Michigan Business & Entrepreneurial Law Review

Volume 9 | Issue 1

2020

The Siren Song of Litigation Funding

J.B. Heaton

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Recommended Citation

J.B. Heaton, *The Siren Song of Litigation Funding*, 9 MICH. BUS. & ENTREPRENEURIAL L. REV. 139 (2019).
Available at: <https://repository.law.umich.edu/mbelr/vol9/iss1/4>

<https://doi.org/10.36639/mbelr.9.1.siren>

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THE SIREN SONG OF LITIGATION FUNDING

J.B. Heaton *

For an investor, litigation funding is too tempting to resist. Litigation funding promises that most elusive of investment returns: those uncorrelated with an investor's other investment returns. Litigation funding also invests in a world that seems fraught with possible pricing inefficiencies. It seems plausible—even likely—that a team of smart lawyer-underwriters can identify high-value litigation investments to generate superior returns for litigation-funding investors. But more than a decade of experience suggests the promise of litigation funding is a siren song. The promise draws investors into the water, but the payoffs may be meager and rare. While litigation funding has always been controversial with defendants and business trade associations, the real problem is that the investment class is a poor one. First, high-stakes civil litigation is far more complex and random than most investors understand. There are an overwhelming number of ways that litigants can lose and far fewer paths to significant victories. Second, few good cases—from an investment perspective—are likely to find their way to funders. Third, litigation funding is probably prone to optimism bias, causing litigation funders to overestimate the probability of victory in their cases. Finally, litigation funding is fungible with little value added by the funder, suggesting that competition will drive down any significant previously-existing profits. While litigation funding serves a valuable social purpose when it finances meritorious cases that otherwise would not be pursued, we can expect investor success in the field to be rare and likely limited to those funders with the most litigation savvy and the best luck. Nevertheless, investors are unlikely to give up on the space despite the large prospect of poor returns.

* J.B. Heaton, P.C., Chicago, Illinois, jb@jbheaton.com. Many thanks to a litigation funder and hedge fund manager, who will remain anonymous, for help in understanding the pitfalls of the litigation funding business. Thanks also to Ronen Avraham, Tony Sebok, and Steve Shavell for helpful comments. Additional thanks to my former colleagues at Bartlit Beck LLP for almost two decades of lessons in the conduct and uncertainties of civil litigation. All errors are my own.

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Alas
it is a boring song
but it works every time.

- Margaret Atwood, *Siren Song* (1974).

I. INTRODUCTION

No aspect of litigation is more controversial than litigation funding.¹ Litigation funding is the non-recourse financing of a party's litigation expenses by a third-party funder. A Law360 poll found that while 86% of attorneys who have used litigation funding report a positive opinion of it, 62% of in-house counsel—perhaps more likely to be on the other side of a funded case—report a negative opinion.² The U.S. Chamber of Commerce remains actively opposed to litigation funding, favoring state legislative efforts to force plaintiffs to disclose their litigation funding arrangements as part of initial discovery

1. In this Comment, I analyze so-called “commercial litigation finance,” the financing of non-consumer litigation. The financing of consumer litigation presents different issues than those analyzed here. For a thorough treatment of consumer litigation finance with empirical results, see Ronen Avraham and Anthony J. Sebok, *An Empirical Investigation of Third Party Consumer Litigation Funding*, 104 Cornell L. Rev. 1133 (2019).

2. Cristina Violante, *What Your Colleagues Think of Litigation Finance*, LAW360 (Dec. 11, 2017, 9:45 PM), <https://www.law360.com/articles/989204/what-your-colleagues-think-of-litigation-finance>.

disclosures in a case.³ Some judges require plaintiffs to disclose their litigation funding arrangements to the court.⁴

We think of the litigation funding arrangement as solving two problems. First, litigation funding is a form of financing. Like a contingency-fee arrangement, the litigation funding arrangement provides financing that may allow a budget-constrained plaintiff to finance litigation that she would otherwise be unable to pursue.⁵ It may also allow a plaintiff that is not budget constrained to finance litigation without tapping other available cash, using that cash for other purposes.⁶ Second, litigation funding is a risk-transfer mechanism. The non-recourse nature of most litigation funding allows the litigant to protect the downside of a loss by trading to the funder more of the potential gains from a win.

While much has been written about litigation funding,⁷ research has more or less assumed that litigation funding makes sense for investors, focusing instead

3. See *Third Party Litigation Funding (TPLF)*, INSTITUTE FOR LEGAL REFORM, <https://www.instituteforlegalreform.com/issues/third-party-litigation-funding> (last visited Sept. 15, 2019) (“The practice, while lucrative for those betting on cases, increases the probability that meritless claims will be brought, inserts questions about who is actually controlling the litigation other than the plaintiff and defendant, and makes settling lawsuits far more difficult and expensive. Even the funders admit they deliberately complicate litigation.”); Andrew Strickler, *Legal Funders, US Chamber Weigh In on NYC Bar Study*, LAW360 (June 4, 2019, 9:50 PM), <https://www.law360.com/articles/1165924/legal-funders-us-chamber-weigh-in-on-nyc-bar-study>.

