THE LITIGATION FINANCE CONTRACT

MAYA STEINITZ*

ABSTRACT

Litigation funding—for-profit, nonrecourse funding of a litigation by a nonparty—is a new and rapidly developing industry. It has been described as one of the "biggest and most influential trends in civil justice" today by RAND, the New York Times*, and others. Despite the importance and growth of the industry, there is a complete absence of information about or discussion of litigation finance contracting, even though all the promises and pitfalls of litigation funding stem from the relationships those contracts establish and organize. Further, the literature and case law pertaining to litigation funding have evolved from an analogy between litigation funding and contingency fees. Much of that literature and case law views both forms of dispute financing as ethically compromising exceptions to the champerty doctrine. On that view, such exceptions create the risks of an undesirable loss of client control over the case, of compromising a lawyer's independent judgment, and of potential conflicts of interest between funders, lawyers, and clients.*

This Article breaks away from the contingency analogy and instead posits an analogy to venture capital (VC). It shows the striking resemblance of the economics of litigation funding with the well-understood economics of VC. Both are characterized by extreme (1) uncertainty, (2) information asymmetry, and (3) agency costs. After detailing the similarities and differences between these two types of financing, this Article discusses which contractual arrangements developed in the area of venture capitalism can be directly applied to

* Associate Professor, University of Iowa College of Law. I thank Herb Hovenkamp, Steve Burton, Todd Pettys, Michelle Falkoff, Tom Gallanis, Alan Morrison, Rob Rhee, Nathan Miller and the participants of the University of Iowa College of Law and University of Wisconsin Law School workshops for the comments. A special thanks to Victor Goldberg for stimulating conversations about the similarity between venture capital and litigation finance as well as comments on an early draft.

litigation finance, which ones need to be adapted, and how such adaptation can be achieved. As much of the theory, doctrine, and practice of VC contracting can be applied or adapted to litigation finance, practitioners and scholars can be spared decades of trial and error in developing standardized contractual patterns.

In addition, the analogy turns most of the conventional wisdom in the field on its head. This Article argues that funders should be viewed as real parties in interest, funders should obtain control over a funded litigation, and attorneys should take funders' input into account. In return, funders should pay plaintiffs a premium for the control they receive, subject themselves to a compensation scheme that aligns their interests with those of the plaintiffs, and enhance the value of claims by providing noncash contributions. Indeed, on the suggested view, noncash contribution—as much as if not more than, capital contribution—should be seen as a key benefit of litigation finance. Courts and regulators should devise rules that enhance the transparency of the industry—in particular the performance outcomes of various litigation funding firms and their ethical propensities. Such a legal regime will foster the emergence of a reputation market that will police the industry and support contractual arrangements.

TABLE OF CONTENTS

INTRODUCTION 459
I. A CASE STUDY: BURFORD'S INVESTMENT IN THE CHEVRON/ECUADOR DISPUTE 465
A. Background: The Chevron/Ecuador Dispute 466
B. The Investment Structure 467
C. The Distribution of Control Between Burford and the Ecuadorian Claimants 471
D. Staged Financing and Right of First Refusal 473
E. Information Sharing, Duty to Cooperate, and Common Purpose 474
F. Negative Covenants, Representations, and Warranties 476
G. Operational Efficiencies 479
II. THE ECONOMICS OF LITIGATION FINANCE 479
A. The Litigation Finance-Venture Capital Analogy in a Nutshell 479
B. Ethical Bounds to Third-Party Profit Making in Litigation 483
C. Information Asymmetry and Agency Costs 488
D. Legal Claims as Assets and Extreme Uncertainty 490
III. VENTURE CAPITAL'S LESSONS LEARNED: CONTROLLING EXTREME UNCERTAINTY, INFORMATION ASYMMETRY, AND AGENCY COSTS THROUGH ORGANIZATIONAL AND CONTRACTUAL ARRANGEMENTS 496
A. Recommended Organizational Structure 496
1. Limited Partnerships and Syndication 496
2. Compensation 497
3. Noncash Contribution 498
B. Recommended Contractual Structure 501
1. The Litigation Finance Fund-Investor Contract 501
a. Control and Compensation 501
b. Mandatory Distributions and Liquidation 502

2. The Litigation Finance Fund-Plaintiff Contract 503
a. Staged Financing 504
b. Role in Management 507
c. Negative Covenants 509
d. Highly Incentivized Compensation, Exit, and Reputation 510
3. The Attorney Retention Agreement 515
CONCLUSION 517

INTRODUCTION

Litigation finance—for-profit, nonrecourse funding of a litigation by a nonparty—is a new and rapidly developing industry globally, and in the United States in particular.[1] So much so, that the RAND Institute for Civil Justice has dubbed it one of the "biggest and most influential trends in civil justice,"[2] and the *New York Times* has recently reported on it at length on its front page and in its "Betting on Justice" series.[3] More generally, litigation funding in all of its forms—law lending, contingency fees, and nonrecourse funding—is pivotal for understanding civil litigation as a whole: "[T]he most ... important phenomena of modern litigation are best understood as results of changes in the financing and capitalization of the bar."[4] For example, in the United States a market in bankruptcy claims emerged some twenty years ago and "nothing has changed the face of bankruptcy in the last decade as much as the new-found liquidity

---

1. New York City Bar Ass'n, Formal Op. 2011-2 § I (2011) ("As of 2011, [the third-party litigation financing] industry has continued to grow, both as to the number and types of lawsuits financed and financing provided. The aggregate amount of litigation financing outstanding is estimated to exceed $1 billion."). On trends in law firm finance, see Larry Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749, 754-59, 788-97 (discussing both traditional and emerging law firm models).

