International Review of Law and Economics xxx (2014) xxx–xxx

Contents lists available at ScienceDirect

International Review of Law and Economics

To litigate or not to litigate? The impacts of third-party financing on litigation☆

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ARTICLE INFO

Article history:
Received 30 April 2013
Received in revised form 4 June 2014
Accepted 27 August 2014
Available online xxx

JEL classification:
K0
K41

Keywords:
Third-party financing
Litigation financing
Frivolous claims
Transaction costs

ABSTRACT

In this paper, we analyze three different ways to finance litigation, namely (i) self-finance by plaintiffs, (ii) contingent fees arrangements and (iii) third-party financing. We show how they impact the access to justice, and the decision to settle or to go to court, when claims can be meritorious or frivolous. Our results show that third-party financing does not always increase the access to justice for a plaintiff, and may even decrease the equilibrium settlement amount. It also increases the number of frivolous claims.

1. Introduction

In Europe, the right for an injured party of a tortious or contractual wrongdoing to receive compensation was granted a fundamental value (Protocol 1 of the European Convention of Human Rights, Tuil and Visscher, 2010). However, in practice, the implementation of this fundamental right is far from being satisfactory. Several types of losses do not receive compensation because of the costs necessary to achieve it. In other words, legal fees still represent an economic barrier to pursuing a lawsuit. As an illustration, the English report "Access to Justice" (Lord Woolf, 1996, Chapter 7) mentions that "the problem of costs is the most serious problem besetting our litigation system (...) Fear of costs deters some litigants from litigating when they would otherwise be entitled to do so and compels other litigants to settle their claims when they have no wish to do so. It enables the more powerful litigant to take unfair advantage of the weaker litigant". The same fears regarding the high litigation costs are expressed in other countries. A 2007 report on the transparency of costs of civil judicial proceedings in the EU shows that high levels of litigation costs are a concern in many European states.[1] In Canada, the legal fees of a typical civil case for a three days trial in the Ontario Court is estimated at $38,200 to the plaintiff (Puri, 1998). These costs can become even higher if we include service of process fees, fees relating to examination of discovery or expert testimony. In the same way, in the U.S., pursuing a civil action in federal court costs an average of $15,000, the Federal Judicial Center reported last year. Cases involving scientific evidence, like medical malpractice claims, often cost more than $100,000.[2] Recently, experts have estimated that four-fifths of low-income people in the U.S. have no access to an attorney when they need one.[3]

☆ An earlier version of this paper circulated as "Litigation Financing: A Comparative Analysis". We thank the editors and the two anonymous referees for their comments. We are also grateful to the seminar participants at Paris II Panthéon-Assas, Paris X, Nice (GREDEG) and Mannheim Universities, as well as those of the CESifo conference on "law and economics" (2011) and SIDE conference in Rome (2012).

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[1] The average cost for a civil case in Europe is between 5000 and 10,000 euros. For more details, see the report on the transparency of costs of civil judicial proceedings in the EU: https://e-justice.europa.eu/content_costs_of_proceedings-37-en.do. In this context, the Family Law Bar Association in England fears that legal aid cuts could put domestic abuse victims at risk, since they could not afford costs to go to court (*The Guardian*, 24 October 2011). Still because of the high litigation costs, lawyers in France recently fear for access to justice for the poors (*Le Monde*, 14 September 2013).

[2] "Funders Put Money on Lawsuits to Get Payouts", *The New York Times*, 14 November 2010.

[3] "Addressing the Justice Gap", *New York Times*, 23 August 2011.

http://dx.doi.org/10.1016/j.irle.2014.08.005
0144-8188/

In such a context, there is a need to find alternative means to fund litigation. Among these means, contingent fees are contracts in which an attorney pays for the litigation costs of a plaintiff. The attorney obtains a percentage of the plaintiff's award if the lawsuit succeeds, but has no compensation if the lawsuit fails.[4] Contingent legal fees are widely used in the US. In around 87% of all torts and 53% of all contractual issues plaintiffs retain their attorney on a contingency basis (Kritzer, 1990). In Europe, contingent fees were strictly forbidden during a long time. However, Germany and the U.K. have recently allowed for them.

Third party financing is another way to finance litigation: it is not the plaintiff nor the attorney but some external "for-profit" funders that pay for the plaintiff's litigation costs in exchange for an agreed share of any recovered proceeds. As under contingent fees, the funders get a percentage of the proceeds only if the claim is successful, either in litigation or in settlement, and get noting if the claim fails. It is worth noting that third-party financing is not a simple extension of contingent fees arrangements to a larger class of funders. The first difference is that under contingent fees agreements, the attorney retained provides services (*i.e.* he invests his time and resources in prosecuting a case), rather than the funds necessary to procure such services. A second difference is that funders choose to finance litigation with the expectation of a positive return that they compare to alternative investments they could make on the financial market. Traditionally, third party involvement in litigation was prohibited in common law as well as in civil law countries. But things begin to change: In Australia, third party litigation funding has been tolerated since the 1990s in some contexts, such as the disposition by liquidators or trustees in bankruptcy of an insolvent's causes of action. In some American state courts (as in Maine or Ohio), third-party financing is now possible, as well as in England and Wales (ILR, 2009b). The industry of third-party financing is also beginning to develop in Germany.[5] In many European countries (as in France, Italy, Spain, Sweden, Austria or Belgium), law does not appear to prohibit third party financing, but the practice is rare or even non-existent.