4. See Jeff Overley, *Opioid MDL Attys Must Disclose Outside Funding, Judge Says*, LAW360 (May 7, 2018, 8:56 PM), <https://www.law360.com/articles/1041305/opioid-mdl-attys-must-disclose-outside-funding-judge-says> (reporting on an order by U.S. District Court Judge Aaron Polster requiring plaintiffs’ attorneys to disclose litigation funding arrangements to the court); Andrew Strickler, *3rd-Party Funders Must Be Disclosed in 6 Fed. Appeals Courts*, LAW360 (Mar. 27, 2018, 8:30 PM), <https://www.law360.com/articles/1026646/3rd-party-funders-must-be-disclosed-in-6-fed-appeals-courts> (reporting that six U.S. federal appeals courts require some disclosure of litigation funders in civil disputes, while 24 U.S. district courts have a requirement that funders be disclosed to the court); e.g., *FastShip, LLC v. United States*, 143 Fed. Cl. 700, 717 (2019) (“Like the patent system as a whole, litigation financing agreements can occasionally be susceptible to abuse But the possibility of abuse does not mean the entire system should be discarded. Instead, courts have focused on the disclosure of such agreements to encourage transparency . . .”).

5. See, e.g., Shayna Posses, *Woodsford Litigation Funding Launches Tel Aviv Office*, LAW360 (Mar. 28, 2019, 1:17 PM), <https://www.law360.com/articles/1142363/woodsford-litigation-funding-launches-tel-aviv-office> (quoting funder’s chief executive officer as stating: “[Israel] has a high volume of [venture capital]-backed, high-tech startups that are rich in intellectual property but limited financial resources. These businesses often find themselves in dispute with U.S. and European giants, for example patent or trade secrets disputes.”).

6. E.g., Caroline Simson, *3rd-Party Funding Now a Top Alternative Choice for Lawyers*, LAW360 (May 16, 2019, 7:24 PM), <https://www.law360.com/articles/1160547/3rd-party-funding-now-a-top-alternative-choice-for-lawyers> (“Funding is also being used by commercial parties that have the funds to pay for arbitration or litigation but would like to save their capital for other uses.”).

7. An early article is George Steven Swan, *Economics and the Litigation Funding Industry: How Much Justice Can You Afford?*, 35 NEW ENG. L. REV. 805 (2001). The literature is now large. See, e.g., David S. Abrams and Daniel L. Chen, *A Market for Justice: A First Empirical Look at Third Party Litigation Funding*, 15 U. PA. J. BUS. L. 1075 (2013); Jonathan T. Molot, *Litigation*

on the social benefits and costs of investor funding. This Article argues that the assumption that litigation funding is an attractive investment class is wrong. Recent short-seller criticisms of one of the largest litigation funders have focused attention on whether the investment success by existing litigation funding firms is as good as claimed.⁸ I argue here that the promise of litigation funding is a siren song, luring investors with promises that few other investment products can make. The promise draws investors into the water, so to speak, but the ultimate payoffs are meagre and rare. Thus, while litigation funding has always been controversial with defendants and their trade associations, the real problem is that the investment class is a poor one.

Part I explains the allure of litigation funding from an investor's perspective. It introduces some basic investment theory and explains the difficulty of earning superior risk-adjusted returns in an efficient market.

Part II explains why the assumption that litigation funding is an attractive investment opportunity is largely incorrect. While the headlines seem filled with stories of enormous judgments and settlements and total legal spending is in the many billions of dollars, more than a decade of experience with litigation funding suggests that its investment promise is an empty one. First, litigation is far more complex and random than most investors understand. Second, only a small subset of meritorious litigation is likely to present itself to funders. Third, litigation funding is probably prone to optimism bias, causing litigation funders to overestimate the probability of victory in their cases. Finally, litigation funding is fungible with little value added by the funder, suggesting that competition will drive down any significant profits that have existed in the business previously.

Part III explores the consequences of what will likely be the poor performance of litigation funding. There is good reason to believe that some litigation funding is socially beneficial because it allows risk-averse plaintiffs to pursue meritorious cases they would otherwise forego because of their risk aversion or inability to fund the litigation. Litigation funding is especially important in allowing meritorious cases to move forward when litigants are otherwise unable to bear the costs and the risks of vindicating their rights. This is especially true against large corporations that have the ability to outspend even wealthy individuals. If litigation funding ultimately proves itself to be a

Finance: A Market Solution to a Procedural Problem, 99 GEO. L.J. 65 (2010); Jonathan T. Molot, *The Feasibility of Litigation Markets*, 89 IND. L.J. 171 (2014); Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649 (2005); Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61 (2011); Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268 (2011); Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455 (2012); Maya Steinitz, *How Much Is That Lawsuit in the Window? Pricing Legal Claims*, 66 VAND. L. REV. 1889 (2013).

8. See Margot Patrick, *Short-Seller Accuses Litigation-Finance Firm Burford Capital of 'Meaningless Metrics'*, WALL ST. J. (Aug. 7, 2019, 7:51 AM), <https://www.wsj.com/articles/muddy-waters-claim-sees-shares-in-litigation-finance-firm-tumble-11565178688?mod=searchresults&page=1&pos=7>.

poor investment class, will litigants be unable to pursue these meritorious cases?

The poor performance of litigation funding is unlikely to keep investors away. Financial economists are coming to understand more and more that investors value lottery-like payoffs more than standard models of risk averse economic agents would suggest. Thus, while a majority of publicly traded common stocks earn less than the one-month Treasury bill rate over their lives, investors still flock to invest in stocks in the apparent belief that *their* stock picks will be the ones to do well. Some funders will—by dint of substantial litigation savvy combined with luck—do well in the space, so there will likely always be funds available to finance litigation with high potential payoffs to the funder. Thus, as in other areas of investment, investor irrationality or lottery-like preferences (or irrationality that results in lottery-like preferences) will likely continue to make funding available, generating social benefits for litigants while laying off the private costs of sub-par investment performance on the litigation funder's investors.