2. *Third Party Litigation Funding and Claim Transfer*, RAND CORP., http://www.rand.org/events/2009/06/02.html (last visited Oct. 10, 2012); *see also* Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1270-71 & n.4 (2011). Litigation funding is accelerated by the global recession, which has created more claims but less funds to pursue them as well as an appetite for new, alternative assets. *See id.* at 1283-85. The expansion of litigation funding is also driven by a global transformation of legal services egged on by the *Legal Profession Act 2004* (NSW) ch 2, pt 2.6, div 2, which allows incorporation of legal practices in Australia, and the Legal Services Act, 2007, c. 29, §§ 71-111, which allows investment in British law firms.

3. *E.g.*, Binyamin Appelbaum, *Investors Put Money on Lawsuits to Get Payouts*, N.Y. TIMES, Nov. 15, 2010, at A1. The report was accompanied by Susan Lorde Martin, Op-Ed., *Leveling the Playing Field*, N.Y. TIMES (Nov. 15, 2010), http://www.nytimes.com/roomfordebate/2010/11/15/investing-in-someone-elses-lawsuit/leveling-the-playing-field, and was followed by an additional report on the finance of divorce litigation. *See* Binyamin Appelbaum, *Taking Sides in a Divorce, Chasing Profit*, N.Y. TIMES, Dec. 5, 2010, at A1; *see also* Peter Lattman & Diana B. Henriques, *Speculators Are Eager to Bet on Madoff Claims*, N.Y. TIMES DEALBOOK (Dec. 13, 2010), http://dealbook.nytimes.com/2010/12/13/speculators-are-eager-to-bet-on-madoff-claims/ (discussing how investment firms are attempting to buy trustee-approved claims against Bernard L. Madoff).

4. Stephen C. Yeazell, Abstract, *Refinancing Civil Litigation*, SOC. SCI. RES. NETWORK (June 18, 2002), http://papers.ssrn.com/so13/papers.cfm?abstract_id=315759.

in claims."[5] Due to litigation funding's increasing salience, courts, legislatures, regulators, and academics have all, as of late, started grappling with the phenomenon head on.[6]

Litigation funding is largely understood as composed of two subindustries. One is usually referred to as "consumer funding"—the funding of relatively small personal claims, predominantly personal injury and divorce cases.[7] This subindustry has a somewhat longer history in the United States, going back approximately fifteen years, to what has in the past been called "law lending." The second, newer subindustry is "commercial funding." This industry relates to the funding of business disputes, such as disputes relating to intellectual property, antitrust, business contracts, and international commercial and investment arbitration—brought by sophisticated

---

5. Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy: Part 2 ABI Committee on Public Companies and Trading Claims*, 11 AM. BANKR. INST. L. REV. 177, 177 (2003).

6. For recent cases addressing litigation funding, see *In re* September 11 Litig., 723 F. Supp. 2d 534, 545-46 (S.D.N.Y. 2010) (stating that lawyers cannot pass on to their clients the cost of financing a contingency suit); Leader Techs. v. Facebook, Inc., 719 F. Supp. 2d 373, 376 (D. Del. 2010) (refusing to extend the common-interest exception to attorney-client privilege waiver to include a financier); Abu-Ghazaleh v. Chaul, 36 So. 3d 691, 693-94 (Fla. Dist. Ct. App. 2009) (holding that given the level of control exerted by a funder, that funder rose to the level of "party"). On the legislative front, Maine became the first state to pass legislation regulating litigation finance. *See* An Act to Regulate Presettlement Lawsuit Funding, 2007 Me. Laws 394 (codified at ME. REV. STAT. tit. 9-A, §§ 12-101 to -107 (2007)). Shortly thereafter, Ohio legalized lawsuit financing by passing H.B. 248, 127th Gen. Assemb. (Ohio 2008) (codified at OHIO REV. CODE ANN. § 1349.55 (WEST 2008)), and in 2010, Nebraska approved the Nonrecourse Civil Litigation Act, Legis. B. 1094, 101st Leg., 2d Sess. (Neb. 2010) (codified at NEB. REV. STAT. §§ 25-3301 to -3309 (2010)). Legislation is currently pending in New York, *see* An Act to Amend the General Obligations Law, in Relation to the Regulation of Non-Recourse Civil Litigation Advance Contracts, Assemb. B. 5410, 2011 Gen. Assemb., Reg. Sess. (N.Y. 2011), and Delaware, *see* An Act to Amend Title 6 of the Delaware Code Relating to Consumer Legal Finance Transactions, H.B. 422, 145th Gen. Assemb., Reg. Sess. (Del. 2010). Regulatory efforts have also been made by the American Bar Association, *see* ABA COMM'N ON ETHICS 20/20, WHITE PAPER ON ALTERNATIVE LITIGATION FINANCE (Draft Oct. 19, 2011), *available at* http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111019_draft_alf_white_paper_posting.authcheckdam.pdf, and the New York City Bar Association, *see* New York City Bar Ass'n, Formal Op., *supra* note 1. For a literature review of the budding academic discourse, see *infra* notes 119-21, 123-26, 130. For a literature survey of earlier works that focused predominantly on law lending—that is, personal injury recourse loans—and Australian and English literature studying litigation finance in those pioneering jurisdictions, see Steinitz, *supra* note 2, at 1279-82.

