation between the terms offered by the funder to clients whose cases are funded depending on whether the clients are connected with lawyers who are one-timers, repeat players, or mega-players. See Section I.E.

⁶³ *See, e.g.* Ohio Supreme Court Bd. of Commissioners on Grievances & Discipline, Op. 2012-3 and New York City Bar Association - Formal Opinion 2011-02 (detailing obligations of lawyer whose client requests assistance in obtaining consumer TPF).

duty to assist the client in negotiating with the funder after the client's case has been resolved. One New York case has dealt with this issue. In *Francis v. Mirman, Markovits & Landau PC*, a client alleged that his lawyer failed to competently negotiate with two consumer TPF providers, leaving him with a net recovery of \$111 out of a \$150,000 settlement in a personal injury claim.⁶⁴ The court held that the lawyer had assume no duty to protect the client in his dealings with a third party, such as TPF firms, after the resolution of suit.⁶⁵ What strikes us as interesting is that the decision indicates that the lawyer did negotiate a \$2500 haircut on behalf of the client.⁶⁶

A case like *Francis* may have been correctly decided, in a world where lawyers are not typically or regularly communicating with funders, but if it turns out – as we have demonstrated – that negotiations over the final price of consumer funding is a regular part of the funders' business model, then a lawyer may have an obligation not explicitly recognized by the *Francis* court. It is hard to specify where this obligation falls under the Model Rule Professional Conduct ("MRPC" or the "Rules"). If a lawyer is not obliged to represent a client vis-à-vis a funder after the client concludes a lawsuit, then the lawyer has not violated Rule 1.1 (competence) if the lawyer fails to get a better result (or any result) vis-à-vis the funder.⁶⁷ Nor is the lawyer violating the prohibition on aggregate settlements (Rule 1.8(g)) by not telling the client about the haircuts that other clients may have received.⁶⁸

But it seems to us that there is something odd about a lawyer disclaiming any obligation to treat all similarly-situated clients equally just because the way in which the similarly-situated clients are treated differently is outside the scope of representation. To be sure, a lawyer does not have to treat each of her clients equally outside the performance of her representation: She can socialize with some but not others, and she can share with some, but not others, private information about financial opportunities as she sees fit.⁶⁹ The extra attention or benefit given by the lawyer to the client is supererogatory and not required. We believe, however, that the phenomenon we have identified goes beyond conceding that a lawyer

⁶⁴ N.Y. Sup. Ct. Kings Cty., No. 29993/10 (January 3, 2013). The client, who settled his case for \$150,000, paid his lawyer a contingent fee of \$50,000; had expenses of \$2,211 and owed two TPF firms \$98,415 arising from two advances totaling \$27,000.

⁶⁵ The court held that the fact that the law firm acknowledged the funding agreement did not constitute an expansion of the scope of representation to include contracts with the funders. *Ibid.*

⁶⁶ *Id.*

⁶⁷ See Rule 1.1 (Competence).

⁶⁸ See Rule 1.8(g) Conflict Of Interest: Current Clients: Specific Rules (on client consent in aggregate settlements).

⁶⁹ Newly adopted Rule 8.4(g) prohibits lawyers "to engage in conduct that the lawyer knows or reasonably should know is harassment or discrimination on the basis of race, sex, religion, national origin, ethnicity, disability, age, sexual orientation, gender identity, marital status or socioeconomic status in conduct related to the practice of law". Even if this rule applied to the delivery of law-related services (see *infra*) it would not apply to the different outcomes for clients based on factors not listed in this rule.

need not treat all her clients the same with regard to the occasional financial opportunity that she might run across. Our analysis is based on the intersection of two principals in the law of lawyering – the idea that some non-legal activities carry with them obligations, in their performance, similar to those of legal activities, and the idea that a lawyer faces a conflict of interest if there is a significant risk that her ability to represent a client is materially affected by a personal interest.