II. THE PROMISE OF INVESTING IN LITIGATION

A. *Low Correlation with Other Investment Returns*

Portfolio theory teaches that diversification can maintain the expected return of a portfolio while also reducing its risk.⁹ The key insight of portfolio theory is that the risk of any single investment in an investor's portfolio is determined almost entirely by its covariance with the returns of other investments in the portfolio rather than the variance of its own returns.¹⁰ Covariance is simply a measure of the tendency of variables to move together or not. A portfolio benefits when an asset's returns have low covariances with other investment returns because the asset's returns are not high when the other returns are high or low when the returns are low. Low covariances tend to force the likely portfolio to return toward its expected value, reducing dispersion around that expected value. Put simply, low covariances can make it more likely that the expected return—or something close to it—is the actual return earned by the portfolio. The covariance of two variables divided by the product of the standard deviations of those variables is the familiar "correlation coefficient," a number between -1 (perfect negative correlation) and +1 (perfect positive correlation). A correlation of 0 reflects no linear relationship between the two variables. When investment returns have a high positive correlation, they tend to move in the same direction and the same time. Consider an investor who holds Microsoft and Amazon.com stock. The correlation of the

9. See Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952); A.D. Roy, *Safety First and the Holding of Assets*, 20 ECONOMETRICA 431 (1952).

10. *Id.*

daily returns on those stocks over the last two years is about 0.76 as of August 16, 2019.¹¹ This means that Microsoft offers only limited diversification to a position in Amazon.com, and vice versa. This is fine when returns are good, but troublesome when returns are bad.

Covariance underlies all modern asset pricing models, including the Capital Asset Pricing Model, known as the CAPM (pronounced “cap M”).¹² In the CAPM, risk is measured by “Beta,” which is the covariance of the returns of an asset with the return on the market of all assets, divided by the variance of the market return. Securities that have returns that tend to be high when market returns are high—that is, those with large positive covariances—are riskier (in the sense of the CAPM) because they tend to fall when the market is falling and rise when the market is rising. An investor would prefer, all else equal, to have returns that are high when the market return is low, because this acts as a sort of insurance policy that pays off when money is otherwise tight because market returns are low. For institutional investors and very wealthy individuals, investments that are uncorrelated with other returns are especially valuable. In the world of institutional investment and high-net worth investing, low correlation—especially with stock market returns—is a sort of Holy Grail.

Litigation funding promises exactly this sort of low-correlation investment opportunity.¹³ The reason is easy to see. Litigation pays off when a defendant pays a settlement or satisfies a judgment against it. The timing of such payments has little to do with the ups and downs of the stock market. There may be some correlation, of course, if a defendant is more able to satisfy a judgment when times in the general economy are good than when times are bad, but that sort of correlation is likely to be very low. Interestingly, if litigation investments have zero correlation with market returns, then the proper benchmark rate for such investments is the risk-free rate. This makes sense because such investments—in a CAPM world—have no risk that is “priced,” that is, covariant with the market return. Essentially, assets whose returns have zero correlation with an investor’s other asset returns are very valuable and do not require much discounting.

11. Data from Bloomberg LLP. I obtained the prices for Amazon.com and Microsoft and calculate returns from August 17, 2017 to August 16, 2019. I then calculated the correlation coefficient.

12. The CAPM was worked out theoretically in the early 1960s. See William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425 (1964); John Lintner, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 REV. ECON. STAT. 13 (1965); Jan Mossin, *Equilibrium in a Capital Asset Market*, 34 ECONOMETRICA 768 (1966); Jack L. Treynor, *Toward a Theory of Market Value of Risky Assets*, in Robert A. Korajczyk, *ASSET PRICING AND PORTFOLIO PERFORMANCE* (1999) (paper circulated in the early 1960s but published only much later).

13. See, e.g., Alan Guy, *2019 Will Bring More Good News for Litigation Finance*, LAW360 (Jan. 2, 2019, 3:21 PM) <https://www.law360.com/articles/1114147/2019-will-bring-more-good-news-for-litigation-finance> (“Publicity regarding recent nine-figure fund raises by established funders and the appeal of investing in uncorrelated assets during a period of market volatility are likely to drive additional capital into the market in the coming year.”).

B. *Potential Market Inefficiencies*

The likely low correlation of litigation funding returns with other investment returns would be a sufficient reason for many investors to consider investing, but litigation funding has another enticing promise: the prospect of earning superior, risk-adjusted returns by finding and exploiting mispricing. This is in stark contrast to the publicly traded equities market where it has become increasingly implausible for investment managers to beat the market with any reliability. The first well-known study of the ability of professionals to find mispriced securities was by Alfred Cowles, published in 1933 in *Econometrica*.¹⁴ Cowles found that “the most successful records are little, if any, better than what might be expected to result from pure chance.”

Additional tests began in earnest in the mid-1960s. For example, in 1966 Professor William F. Sharpe, who would go on to share the Nobel Prize in Economics for the development of the Capital Asset Pricing Model, published *Mutual Fund Performance*,¹⁵ finding support for “the view that the capital market is highly efficient and that good [mutual fund] managers concentrate on evaluating risk and providing diversification, spending little effort (and money) on the search for incorrectly priced securities.”¹⁶ In his 1968 study,¹⁷ Professor Michael C. Jensen found similar evidence. Over subsequent decades, evidence has mounted against the notion that active investors beat the apparently efficient securities markets. This inability of professional money managers to beat passive benchmarks is, for many, highly persuasive evidence of market efficiency in the pricing of publicly traded securities.¹⁸

Litigation investments are not subject to the same forces that drive the prices of most publicly traded securities to informationally-efficient levels. Market efficiency depends mainly on the relevant market being free and open in the sense that investors can buy and sell without substantial restrictions on participation like substantial lockups of potential sellers or bans on short selling. Litigation investments are not traded in such a free and open market. Therefore,

14. Alfred Cowles, *Can Stock Market Forecasters Forecast?*, 1 *ECONOMETRICA* 309 (1933).

15. William F. Sharpe, *Mutual Fund Performance*, 39 *J. BUS.* 119 (1966).

16. *Id.* at 138.

17. Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 *J. FIN.* 389 (1968).

18. See, e.g., Stanley J. Kon & Frank C. Jen, *The Investment Performance of Mutual Funds: An Empirical Investigation of Timing, Selectivity, and Market Efficiency*, 52 *J. BUS.* 263, 263 (1979) (observing that Jensen’s mutual fund studies “have been cited as support for the strong form of the Efficient Markets Hypothesis (EMH); that is, whether any investor has monopolistic access to any information relevant for price formation.”); Eugene F. Fama, *Two Pillars of Asset Pricing*, 104 *AM. ECON. REV.* 1467, 1482 (2014) (“However one judges market efficiency, it has motivated a massive body of empirical work that has enhanced our understanding of markets, and, like it or not, professional money managers have to address its challenges.”).

litigation funders could possibly make investments that generate superior risk-adjusted returns.¹⁹

C. Easy Money

Given the promise of litigation funding as an investment, litigation funders have unsurprisingly had an easy time raising money. In 2013, one such firm was able to raise \$300 million in less than a year.²⁰ Two years later, the fund had more than \$1.4 billion under management.²¹ By the end of that year, the litigation fund sold out to a large publicly traded funder, Burford Capital, for \$160 million, or more than 10% of assets under management.²² In 2018, a start-up litigation fund founded by a veteran of one the largest funds, Bentham IMF, raised \$250 million.²³ Another fund reported raising \$125 million, which included “\$100 million through university endowments, \$50 million from the University of Michigan, with the rest coming from various funds and high-net-worth individuals.”²⁴ Harvard University’s endowment is a large investor in litigation funding.²⁵

These figures suggest that the lure of litigation funding is strong. Litigation funders have been able to raise funds at a time when, for example, hedge fund

19. Burford Interim Report 2019, Burford Capital, <https://www.burfordcapital.com/wp-content/uploads/2019/08/BUR-32541-Interim-Report-2019-WEB.pdf> (last visited Sept. 15, 2019) (“It is also important to bear in mind that the complexity and illiquidity of legal finance assets is precisely what gives Burford its edge and its historic ability to generate desirable returns. If litigation assets were easy to value, the economics of our business would be very different.”).

20. See Andrew Strickler, *Attys, CFOs More Open to Litigation Finance*, Survey Finds, LAW360 (Jan. 16, 2014), <https://www.law360.com/articles/501563/attys-cfos-more-open-to-litigation-finance-survey-finds> (“In April, a new player in the industry, Chicago-based Gerchen Keller Capital LLC, announced it had raised more than \$100 million in three months and was set to back their first cases. On Monday, Gerchen Keller said they had raised a second fund and had about \$300 million under management.”).

21. See Andrew Strickler, *Litigation Backer Gerchen Keller Tops \$1B with New Fund*, LAW360 (Jan. 6, 2016), <https://www.law360.com/articles/743219/litigation-backer-gerchen-keller-tops-1b-with-new-fund> (“The Chicago-based Gerchen Keller, which claims to be the world’s largest investor focused on litigation and regulatory matters, said its new fund brings its total assets under management north of \$1.4 billion.”).

22. See Benjamin Horney, *Burford’s \$160M GKC Buy Creates Litigation Funding Giant*, LAW360 (Dec. 14, 2016, 5:50PM), <https://www.law360.com/articles/872631/burford-s-160m-gkc-buy-creates-litigation-funding-giant>.

23. See Andrew Strickler, *Litigation Funder Validity Poaches Pair from Bentham IMF*, LAW360 (Dec. 4, 2018, 3:25 PM), <https://www.law360.com/articles/1107944/litigation-funder-validity-poaches-pair-from-bentham-imf> (reporting on fund’s starting capital).

24. Darcy Redden, *Lake Whillans Closes \$125 Million Litigation Funding Round*, LAW360 (Jan. 4, 2018), <https://www.law360.com/articles/998726/lake-whillans-closes-125m-litigation-funding-round>.

25. See Michael McDonald, *Harvard Invests in Litigation Strategy That Has Posted Big Gains*, BLOOMBERG (June 26, 2019), <https://www.bloomberg.com/news/articles/2019-06-26/harvard-invests-in-litigation-strategy-that-has-posted-big-gains> (describing Harvard’s investment in fund raises by IMF Bentham).

managers operating in the public stock markets have been experiencing withdrawals and closing while new funds have difficulty raising capital. In contrast, litigation funding is not yet a winner-takes-all market, at least in terms of fund-raising. Investors appear to believe that the asset class is attractive and that there is no shortage of talent able to earn superior, risk-adjusted returns.

But there are reasons to be skeptical.