7. *See* STEVEN GARBER, RAND CORP., ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES 9-10 (2010) (RAND Corp. occasional paper), *available at* http://www.rand.org/pubs/occasional_papers/ 2010/RAND_OP306.pdf.

parties and involving larger stakes.[8] This Article focuses exclusively on commercial funding.[9] Specialized investment firms dedicated exclusively to litigation funding have pioneered it in the United States. However, in addition, what started as a trickle of investments by hedge funds—not specializing in litigation but rather investing opportunistically—has recently turned into a flood.[10]

But this growing industry is shrouded in secrecy[11] and, to make matters more complicated, its funding structures are "as various as snowflakes."[12] Commentators have identified a variety of possible investment structures. These include recourse and nonrecourse loans, which can be either secured or nonsecured.[13] Investments may take the form of a purchase, an assignment of a claim, or even the sale of an interest in the judgment.[14] These, in turn, may be directly or indirectly syndicated.[15] Funders may form joint ventures with other funders; law firms may cofinance with other law firms using cocounseling agreements; and insurance companies may offer

---

8. *See id.* at 13-15. See a discussion of the "first wave" and "second wave" of litigation funding, including a literature review relating to the former, in Steinitz, *supra* note 2, at 1277-78.

9. Although acknowledging that litigation funding is a controversial practice, this Article assumes that litigation funding is an industry whose time has come and proceeds from that premise to discuss how—not whether—it should take place.

10. Margie Lindsay, *Third-Party Litigation Funding Finds Favour with Hedge Funds*, HEDGE FUNDS REV. (Jan. 19, 2012), http://www.hedgefundsreview.com/hedge-funds-review/news/2139727/audio-party-litigation-funding-favour-hedge-funds. This information is also based on off-the-record interviews conducted by the author with various investors.

11. *See* Roger Parloff, *Have You Got a Piece of This Lawsuit?*, FORTUNE (May 31, 2011, 5:00 AM), http://features.blogs.fortune.cnn.com/2011/05/31/have-you-got-a-piece-of-this-lawsuit; *see also* Neil Rose, *Whatever You Want*, LAW SOC'Y GAZETTE (Jan. 17, 2008), http://www.lawgazette.co.uk/features/whatever-you-want ("This is very much a bespoke market.").

12. *See* Lindsay, *supra* note 10 (quoting Selvyn Seidel, Founder and Chairman of Fulbrook Management) (internal quotation marks omitted).

13. *Introduction* to UCLA LAW-RAND CTR. FOR LAW & PUB. POLICY CONFERENCE PROCEEDINGS: THIRD-PARTY LITIGATION FUNDING AND CLAIM TRANSFER 1, 1 (Geoffrey McGovern et al. eds., 2010) [hereinafter CONFERENCE PROCEEDINGS], *available at* http://www.rand.org/content/dam/rand/pubs/conf_proceedings/2010/RAND_CF272.pdf; Selvyn Seidel, *Stakeholders and Products in Third-Party Funding Arrangements*, *in* CONFERENCE PROCEEDINGS, *supra*, at 4, 5; *see also* Nathan M. Crystal, *Professional Ethical Issues in Third-Party Litigation Financing*, *in* CONFERENCE PROCEEDINGS, *supra*, at 15, 15-18; Timothy D. Scrantom, *Sources and Structures of Claim Investments*, *in* CONFERENCE PROCEEDINGS, *supra*, at 11, 11-12.

14. Crystal, *supra* note 13, at 15.

15. Selvyn Seidel, *An Overview*, *in* CONFERENCE PROCEEDINGS, *supra* note 13, at 68.

litigation insurance products. Other forms of indirect investments in legal claims, which are beyond the scope of this Article, include law firm loans offered by banks and equity investment in law firms.[16]

One litigation funding firm has disclosed its investment structures to its investors in the following terms:

> The Company intends to make use of a wide variety of investment structures .... Examples of possible structures include, *inter alia*:
> • funding the legal expenses associated with pursuing or defending a claim in exchange for a payment based on the claim's outcome;
> • acquiring an interest in all or a part of a claim or claimant at various stages during the adjudication process, including after a judgment or award has been rendered;
> • lending money, either directly or through a law firm established by the Principals, to fund the activities of a law firm, the litigation of a portfolio of cases, or the litigation of a single case;
> • arranging and participating in structures that remove the risk of liability from companies' balance sheets;
> • acquiring interests in intellectual property that is the subject of claimed infringement; and
> • participating in post-insolvency litigation trust structures.[17]

Even within the paradigmatic investment structure of the first bullet above, which is modeled on the contingency fee, variations abound.[18] How parties choose to structure their litigation funding agreements depends on a variety of factors such as: (1) the type of investor—ad hoc institutional investors, such as a hedge fund or

---

16. Crystal, *supra* note 13, at 16; *Roundtable Discussion Summary*, *in* CONFERENCE PROCEEDINGS, *supra* note 13, at 21, 22; James E. Tyrell, *Lawyer Investments in Claims*, *in* CONFERENCE PROCEEDINGS, *supra* note 13, at 9, 9; Stephen Yeazell, *Third-Party Finance: Legal Risk and Its Implications*, *in* CONFERENCE PROCEEDINGS, *supra* note 13, at 18, 19.

17. Admission Document from Burford Capital Ltd. 21 (Oct. 21, 2009) [hereinafter Burford IPO memo], *available at* http://www.burfordfinance.com/docs/default-document-library/burford-admission-document.pdf.