First, it is likely that consumer TPF is a “law-related” service as that term is used in the Rules.⁷⁰ Rule 5.7, which discusses law-related services, approaches the issue from the perspective of a lawyer who provides a law-related service in the context of a discrete transaction, where the client purchases the service from the lawyer in a transaction separate from the lawyer’s representation.⁷¹ In the problem posed by the haircuts, the lawyer is not performing the law-related service for money but is doing it gratuitously. We do not see the difference of payment to be important. The only question is whether the client is owed the extra obligations that a lawyer owes a client in the course of providing the service if there is a risk that the typical client would “fail[] to understand that the services may not carry with them the protections normally afforded as part of the client-lawyer relationship.”⁷² We think that this condition is satisfied in the context of an attorney who handles a client’s settlement of funds, including the maintenance of an escrow account for the funds that are delivered by the defendant and the payment of all other parties who have valid liens which the lawyer is obliged to either pay or for whose benefit the lawyer must hold funds, in accordance to the law of the jurisdiction.⁷³ Negotiating a smaller payment to the funder, who has a lien on the client’s funds, is a law-related service even if it is not one that lawyer regularly offers the public and for which she would not charge separately.

Second, if the haircut negotiation of any one client – including the decision not to negotiate a haircut on behalf of any one client – is affected by the lawyer’s practice of negotiating haircuts for her other clients, then Rule 1.7(a)(2) is triggered. The rule says, that a “concurrent conflict of interest exists if . . . there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client. . . or by a personal interest of the lawyer.” Typically, this rule is

⁷⁰ Comment 9 to Rule 5.7 (Responsibilities Related to Law-Related Services) states that:

A broad range of economic and other interests of clients may be served by lawyers’ engaging in the delivery of law-related services. Examples of law-related services include providing title insurance, financial planning, accounting, trust services, real estate counseling, legislative lobbying, economic analysis, social work, psychological counseling, tax preparation, and patent, medical or environmental consulting.

⁷¹ See, e.g., Arizona State Bar Comm. on the Rules of Professional Conduct, Op. 05-01, 5/05 (Applying Rule 5.7 to referral of client to investment service in which the lawyer has a financial interest).

⁷² Comment 1 to Rule 5.7 (Responsibilities Related to Law-Related Services).

⁷³ See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, § 44 (2000) (Safeguarding and Segregating Property).

triggered when a lawyer is representing two clients in legal matters who are also business competitors, or where the lawyer has a business interest that would be affected by her representation of a client in a legal matter. But if Rule 5.7 extends this duty of fair play to matters that are not strictly speaking legal, but law-related, then the lawyer has a conflict if the delivery of those law-related services to one client would materially limit her ability to deliver that service to another client, or if the delivery of the law-related service to a client would be materially limited by the lawyer's personal interests in the delivery of that service.

The pattern of haircut negotiations uncovered in this study indicates a conflict of interest with regard to both other clients and the lawyer. If the lawyer is only able to secure haircuts for some clients, but not others, then the decision by the lawyer to secure a haircut for Peter by definition affects her ability to secure it for Paul. Further, if the lawyer's ability to secure a haircut for some clients but not others is determined by her desire to maintain good relations with the funder, then her decision not to pursue a really good haircut for Paula (as opposed to a merely mediocre haircut, or no haircut at all) means that the lawyer's personal interests (in managing her practice) affects Paula.

A simple analogy would be as follows. Imagine a medical malpractice lawyer regularly negotiates with medical providers who have liens against her clients after settlement. The lawyer does not have to engage in these negotiations; and she does not charge for them; and she does not disclose to her clients that she has even engaged in them until after she has tried. Some clients receive unexpected good news ("You'll be happy to know that I was able to get Medicare to reduce its stated cost of that MRI"); some receive unexpected bad news ("I'm really sorry -- I tried to get Medicare to reduce its stated cost of that MRI"); and some clients never hear anything at all from the lawyer because she did not even try. There may be many valid reasons for the lawyer to have chosen not to exert herself. But if those reasons include concerns about increasing the likelihood of successful negotiations on behalf of other clients, or improving the lawyer's ability to work with medical providers so that she can enjoy a reputation as a lawyer who can "work with the hospitals," then Rule 1.7(a)(2) is triggered. The lawyer owes her clients more than, for example, a mere businessperson would owe her customers were she to, on the basis of whim, "go the extra mile" for some but not others.