III THE PERILS OF INVESTING IN LITIGATION

A. *The Complexity of High-Stakes Civil Litigation*

High-stakes civil litigation can seem like a simple matter of win or lose, but the process is extraordinarily complex.²⁶ Economic models often present litigation as involving a simple comparison of the probability of a plaintiff's victory as the plaintiff perceives it, P_p , the judgment that the plaintiff will win if victorious, J , the cost of litigation for the plaintiff, C_p ,²⁷ the probability of a plaintiff's victory as the defendant perceives it, P_d , and the cost of litigation for the defendant, C_d .²⁸ There is then a simple inequality that implies that the plaintiff will settle the case if:

$$P_p J - C_p < P_d J + C_d$$

That is, the case should settle if the risk neutral plaintiff's expected gain from litigating is less than the risk neutral defendant's expected loss. Further, the case should settle somewhere in the range of those two amounts. Cases should always settle if the parties agree on J and P , because the plaintiff's costs are a reduction from her expected gain (forcing the left side of the equation down) and the defendant's costs are an addition to his expected loss (forcing the right side of the equation up). If the inequality is reversed:

$$P_p J - C_p > P_d J + C_d$$

then the case will go trial.

This simple model of litigation can generate a number of insights, but it is simplistic to the point of absurdity in light of the complexity of real-world litigation. The probability of victory is not so easily determined. The classical

26. Surprisingly, little research addresses the problem of complexity and litigation prediction. Colleen V. Chien, *Predicting Patent Litigation*, 90 TEX. L. REV. 283 (2011) provides an exception. Some attempts to frame the problem are quite simplistic. See, e.g., Michaela Keet, *Litigation Risk Assessment: A Tool to Enhance Negotiation*, 19 CARDOZO J. CONFLICT RESOL. 17 (2017).

27. Costs include legal fees, discovery costs, trial exhibits, travel expenses, expert witness fees, court costs, etc., but exclude costs that are not out-of-pocket like the opportunity costs of time and attention given to the litigation.

28. The classical models were developed in the early 1970s. See John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); William R. Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973).

model treats the litigation outcome almost as a coin toss, with a certain probability P of coming up “victory” and a probability $1-P$ of coming up “defeat.” In the real world, there are a multitude of variables that make it difficult to estimate P . Put differently, the decision tree for real world litigation is profoundly complex.

Consider a very simple case where there is a single cause of action with four elements that the plaintiff must establish to win her case. One of those elements is the existence and amount of damages, which effectively makes for a five-element case. When the plaintiff files her case, she must allege each of the elements of her claim in satisfaction of the required pleading standard. Assuming that the amount of damages need not be pled, there are four elements that must be pled in accordance with the relevant pleading standards. There are 15 ways to get past this stage for the plaintiff. First is to adequately plead each of the 4 elements and proceed to discovery (assuming that we are in a jurisdiction like the federal courts where no immediate appeal is available for denial of a motion to dismiss, and not in a state like New York where interlocutory appeals of most every ruling are available). Second is to fail to plead any of the four elements (1 possibility) adequately according to the trial court’s decision but to obtain a full reversal of that decision on appeal. Third is to fail to plead three of the four elements (4 possibilities) but to obtain a full reversal of that decision on appeal. Fourth is to fail to plead two of the four elements (6 possibilities) but to obtain a full reversal of that decision on appeal. Fifth is to fail to plead one of the four elements (4 possibilities) but to obtain a full reversal of that decision on appeal.

Against these 15 ways to get past a motion to dismiss, there are 65 ways to lose. First, the plaintiff could fail to plead any of the elements in the view of the trial court. There is one way to fail to plead all the elements. On appeal, the trial court could be upheld as to all the elements (1 possibility), upheld as to any three of the elements (4 possibilities), upheld as to any two of the elements (6 possibilities), or upheld as to any one of the elements (4 possibilities). There are then 15 ways to lose the motion to dismiss when the trial court finds no element to be adequately alleged. With a trial court finding that there are three elements inadequately alleged, there are 28 ways to lose,²⁹ with two elements inadequately alleged, there are 18 ways to lose,³⁰ and with one element inadequately alleged there are 4 ways to lose: the determination as to that one element (of which there are four possibilities) is affirmed on appeal. Thus, the motion to dismiss and possible appeal alone generates 80 possible outcomes.

29. There are 4 ways to fail to plead 3 elements at the trial court level. For each of these, the appellate court can affirm on all three elements (1 possibility), affirm on two of the three elements (3 possibilities), or affirm on any one of the three possibilities (3 possibilities). Thus, there are $4 \times 7 = 28$ ways to lose when failing to plead three elements.

30. There are 6 ways to fail to plead 2 elements at the trial court level. For each of these, the appellate court can affirm on both elements (1 possibility) or on either one of the two elements (2 possibilities). Thus, there are $6 \times 3 = 18$ ways to lose when failing to plead two elements.

Matters get worse from there. Once discovery begins, there are a practically unknowable number of ways that evidence can present itself in the form of documents (including emails), the deposition testimony of fact witnesses (parties and nonparties), and the depositions and reports of expert witnesses.³¹ At the onset of a case, it is essentially impossible to determine what the set of evidence will look like at the close of fact and expert discovery. But that set of evidence largely determines the probabilities of the paths for either getting stopped at summary judgment³² or proceeding to trial. Assuming we have the four-element claim with the amount of damages to be proven at trial, there are now another 80 paths, 15 of which get past summary judgment (in some cases after appeal), and 65 of which end the case after an unsuccessful appeal. For the paths that get past summary judgment to trial, we have the same number of paths, but now with the added range of damages numbers that might be awarded by the judge or jury. In addition, the standards of review on appeal change at the summary judgment and post-trial stages for some matters decided by the fact-finder.