18. *See* Rose, *supra* note 11 ("Allianz has a starting point of 30% of the first £350,000 recovered, and 20% on anything above that. IM relates its take to when monies are recovered, ranging from 25% for up to six months from the letter of intent, to 50% for over 18 months. S&W ranges anywhere between 15% and 45%. In general, a funder will be looking for at least three or four times the sum invested.").

bank, or specialized institutional investors, either private or public; (2) the investor's needs; (3) regulatory or ethical restrictions; and (4) tax considerations.[19]

Despite the increasing importance and growth of the industry, there is a complete absence of either information about or discussion of litigation funding contracting—both its theory and its practice.[20] Further study of litigation funding agreements is badly needed. To state the obvious, the litigation funding contract is the foundation and framework of the funding relationship. The absence of any guidance on how to contract for litigation funding significantly raises the transaction costs of such funding because parties must start from scratch when entering a litigation funding agreement.[21] This void also creates an uneven playing field for unsophisticated clients who cannot afford to negotiate a form contract presented by an experienced funder. In other words, there is both an efficiency-based and justice-based need for academic discussion of the litigation finance contract, both of which this Article seeks to address. Additionally, the void leads to a public policy discourse based, at least partially, on ignorance of how funding arrangements operate in practice or in theory. Finally, by breaking away from the analogy to contingency fees, and positing instead an analogy to venture capital, it becomes clear that in addition to a justice argument in favor of litigation finance—for example, access to justice—litigation financiers may be valuable because they can enhance the value of lawsuits, to the benefit of the original claim holders, by way of noncash contributions.

This Article therefore aims to fill this gap. The Article develops an analogy between the economics of venture capital (VC) and of litigation finance. Both are forms of finance characterized by extreme (1) uncertainty, (2) information asymmetry, and (3) agency

---

19. *See* Burford IPO memo, *supra* note 17, at 12-17, 21-22.

20. Given the novelty of the phenomenon, no model contracts exist. As discussed below, funders regard such contracts as proprietary and include nondisclosure clauses in them. Few cases dispute the funding agreement itself and, therefore, no examples of contracts can be gleaned from courts' opinions. Even fewer cases have led to public disclosure of the actual underlying contracts. These are discussed *infra* Part I.

21. As one litigator framed it, in a private conversation, "litigators like me find themselves in a position where they have to negotiate highly complex financial deals. This is not what we are trained to do. And it's too time consuming to expect a partner from the finance department to assist since he cannot bill for that time."

costs.[22] Therefore, much of the theory, doctrine, and practice of VC contracting, which developed over more than half a century to deal with similar problems, can be adapted to the litigation funding context. This insight can represent a quantum leap for practitioners and scholars—who will not have to muddle through decades of trial and error—and can allow them to start from a standardized set of contractual patterns.

Part I explores, as a case study, Burford's investment in the high-stakes, high-profile Chevron/Ecuador dispute. It illustrates that certain funding relationships make use of VC features but mostly in order to address funders' interests, whereas the unequal bargaining power, regulatory restrictions, and underdeveloped reputational markets conspire to prevent the development of correlating protections for the plaintiffs.

Part II describes the economics of litigation funding. It details how the ethical constraints—for example, the risk of plaintiffs losing control to funders, of waiver of attorney-client privilege, and of diminished independent judgment by lawyers—translate in economic terms into magnified agency costs and information asymmetries. Part II also applies economic, finance, and behavioral literature to an analysis of legal claims as assets, showing these assets to be highly risky and uncertain.

Part III describes VC's lessons learned—how to control similar extreme uncertainty, information asymmetry, and agency costs through organizational and contractual arrangements—and suggests arrangements that protect plaintiffs while accommodating value enhancements by funders. This Part sets out the benefits of organizing litigation finance firms as limited partnerships, with an incentive-aligning compensation scheme, that are incentivized and expected to provide plaintiffs with noncash contributions. This Part also suggests that contracts between litigation finance firms and plaintiffs make use of staged financing, representation in case management, certain negative covenants, and exit provisions. And it emphasizes the role of reputation and therefore transparency in policing ethics. This analysis suggests that control should be allocated to funders, but that funders must pay for it—including with upfront cash when appropriate. It also suggests how the contract

22. *See infra* Part II.C-D.

between the litigation finance firm and its investors, on the one hand, and the attorney retention agreement, on the other, can be structured to support the litigation finance firm-plaintiff contract.

The Article concludes with a set of conceptual and practical recommendations. These include reframing our understanding of funders as real parties in interest, extending attorney-client privilege to facilitate the noncash contribution of funders, pricing and paying for the complete control endowed to plaintiffs by operation of law, and encouraging plaintiffs and their lawyers to disfavor funders who are not specialized and organized as proposed herein.

I. A CASE STUDY: BURFORD'S INVESTMENT IN THE CHEVRON/ECUADOR DISPUTE

This Part will explore Burford's investment in the Chevron/Ecuador dispute as a case study of: (1) how private ordering in litigation funding is evolving to adopt contractual structures not dissimilar to those documented in the VC industry pertaining to funders' interest in reducing extreme uncertainty, information asymmetry, and agency costs; and (2) how regulatory restrictions coupled with a lack of transparency and the consequently limited reputational markets conspire to prevent the development of the correlating protections of the plaintiffs, such as compensation for transfer of control, noncash contribution, and monitoring.