The proponents of third-party financing argue that it allows a better access to justice, since it deeply lowers the budgetary constraint of the plaintiffs thanks to the large financial means of the funders. The Jackson report on civil litigation costs,[6] which sought to increase access to justice, gave important public approval for third-party financing: "it may be the most effective means of promoting access to justice for a claim against, say, a multinational pharmaceutical company". However, as underlined by the Chamber Institute for Legal Reform (ILR, 2009a, p. 4), increasing the access to courts also "increases the likelihood that any potential defendant will be hauled into court on a meritless claim". Indeed, critics attack third-party funding on a variety of grounds, including that it increases frivolous lawsuits, is unnecessary, creates conflicts of interest and imperils the relationship between attorneys and clients. In addition, third-party financing implies the coordination of three players (the attorney, the plaintiff and the funder) which raises new costs to organize the relationship.

In this paper, we compare three different ways to finance litigation, namely self-finance, contingent fees and third-party financing. Our comparison aims to establish what are the impacts of each of these systems on (i) the number of plaintiffs accessing to courts, (ii) the equilibrium settlement amounts, (iii) the decision of the defendant to settle or to go to court, and (iv) the probability that an uninjured plaintiff decides to file a (frivolous) claim. We do not aim to explore all possible ways to finance litigation, nor to seek to determine which of these financing systems would be the most socially efficient. We only focus on how third-party financing (whose potential introduction in several countries raises a lot of debates) leads to different incentives for plaintiffs to file a claim, and for defendants to settle or not, compared to self finance or contingent fees arrangements. Our main argument is that coordinating a three-player relationship is more costly than coordinating a bilateral one. To compensate for those higher charges, funders may require a higher rate of return on capital when they finance litigation. Then, third-party financing overcomes the budget constraint of the plaintiff, but leads to another "profitability" constraint: claims have to be profitable enough to be financed so as to support the additional organizational costs. We also extend our model by introducing asymmetric information. We assume that the defendant may face two types of plaintiff: a truly injured one and an uninjured one. The defendant is the only agent who cannot distinguish between a frivolous and a meritorious one. We show that under each litigation financing system, two types of equilibria appear, according to the defendant's belief of the probability that the claim is meritorious. Our results highlight that the higher the rate of return on capital the funders require under third-party financing, (i) the lower the probability that a plaintiff accesses to court is, and (ii) the lower the equilibrium settlement amount offered by the defendant is. As a consequence, (iii) the higher the probability that the defendant decides to settle rather than to go to court is, and (iv) the higher the probability that an uninjured plaintiff opens a file with the hopes of obtaining a settlement is. This allows us to show that third-party financing may be more beneficial to frivolous claims than meritorious ones, and that it may even lead to higher total litigation costs under some conditions.

The rest of the paper is organized as follows: Section 2 relates our paper to the previous literature. In Section 3, we describe the benefits and costs of third-party financing, and justify why it leads to a higher opportunity cost to raise funds. In Section 4, we compare the types of litigation financing when claims are meritorious. In Section 5, we consider that claims can be either meritorious or frivolous. Section 6 concludes.

2. Literature review

The basic theoretical framework of our model is inspired by Katz (1990) and Miceli (1994). Katz (1990) presents a model that explains frivolous suits as a result of defendant uncertainty regarding the merits of plaintiffs' claims. We adopt the same definition of a "frivolous lawsuit", *i.e.* a suit that has sufficiently low chance of prevailing at trial so that it would not be brought but is filed only in the hopes of obtaining a favorable settlement. In other words, a frivolous lawsuit is "that of an uninjured plaintiff obtaining a payment to which he is not entitled, at the expense of an uninformed defendant" (Katz, 1990). Miceli (1994) compares two types of litigation financing, namely hourly fees paid by the plaintiff and contingent fees arrangements, when claims can be either meritorious or frivolous. We extend this framework into two directions: first, we introduce a third type of litigation financing, *i.e.* third-party financing under which external funders finance the claim. Second, we introduce a cost constraint on the plaintiff: while Miceli (1994) assumes that a plaintiff can always afford to go to court, we rather consider that a plaintiff cannot finance the cost to go to court above some threshold. This allows us to show that each financing system

[4] This is often referred to as the "no win, no fee" principle. Let us also add that we consider here that the "third party" is a for-profit one. We do not deal with other types of "third parties" as insurance or government. This is consistent with the expression of "third party financing" that is today dedicated to external funders.

[5] The most representative litigation funding company is Allianz ProzessFinanz, that has funded cases including copyrights, contract, labor and employment, trade, corporate, insolvency and commercial matters. In 2004, only 0.4% of cases used third-party financing in Germany as for *Jackson LJ Review of civil litigation costs: Preliminary Report* (2009, p. 564).

[6] Lord Justice Jackson, *Review of Civil Litigation Costs*, April 2010, paragraph 4.4.4.

Please cite this article in press as: Deffains, B., Desrieux, C., To litigate or not to litigate? The impacts of third-party financing on litigation. International Review of Law and Economics (2014), http://dx.doi.org/10.1016/j.irle.2014.08.005