Now consider that our example concerned a single cause of action with four elements. Most high-stakes civil cases have multiple counts.³³ Each of those cases has the same nature of complexity, including—perhaps most importantly—how discovery unfolds once the case has passed the initial pleading hurdles. It is extremely difficult for even the most seasoned and experienced litigators to even roughly judge the chance of victory in a case. The probability that a litigation funder's underwriter can do so is quite low.

B. *Good Cases are Hard to Find*

There are many meritorious cases in the world. The litigation funder's problem is to find the subset of meritorious cases that make sense as investments. That is no easy task.

First, a significant problem in litigation funding is the difficulty of scaling up an investment in a good case. Litigation funders can, in some circumstances, buy a direct participation in a claim, but most limit their investment to funding the costs of litigation. But even a large litigation can only generate so much expense. A litigation funder may find a great case on the merits but must limit its investment to the costs of the case. This is quite unlike the investment

31. Some have argued that the uncertainty of what might be uncovered in discovery can justify even lawsuits that have a negative expected value when the case is filed. See Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267, 1277 (2006).

32. We have little systematic understanding of how summary judgment works in practice and what factors determine outcomes. See Jonah B. Gelbach, *Rethinking Summary Judgment Empirics: The Life of the Parties*, 162 U. PA. L. REV. 1663 (2014).

33. See, e.g., Christina L. Boyd & David A. Hoffman, *Litigating Toward Settlement*, 29 J. L. ECON. & ORG. 898, 899 (2013) ("A single filed complaint may advance multiple, often competing, theories, and causes of action.").

problem facing other investment managers. An investment manager who decides that Google stock is a great investment can pretty much buy as much of that stock as she wants. The same is true for an investment manager who wants to own U.S. 30-year Treasury bonds or invest in oil and gas. Scale is not a problem in such investments. The litigation funder, however, is more like a small-business lender. Each case is its own small business and needs only a certain amount of capital.

Second, not all good cases that need significant capital will present themselves to the litigation funder. Litigation funding trades downside protection—essentially, the possibility of losing the case while having borne the costs of litigation—for a share of the upside in the litigation. Because the funding must have a positive expected value for the litigation funder to take it, the funding will have a negative expected value for the plaintiff if she and the litigation funder agree on the merits (probability of victory) of the case. The plaintiff will not take the negative expected value funding unless she is risk averse or budget-constrained (that is, does not have the money to fund the litigation herself). Moreover, a plaintiff who is budget-constrained will take only the amount of financing necessary to overcome the budget constraint, limiting the funder's ability to scale his investment. If the plaintiff is optimistic about her case relative to the litigation funder, this will only exacerbate her unwillingness to accept unnecessary funding, because her optimism makes the funding seem even more of a bad deal than when she is not optimistic. In other words, a plaintiff who sees her litigation as highly likely to prevail will be more reluctant to share a reward with a litigation funder.

Third, some of the cases that present themselves to the litigation funder will not be good cases. Because litigation funders provide non-recourse financing, a plaintiff can have some upside with little or no financial downside. A risk neutral plaintiff who is pessimistic relative to the litigation funder will accept funding even for a case that she perceives to have negative expected value. We would expect funders (and investors placing money with funders) to be especially cautious of funding litigants who are not budget constrained and who are not plausibly risk averse for the amounts at stake in the investment.

C. The Problem of Optimism

Excessive optimism is a well-documented psychological bias. People exhibit an optimism bias when they systematically overestimate the probability of a good event and underestimate the probability of a bad event. The relevant psychological literature presents two pervasive findings that make optimism an interesting subject of study for corporate finance researchers. First, people are more optimistic about outcomes they believe they can control. Second, people are more optimistic about outcomes to which they are highly committed. Litigation funding investments are likely to evoke optimism for both of these reasons.

While litigation funders may be realistic about the inherent uncertainties of litigation, they may still believe they have, and will continue to have, substantial control over the litigation. Their investment can be contingent on the involvement of counsel of their choice. While they cannot dictate strategy to the litigation team or make settlement decisions for the client, the possibility of repeat business by the funded plaintiff's lawyers can create some pressure to take the funder's view into account. At the start of the case, the funder may also simply overestimate their ability to persuade the litigation team and client to view the case as the funder does. Litigation funders are also likely to be highly committed to the outcome of the case. Indeed, there is little else about the litigation funding arrangement that matters as significantly as the financial outcome.

Optimism is particularly problematic for litigation-funding investors because optimism is likely to result in a winner's curse outcome, similar to bidders in corporate acquisitions.³⁴ The winner's curse is the tendency for the winner in an auction or bidding process to be the potential buyer who most overvalues the asset being sold.³⁵ In this context, if several litigation funders evaluate a potential case, the litigation funder that funds the case—likely the one who (1) agrees to fund the litigation and (2) offers the best terms to the plaintiff—may be the litigation funder who most overvalued the case's potential. Here, the possible market inefficiencies for litigation investments can come back to bite the investor. In a market for a publicly traded stock, some investors' ability to sell short (that is, borrow shares they do not own, sell them, and hope to buy them back in the future at a lower price), can depress prices that have been driven too high by investor optimism.³⁶ No such mechanism

34. See Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986); Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989); J.B. Heaton, *Managerial Optimism and Corporate Finance*, 31 FIN. MGMT. 33 (2002); Ulrike Malmendier & Geoffrey A. Tate, *Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction*, 89 J. FIN. ECON. 20 (2008).