Fortune magazine covered Burford's investment in the Chevron/Ecuador dispute based on the premise that

> Burford is ... "the largest and most experienced international dispute funder in the world," as its promotional materials state, so we're not looking here at some aberrational outlier in the field.... [And,] we can be assured that Burford's conduct probably represents the very best practices the young industry has to offer.[23]

23. Parloff, *supra* note 11. Similarly, Professor Anthony Sebok, "who has made a subspecialty of probing the legal and ethical questions surrounding litigation finance," has been quoted as saying that there is "nothing unusual from [the] point of view of the litigation finance world" in this contract. Daniel Fisher, *Litigation-Finance Contract Reveals How Investors Back Lawsuits*, FORBES (July 6, 2011), http://www.forbes.com/sites/danielfisher/2011/06/07/litigation-finance-contract-reveals-how-investors-back-lawsuits. It is also the experience of this author, based on interviews as well as a review of the litigation finance

A. Background: The Chevron/Ecuador Dispute

On February 14, 2011, an Ecuadorian court issued an $18 billion judgment against Chevron in an environmental litigation brought against it by a group of indigenous peoples in the Amazonian rain forest of Ecuador.[24] The litigation stems from personal injuries and environmental damage in the form of the pollution of rain forests and rivers in Ecuador.[25] These damages are a result of oil operations conducted by Texaco, subsequently acquired by Chevron in 2001, during drilling operations that lasted from 1964 to 1990.[26] When Chevron acquired Texaco, it also "acquired" what became known as the Chevron/Ecuador case.[27]

The award is the largest judgment ever imposed for environmental contamination in any court, and the litigation has been ongoing for over seventeen years.[28] The costs of the litigation up to the

---

contracts listed below, that the contract, although lengthier and more involved than some, is not an aberration as it relates to the issues discussed herein. That said, it should be noted that this investment has some features that may distinguish it from most investments. The Chevron/Ecuador litigation is a cross-border litigation. Underlying it is a form of class action. And an unusually large foreign judgment had already been rendered at the time of the investment. For a prophecy that litigation funding of transnational disputes is set to rise, see Cassandra Burke Robertson, *The Impact of Third Party Financing on Transnational Litigation*, 44 CASE W. RES. J. INT'L L. 159 (2011). Additional contracts reviewed include those underlying the following litigations: *In re* Parmalat Sec. Litig., 659 F. Supp. 2d 504 (S.D.N.Y. 2009); Trust for the Certificate Holders of Merrill Lynch Mortg. Investors v. Love Funding Corp., 918 N.E.2d 889 (N.Y. 2009); Anglo-Dutch Petroleum Int'l, Inc. v. Haskell, 193 S.W.3d 87 (Tex. App. 2006). Also reviewed were the "Minor Investor" contracts relating to the Chevron/Ecuador investment discussed below, *see* Exhibits to Declaration of Kirsten L. Hendricks, Chevron Corp. v. Donziger, No. 11-cv-00691-LAK (S.D.N.Y. Nov. 29, 2011), ECF No. 355 [hereinafter Minor Funder Contracts], and, for the sake of comparison, standard forms of consumer investment contracts developed to comply with different states' consumer protection legislations, *see, e.g.*, Purchase Agreement Between Dean Plaintiff and Oasis Legal Finance, LLC (Sept. 13, 2010) (on file with author).

24. *See* Chevron Corp. v. Donziger, 768 F. Supp. 2d 581, 621 (S.D.N.Y. 2011).

25. *See id.*

26. *See id.* at 597. The claim is a "popular action," the closest form of joinder to class action available in Ecuador. *See* Thomas T. Ankersen, *Shared Knowledge, Shared Jurisprudence: Learning to Speak Environmental Law Creole* (Criallo), 16 TUL. ENVTL. L.J. 807, 814 (2003).

27. *See Chevron Corp.*, 768 F. Supp. 2d at 594 & n.2.

28. Patrick Radden Keefe, *Reversal of Fortune*, NEW YORKER, Jan. 9, 2012, at 38; Simon Romero & Clifford Krauss, *Chevron Is Ordered to Pay $9 Billion by Ecuador Judge*, N.Y. TIMES, Feb. 15, 2011, at A4. The judgment ordered $9 billion dollars in compensatory damages and another $9 billion dollars in punitive damages, which would become effective if Chevron did not apologize by February 3, 2012. Chevron did not apologize. *See Ecuador: Chevron Will*

judgment were borne by the attorneys who took the case on a contingency basis.[29] Far from concluding the dispute, the Ecuadorian judgment was the opening gunshot in a new phase of appellate proceedings in Ecuador and parallel proceedings in the United States and in various foreign and international fora.[30]

In a satellite litigation in which Chevron is currently suing claimants' former lead attorney, Steven Donziger, and advancing various allegations under the RICO statute, Chevron requested, and was granted by U.S. District Court Judge Kaplan, Donziger's entire case file—documents spanning nearly two decades.[31] Among these documents was the funding agreement between the plaintiffs and Burford.

B. The Investment Structure

Burford invested $4 million as a first round of investment in the Ecuadorians' case in exchange for a 1.5 percent stake in any recovery, and agreed to provide two additional rounds of investment, in the amount of $5.5 million each, entitling it to a 5.5 percent share of the recovery.[32] The investment was effected through a Cayman Islands entity called Treca Financial Solutions (Treca). Treca entered into a funding agreement (hereinafter, the Treca Agreement or Agreement) with Friends of the Defense of the Amazon (FDA), a nonprofit, and some forty named individuals (Claimants) who represent thousands of other villagers. *Fortune* magazine summed up the deal:

> If Burford ponies up the full $15 million and the plaintiffs end up recovering $1 billion, Burford will get $55 million. If the plaintiffs recover $2 billion, Burford gets $111 million, and so on.

Not Apologize for Pollution, Even to Save $8.5 Billion, N.Y. TIMES, Feb. 4, 2012, at A7.

29. *See* Keefe, *supra* note 28.

30. *See* Memorandum by Patton Boggs, Invictus: Path Forward: Securing and Enforcing Judgment and Reaching Settlement 7-8, 12-13, 17-21, *available at* http://www.earthrights.org/sites/default/files/documents/Invictus-memo.pdf (setting forth the details of the plaintiffs' enforcement strategy).