If we are correct in this analysis, it would be simple for lawyers to comply with their obligation under Rule 1.7(a)(2) by securing client consent to the conflict as provided for under the rule. This conflict is one which should be consentable and is unlikely to interfere with the lawyer's competent and diligent representation of

any of her clients.⁷⁴ This is because it is very likely that the lawyer does not know *ex ante* for whom she will be seeking a haircut, and it would be rational for a client to agree to a chance of a haircut rather than a Procrustean solution where the lawyer is prohibited from seeking a haircut for any client if she does not seek haircuts for all of them. Even among the clients of the mega-players, who already benefited *ex ante* from their lawyers' strong relationship with the funder, it would not be difficult, and it would be fairer, if the lawyer disclosed to clients upon being retained, that if they received funding with the aid of the lawyer, there was a 1 in 3 chance that they would not enjoy the same opportunity of a post-settlement haircut that was enjoyed by other clients similar to them represented by that lawyer.

But this should not be the end of the story. We do not know why more than half of the typical consumers got haircuts, and how they were calculated, and whether the savings enjoyed by some could be spread more evenly to all. It seems premature to assume that the savings could be spread, but it also seems premature to assume that the current method of distributing the savings – *ad hoc* negotiations by the lawyers after the case is concluded – is the best way to insure the welfare of the class of consumers who use TPF. Full disclosure, which Rule 1.7 would require, seems like a good first step. Nothing would prevent state regulators from taking further steps and requiring the funders to explain how decisions to grant haircuts are made. To the extent that the savings are distributed on a random basis, a regulator could demand that the funders treat the TPF consumer in a nondiscriminatory fashion after their case has been concluded. At the very least, transparency would promote competition among the funders resulting in improved consumer welfare.

CONCLUSION

TPF is an old idea that has become new again. As legal practice becomes more market-driven, it is inevitable that litigation will be commodified and legal claims will be bought by third parties. This article has examined the behavior of only one part of the market in litigated claims – one occupied by vulnerable, less sophisticated consumers. It is a market which, like many consumer markets, may need to be regulated. In consumer TPF, regular people are invited to sell a small portion of an unfamiliar piece of property (a legal claim) to well-organized and highly sophisticated entities. The risks to the sellers in this market are clear.

This article shows that the deals struck between consumers and funders are not as bad for the consumer as has been reported by academics and in the media. Since a consumer in TPF is selling an

⁷⁴ See Rule 1.7(b) (describing conditions under which a lawyer facing a conflict found under Rule 1.7(a) may represent a client).

asset (or a portion of an asset), there are no obvious parallels for policymakers to use to measure whether the market for these claims is in need of intervention through some kind of regulatory mechanism. Comparisons with sub-prime debt and payday lending are only vaguely relevant. But any kind of discussion, regardless of what is used as a point of comparison, must start with an accurate picture of the typical price paid for consumer litigation claims, and we provide that. The median consumer sells \$3380 of her anticipated proceeds from her lawsuit for \$2250, and in exchange, transfers to the funder (the buyer) a 12% risk that she would not have received those proceeds, as well as the opportunity to use any proceeds she would have received immediately, and not in 14 months. Consumer TPF is a hybrid between a sale and a loan, and as such, should be approached with an open mind based on accurate data.

This Article provides some of the data that necessary for a clear-eyed analysis the reforms that should be adopted, depending on the goals sought by the state and the bar. The most important finding of this Article, we believe, is that what we call the “embedded interest rate” – which is the figure featured in every media and academic account of consumer TPF – is not the “effective interest rate”. The effective interest rate – the average premium actually paid by the consumer and actually earned by the funder is 50% for the average advance of 14 months. We also explain why these two rates differ by focusing on the role played by complexity and *ex post* haircuts, which are practices hidden from view. It is possible that removing the complexity at the front end would not lead to a reduction in the number of haircuts negotiated at the end of the funding cycle, but it might reduce the indeterminacy of the size of those haircuts. If the real price of consumer litigation funding is, on average, closer to 44% per annum, it seems to us that both consumers and funders would benefit from having that fact known as clearly and transparently as possible.