35. See E.C. Capen, R.V. Clapp & W.M. Campbell, *Competitive Bidding in High-Risk Situations*, 23 J. PETROLEUM TECH. 641 (1971); Max Bazerman & William F. Samuelson, *I Won the Auction but Don't Want the Prize*, 27 J. CONFLICT RESOL. 618 (1983); John H. Kagel & Dan Levin, *The Winner's Curse and Public Information in Common Value Auctions*, 76 AMER. ECON. REV. 894 (1986).

36. The classic explanation is that "without short selling the price of a security is raised if there is divergence of opinion. A sufficient amount of short selling could increase the volume of the security outstanding until its price was forced down to the average valuation of all investors." Edward M. Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151, 1162 (1977). There is substantial evidence that short selling is important to market pricing. See, e.g., Charles M. Jones & Owen A. Lamont, *Short-Sale Constraints and Stock Returns*, 66 J. FIN. ECON. 207 (2002); Karl B. Diether, Kuan-Hui Lee & Ingrid M. Werner, *Short-Sale Strategies and Return Predictability*, 22 REV. FIN. STUD. 575 (2009) (examining the extent and importance of short selling in U.S. stocks); Pedro A.C. Saffi & Kari Sigurdsson, *Price Efficiency and Short Selling*, 24 REV. FIN. STUD. 821 (2011) (examining the same for global stocks); Ekkehart Boehmer & Juan (Julie) Wu, *Short Selling and the Price Discovery Process*, 26 REV. FIN. STUD. 287 (2013) (documenting the greater accuracy of stock prices when short sellers are active); Mahdi Nezafat, Mark Schroder &

exists for litigation investments, so optimism is likely to result in a painful winner's curse in some, perhaps many, litigation investments.

D. *Competition Without Comparative Advantage*

Notions of perfect competition are as old as the field of economics.³⁷ In one modern formulation, a perfectly competitive environment is one where “there are perfect-substitute outside options: if a buyer or seller tries to press his trading partner for more favorable terms of trade, the latter has recourse to a perfect-substitute, alternative buyer or seller.”³⁸ Sellers of litigation funding are likely to find themselves in near perfect competition with one another. Funding is fungible. With so much capital drawn into the litigation funding business and a limited number of good cases to choose from, litigation funders cannot hope (for long) to extract returns much above a perfectly competitive level. Even if large existing publicly traded litigation funders are to be believed in their often-opaque financial reporting of excellent returns from investments, those returns are likely to fall as funders compete with each other to put their capital to work.

The fungibility of litigation finance contrasts with, for example, private equity and venture capital. Both private equity firms and venture capitalists have substantial control rights in the companies where they invest.³⁹ This makes it possible for private equity funds and venture capitalist funds to distinguish themselves from competitors on dimensions other than the money they provide.⁴⁰ Private equity managers promote their reputations for working well with company management.⁴¹ By contrast, litigation funders must remain passive.⁴² This passivity limits the ways that litigation funders can differentiate

Qinghai Wang, *Short-Sale Constraints, Information Acquisition, and Asset Prices*, 172 J. ECON. THEORY 273 (2017) (presenting a model that short-sales constraints during financial crises increase volatility and may not support prices).

37. See Joan Robinson, *What is Perfect Competition?*, 49 Q. J. ECON. 104 (1934).

38. Louis Makowski & Joseph M. Ostroy, *Perfect Competition and the Creativity of the Market*, 39 J. ECON. LITERATURE 479, 481 (2001).

39. See Paul Gompers et al., *What Do Private Equity Firms Say They Do?*, 121 J. FIN. ECON. 449 (2016) (describing private equity governance of their portfolio companies); Steven N. Kaplan & Per Strömberg, *Venture Capitalists as Principals: Contracting, Screening, and Monitoring*, 91 AM. ECON. REV. 426 (2001) (describing venture capitalist governance of their portfolio companies).

40. See Viral V. Acharya et al., *Corporate Governance and Value Creation: Evidence from Private Equity*, 26 REV. FIN. STUD. 368, 370 (2013) (suggesting that private equity firms differ in their ability to add value at portfolio companies).

41. E.g., GTCR LLC, <https://www.gtcr.com/the-leaders-strategy/>, (“As a leading private equity firm, GTCR pioneered The Leaders Strategy™—finding and partnering with management leaders in core domains to identify, acquire and build market-leading companies through transformational acquisitions and organic growth. This differentiated approach has stood at the core of GTCR’s investment strategy for more than 35 years.”) (GLCR is a large Chicago-based private equity firm).

42. E.g., Danielle Cutrona, *Answers to Key Legal Finance Ethics Questions*, LAW360 (July 16, 2019, 4:07 PM), <https://www.law360.com/articles/1178103/answers-to-key-legal-finance-ethics-questions>, (“Legal finance providers enter into carefully negotiated transactions with law

themselves from one another other than by offering better financial terms to those taking litigation finance.

IV. WILL LITIGATION FUNDING SURVIVE BAD RETURNS?

The primary social benefit of litigation funding is that it allows risk-averse plaintiffs to pursue meritorious cases they would otherwise forego because of their risk aversion and/or inability to fund the litigation. Most individuals are risk averse. Risk aversion causes plaintiffs to act as if they are pessimistic about cases when they are not, and this can allow defendants to avoid answering for wrongdoing. Like a contingency fee arrangement, a non-recourse litigation funding arrangement provides financing that allows a budget-constrained and/or risk averse plaintiff to finance litigation that she would otherwise be either unable or unwilling to pursue. The non-recourse nature of most litigation-funding allows a litigant to protect against the downside of a loss—primarily, the inability to recover costs—by trading to the funder a portion of the gains from a judgment or settlement.