31. Order on Plaintiff's Motion for a Temporary Restraining Order at 2, Chevron Corp. v. Donziger, No. 11-cv-00691-LAK (S.D.N.Y. Feb. 8, 2011), ECF No. 77.

32. Funding Agreement Between Treca Financial Solutions, Friends of the Defense of the Amazon, and forty named claimants §§ 2.1(a), 3(h) (Oct. 31, 2010) [hereinafter Treca Agreement] (on file with author).

> But here's the best part for investors: If the plaintiffs recover less than $1 billion—all the way down to a mathematical floor of about $69.5 million—Burford still gets the same payout it would have received if there had been a $1 billion recovery. In other words, if there were a $69.5 million recovery, Burford would still get $55 million, though that sum would, under the circumstances, constitute almost 80% of the pot. In that event, by the way, the remaining 20% would not go to the plaintiffs; rather, it would go to other investors, who are also supposed to get their returns on investment (not just their capital outlays) before the plaintiffs start seeing a dime. In fact, under the "distribution waterfall" set up by the 75-page contract, it is only after eight tiers of funders, attorneys, and "advisers" (including the plaintiffs' e-discovery contractor) have fed at the trough that "the balance (if any) shall be paid to the claimants."[33]

The deal is structured as an assignment of all litigation rights to a trust set up by the Claimants[34] and governed under Ecuadorian law (the Trust).[35] The Trust holds "all of the litigious rights as well as any and all interest in the Claim, the Award, any proceedings of the enforcement enforce [sic] the Award, and any proceeds ... of any of the foregoing held by the Claimants as of the date of the assignment ... (collectively, the 'Litigation Rights')."[36] The term "Award"—namely the actual, ex post value of the claim, if successful—is, in turn, described in a page-long definition and includes:

> [The] gross ... value awarded ... by virtue (directly or indirectly) of ... the Claim, whether by negotiation, arbitration, mediation, diplomatic efforts, lawsuit, settlement, or otherwise ... plus ...

---

33. Parloff, *supra* note 11.

34. Although some forty individuals are named as parties to the agreement, Treca Agreement, *supra* note 32, sched. 1, it is the FDA that is "the sole beneficiary of the Claim as a result of the designation by the Claimants," *id.* sched. 1, § 21. The Agreement purports to bind Claimants who have not signed the agreement. *See, e.g.*, *id.* § 1.3 (defining the term "obligations of the Claimants" to mean "obligations expressed to be performed by the Claimants, whether or not those Claimants are signatories to this Agreement"); *id.* § 8.4-5 (asserting that FDA must secure the obligations of Claimants whether or not they are bound by the Agreement). The Agreement purports to empower the FDA to act on behalf of all Claimants, named and unnamed, including Claimants who are not signatories to the Agreement. *See id.* § 8.4.

35. *Id.* § 23.1.

36. *Id.* § 8.1(a).

> any recovered interest, penalties, attorneys' fees and costs ... plus ... any interest awarded or later accruing .... [And also] cash, real estate, negotiable instruments, choses in action, contract rights, membership rights, subrogation rights, annuities, claims, refunds .... [And] including ... the value of, or any obligation to perform or conduct, any investigation or other assessment (including ... to assess risk to any human or the environment), clean-up, remediation, or mitigation or prevention or measures arising from or relating to the Claim .... "Award" shall include [all of the above] awarded by the courts of the Republic of Ecuador otherwise than to the Claimants as a result of the application of ... Ecuador's *Environmental Management Act*.[37]

Once the Trust is established, the FDA must cause each claimant to assign all of his or her litigation rights in exchange for a "beneficial interest in the Trust."[38] Each Claimant must further "irrevocably assign to the Trust all of his ... rights under th[e] Agreement."[39] In a section titled "Independent Actors," the parties agree that the arrangement "does not create any joint venture, partnership, or any ... type of affiliation, nor [does it] create a joint ownership of the Claim."[40] Once the Trust is established, the Trustee must "execute and deliver to the Funder a joinder agreement by which it assumes the obligations ... to be performed by the Claimants, whether or not those Claimants are signatories to" the Treca Agreement.[41] The Trustee and FDA must grant the Funder a "valid, perfected and

37. *Id.* sched. 3. The term "Claim" itself is defined to include "proceeding[s] in any jurisdiction ... as the same may be varied or enlarged by the addition of claims and/or additional parties ... and shall include ... appellate, annulment[,] ... enforcement, ancillary, parallel or alternative dispute resolution proceedings[,] ... diplomatic or administrative proceedings[,] ... arrangements, settlements, [and] negotiations." *Id.*

38. *Id.* § 8.2. Any Claimant who "executes an Assignment Agreement shall have exactly the same rights, obligations and expectations with respect to the Claim and the Award ... as such Claimant had immediately prior to executing" the assignment. *Id.*

39. *Id.* § 8.3.

40. *Id.* § 16.1. The stated purpose of this section is to avoid any tax implications such structures may entail, *id.*, but in all likelihood, the purpose is also to avoid any fiduciary duties, *id.* § 16.4 ("[N]othing in this Agreement shall give rise ... [to] a fiduciary, lawyer-client, agency or other relationship between the Parties or between their counsel, notwithstanding the information or observations or opinions that may be shared between them.").

41. *Id.* § 8.4.

first ranking security interest" in the claim and the award.[42] In other words, if a court awards remedial measures for the benefit of the harmed community, the Claimants must pay the monetary value of the Funder's portion of such remedial measures. The Claimants may also need to pay the Funder if any award is granted to nonparties.[43]

The extensive provisions relating to perfecting a first ranking security, transferring all rights and proceeds into a Trust, and installing trusted lawyers and Trustees to manage the Trust are all mechanisms put in place in order to address one of the greatest *uncertainties* relating to litigation, especially transnational litigation or arbitration—the uncertainty regarding the cross-border enforceability of the rights in an award, as well as the award itself.[44]

The investment in the Chevron/Ecuador litigation has been syndicated by Burford, the "Major Funder," among a variety of "Minority Funders."[45] Chevron describes in a pleading the entire web of investment relationships in the following terms:

---

42. *Id.* § 8.5

43. Commentators who have written about the commodification problem of litigation funding have suggested that this may have a chilling effect on accepting remedial measures. This risk is heightened in tort cases. *See infra* notes 124-25. It is very likely that these provisions would not be enforced as against public policy. It is also likely that a court would cap an arrangement whereby upward of 80 percent of the settlement proceeds go to the Funder. For example, this is achieved in United States contingency fee cases through the "lodestar standard"—the standard courts use to assess the reasonableness of attorneys' fees in class action cases. According to this standard, courts multiply counsel's reasonable hours by a reasonable hourly rate, which is then adjusted by several factors. *See* Lindy Bros. Builders, Inc. v. Am. Radiator & Standard Sanitary Corp., 487 F.2d 161, 166-69 (3d Cir. 1973) (establishing the lodestar standard). *See generally* Jonathan R. Macey & Geoffrey P. Miller, *Judicial Review of Class Action Settlements*, 1 J. LEGAL ANALYSIS 167, 193 (2009) (analyzing court standards of review for class action settlements).

44. On the challenges of enforcing against foreign assets in transnational litigation and international arbitration, see Jane L. Volz & Roger S. Haydock, *Foreign Arbitral Awards: Enforcing the Award Against the Recalcitrant Loser*, 21 WM. MITCHELL L. REV. 867, 871 (1995).

45. *See generally* Intercreditor Agreement between Treca Financial Solutions, Torvia Limited, and others (Oct. 31, 2011) [hereinafter Intercreditor Agreement] (on file with author); Minor Funder Contracts, *supra* note 23. The Intercreditor Agreement is a contract entered into by the Claimants via their representative FDA, Treca/Burford as a "Major Funder," certain other "Minority Funders," and the American and Ecuadorian counsel for the Claimants. It is incorporated by reference into the Treca Agreement, *supra* note 32, sched. 4, and it ensures all of the Treca Agreement provisions apply equally to all past, present, and future investors, Intercreditor Agreement, *supra*, § 1.28.

> Defendants secured new funding from litigation investment firms, attorneys, and freelance investors. Much of their new funding came from New York-based Burford Advisors .... [A]t the same time they executed the Treca Funding Agreement and the Intercreditor Agreement, the parties were finalizing an agreement with Torvia Limited, a company incorporated under the laws of Gibraltar and owned by Russell DeLeon, a person of interest in an ongoing federal criminal investigation ("Torvia Agreement"). Torvia initially invested $2 million in the litigation on March 4, 2010 and further transferred $1.25 million to [the former lead plaintiffs' attorney] on August 17, 2010 for a 3% cut of the "Net Plaintiff Recovery" from the Judgment.[46]

Having provided an overview of the agreement, the following Subsections will highlight similarities between Burford's approach to the funding of the Ecuadorians' claims and mechanisms developed by venture capitalists to protect themselves against challenges arising from information asymmetry, agency costs, and extreme uncertainty. These mechanisms include control, staged financing, information sharing, the duty to cooperate, negative covenants, and operational efficiencies. This will set the stage for the general theoretical discussion of litigation finance contracting in Parts II and III.

C. The Distribution of Control Between Burford and the Ecuadorian Claimants

The Trust described above is directed and controlled by "the Claimants' Representatives, or a board of managers constituted under the Trust Deed."[47] These representatives and managers have, specifically, "the right to direct and control the Trustee with respect to the pursuit of the claim," including "the litigation strategy, ... the appointment and direction of counsel[,] and approval of any settlement that the Claimants' Representatives or ... board may authorize."[48] The Trust Deed is to be drafted in cooperation by

---

46. Chevron's Memorandum of Law in Support of Its Motion for an Order of Attachment and Other Relief at 12-13, Chevron Corp. v. Doziger, 840 F. Supp. 2d 773 (S.D.N.Y. 2012) (No. 11-cv-00691-LAK) (citations omitted); *see also id.* at 13-14 (going on to list additional individuals and entities investing anywhere from $50,000 to $1 million).

47. Treca Agreement, *supra* note 32, § 8.1(b).

48. *Id.*

Claimants' and Funders' attorneys, and the drafting of the deed is subject to a special dispute resolution mechanism that is different than the one governing the rest of the agreement.[49] For instance, "the Trustee is the only [p]erson entitled to ... pursue the Claim and enforce ... the award."[50] All proceeds of the award are to be paid to the Trust and then distributed in accordance with the Intercreditor Agreement.[51]

The Agreement states that both sides agree their "common interest is served by settling the Claim for a commercially reasonable amount."[52] In a provision that seems contradictory with the investment structure described above, and which is probably meant to provide cover in relation to the rules of professional responsibility that leave absolute control over settlement in clients' hands, the Agreement also states that "the Claimants may at any time without the consent of the Funder either settle or refuse to settle the Claim for any amount."[53]

The key mechanism that provides control to the Funders is the installment of "Nominated Lawyers." The Nominated Lawyers are defined as lawyers "selected by the Claimants with the Funder's approval."[54] The law firm of Patton Boggs LLP has been selected to serve in this capacity, and they have selected James Tyrrell as the lead Patton Boggs lawyer.[55] In fact, the execution of engagement agreements between the Claimants and Patton Boggs, a firm with close ties to the Funder, is a condition precedent to the funding.[56]

---

49. *Id.* § 8.1(d).