Litigation funding is especially important in allowing meritorious cases to move forward when litigants would otherwise be unable to bear the costs and risks of vindicating their rights, especially against large corporations that have the wherewithal to greatly outspend even wealthy individuals. If litigation funding ultimately proves itself to be a poor investment class, will litigants then be unable to pursue these meritorious cases?

There is good reason to believe that poor returns to litigation funders will not drive investors out of the space. The best evidence supporting this belief comes from experience with active investment management in publicly traded stocks. Passive index funds have long outperformed active equity managers.⁴³ Accumulated evidence of underperformance by active managers has generated a massive shift to passive investing, but many investors continue to chase the promise that active management will outperform passive management.⁴⁴ The

firms and corporations represented by sophisticated counsel. Their agreements should explicitly state that the legal financier neither controls nor will seek to control strategy, settlement or other litigation-related decision-making, nor direct a counterparty to settle a case at all, or for a particular amount. Nor should legal finance providers withhold contractually required funding for strategic reasons: They are passive investors, and do not control the legal assets in which they invest. Those decisions remain entirely with the client.”) Danielle Cutrona is director of global public policy for Burford Capital LLC.

43. See, e.g., Daisy Maxey & Chris Dieterich, *Indexes Beat Stock Pickers Even Over 15 Years*, WALL ST. J. (Apr. 13, 2017), <https://www.wsj.com/articles/indexes-beat-stock-pickers-even-over-15-years-1492039859>; Chris Newlands & Madison Marriage, *99% of Actively Managed US Equity Funds Underperform*, FIN. TIMES (Oct. 23, 2016), <https://www.ft.com/content/e139d940-977d-11e6-a1dc-bdf38d484582>.

44. See, e.g., Kate Beioley, *US active funds suffer record \$143bn ‘exodus’ in December*, FIN. TIMES, (Jan. 17, 2019), <https://www.ft.com/content/4b863bbe-1a7a-11e9-9e64-d150b3105d21>; Chris Flood, *Vanguard Retains Title as World’s Fastest-Growing Asset Manager*, FIN. TIMES, (Jan. 4, 2018), <https://www.ft.com/content/4245e135-d719-311c-a9d2-d9a75ec8ac79>; Attracta Mooney, *Passive Funds Grew 4.5 Times Faster Than Active in 2016*, FIN. TIMES (Feb. 11, 2017),

fact that so many investors continue to pursue active management in the face of inferior performance suggests investors might do the same in the litigation funding space.

In fact, not only have investors in publicly traded stocks been willing to stick with active equity management despite underperformance, investors generally have been willing to stick with stock investments despite the fact that only a tiny amount of stocks do better than the risk-free rate over their lives as listed companies. In pathbreaking work published in 2018, finance professor Hendrik Bessembinder found reports that the majority of U.S.-listed common stocks since 1926 returned (inclusive of dividends) less than the risk-free rate (that is, the one-month Treasury bill) over their lives as listed companies, so that just 4% of listed U.S. companies account for all of the gains of the U.S. stock market from 1926 to 2016.⁴⁵ In follow-up work in 2019, Bessembinder and his colleagues extended their results for 1990 to 2018 to other countries and found similar results: a majority of both U.S. and non-U.S. stocks underperformed the one-month U.S. treasury bill rate.⁴⁶ Despite these facts, investors stand ready, willing, even eager, to invest in publicly traded stocks.

The willingness of investors to stick with active management and investment in individual stocks despite bad past performance suggests that investors will not be deterred from investing in litigation finance simply because returns are not as high as expected.

V. CONCLUSION

Much criticism against litigation funding—that it will lead to frivolous litigation⁴⁷ or deprive litigants of control over their cases—is unpersuasive. Litigation funders must be highly selective about the cases they fund. Litigation funding is nonrecourse funding (i.e., without guarantees or collateral), so litigation funders get paid only from recoveries in the litigation. It is economically irrational for litigation funders to fund frivolous litigation. Only if litigation funders work to screen out unmeritorious cases are they likely to earn a sufficient return on their incurred risk—losing cases typically results in a total loss of investment.

<https://www.ft.com/content/c4f6ee56-e48c-11e6-9645-c9357a75844a>; Corrie Driebusch, *Investors Pulling More Money From Actively Managed U.S. Stock Funds*, WALL ST. J. (Jan. 13, 2016), <https://www.wsj.com/articles/investors-pulling-more-money-from-actively-managed-u-s-stock-funds-1452702638>.

45. See Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440, 441 (2018).

46. See Hendrik Bessembinder, Te-Feng Chen, Goeun Choi & K.C. John Wei, *Do Global Stocks Outperform US Treasury Bills* (July 5, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3415739.

47. See, e.g., Michael Abramowicz, *Litigation Finance and the Problem of Frivolous Litigation*, 63 DEPAUL L. REV. 195 (2014).

The real criticism of litigation funding is not that it inflicts damages on the justice system or litigants. It is that, for most investors, litigation funding is probably too good an investment to be true. Some funders will succeed, but they are likely to be those founded by former litigators with true depth of experience, not those with limited experience in law without deep relationships to find and evaluate a significant deal flow of cases with a cold eye. Most funders will probably deliver poor returns to their investors, and it is possible the returns to the industry as a whole will be negative once all currently committed capital has turned over. Most investors could take a lesson from Odysseus. They can listen to the luring promises of low correlation and market inefficiencies but they should remain firmly tied to the mast of their ship, avoid the sirens' temptation, and navigate investments to safer waters. But there is little reason to doubt that some will continue to fall for the siren song of litigation funding. For society and the justice system, that may be a good thing.