50. *Id.* § 8.1(a).

51. Intercreditor Agreement, *supra* note 45, § 2.2.

52. Treca Agreement, *supra* note 32, § 4.2.

53. *Id.* § 4.2.

54. *Id.* sched. 3.

55. *Id.* sched. 1, §§ 2.1(a), 3(b).

56. *Id.* § 2.1(c). The ties between Burford and Patton Boggs generally, and the lead Patton Boggs attorney named in the Agreement specifically, has been described thus:

> Tyrrell is a former [partner] of Burford['s] chairman ... from the days when both were partners at Latham & Watkins.... [As Burford was negotiating the Treca Agreement, it was] subleas[ing] its office space from Patton Boggs's New York office, which Tyrrell heads.... [And, most importantly,] Burford is a client of Tyrrell's.

Parloff, *supra* note 11.

Patton Boggs is also one of the "Active Lawyers"—the lawyers conducting the representation.[57]

In addition to being actively involved in conducting the representation, the Nominated Lawyers control the purse strings. During the course of the litigation, authorization of the named, lead Nominated Lawyer must be obtained for all expenses,[58] and only he can effect the payment.[59] At the conclusion of the litigation, the award proceeds must be delivered to either the Nominated Lawyers or the Trustee, who will manage and distribute them according to the distribution waterfall.[60] In addition to exerting control, it is clear that the Nominated Lawyers, who among other things control the purse strings and serve as monitors, supervise the costs and course of the litigation.[61]

D. Staged Financing and Right of First Refusal

In the timing of Burford's provision of funds under the Agreement we see a form of staged financing common in venture capital. As discussed above, the litigation funding firm's capital commitment is to be funded in three tranches: an initial tranche of $4 million and two additional tranches of $5.5 million each.[62] The Funder retains a right of first refusal on subsequent rounds, and if it declines to fund a tranche, the Claimants have a right to secure funding from other sources.[63] In addition, the Funder has termination rights: it

---

57. Treca Agreement, *supra* note 32, sched. 1, § 3(c). The overlap is reinforced in the definition of the "Nominated Lawyers Representative," which is defined as James Tyrrell or, if he "ceases to act in [that] capacity, then another lawyer *prominently and actively involved in the Claim* selected by the Claimants with [Burford's] approval." *Id.* sched. 3 (emphasis added).

58. *Id.* sched. 1, § 2.1. "Expenses" are defined at length and include, among other things, fees and expenses of lawyers, and fees and expenses associated with any court or arbitral proceedings, *id.*, but exclude "any expenses of the Claimants themselves" and any "awards against the Claimants," *id.* sched. 1, § 2.2(a), (d).

59. *Id.* sched. 1, § 2.1.

60. Intercreditor Agreement, *supra* note 45, §§ 2-3.

61. The explicit language of the contract declares that the Funder is engaged in the business of investment and not the practice of law or other professional activities, and that it will not "give or interfere with counsel's giving of legal advice." Treca Agreement, *supra* note 32, § 16.2-3. This language, however, is probably intended to avoid a charge of the unauthorized practice of law in any of the jurisdictions implicated in the Agreement.

62. *See supra* note 32 and accompanying text.

63. Treca Agreement, *supra* note 32, §§ 2.1(f), 19.1. However, such funding from third

may terminate the Agreement in case of a breach of a material condition, representation, or warranty, as well as due to a breach of the duty to cooperate[64]—discussed below. The staged financing reduces information asymmetry, uncertainty, and agency costs.[65]

E. Information Sharing, Duty to Cooperate, and Common Purpose

A detailed information-sharing regime is prescribed in a provision entitled "Claimants' Duty to Co-Operate."[66] It provides that the Claimants "irrevocably instruct the Nominated Lawyers to keep the Funder fully and continually informed of all material developments ... and to provide the Funder with copies of all material documents."[67] In a separate provision, the Agreement emphasizes that the Claimants' duty to cooperate is "of the essence of the Agreement" as well as a "condition thereof."[68] And in fulfillment of another condition precedent, the Claimants instruct the Nominated Lawyers to provide the Funder all material documentation and material written advice provided by the Nominated Lawyers to the Claimants, to "respond to reasonable requests for material information from the Funder" on an ongoing basis, and to inform the Funder of any form of discontinuance of the action.[69]

The contract then goes on to specify, with some detail, the duties of cooperation, including duties to:

> devote sufficient time and attention[,] ... provide all ... material Documentation[,] ... submit to examination by the [lawyers] for the preparation of written statements[,] ... consult with the [lawyers] as they [prepare to pursue, enforce or settle] the Award[,] ... appear at any proceedings or hearings[,] ... [and]

---

parties must be consistent with the Intercreditor Agreement. *Id.* § 2.1(f).

64. *Id.* §§ 11.1, 13.4.

65. *See infra* Part III.B.2.a.

66. Treca Agreement, *supra* note 32, § 5.

67. *Id.* § 5.1. In an attempt to preserve the attorney-client privilege over the communication between Claimants and the Nominated Lawyer, the provision goes on to state the following: "The Claimants and the Funder agree that the Nominated Lawyers may not disclose information or documents that the Nominated Lawyers reasonably believe could or would jeopardize any privilege." *Id.*

68. *Id.* § 13.4.

69. *Id.* § 13.1(a)-(d).

> cause all persons related to the Claim ... to submit to examination by the [lawyers].[70]

Given that the information sharing regime structured by the Agreement would potentially create a waiver of attorney-client privilege, work-product doctrine, and similar protections, as discussed below,[71] the contract includes a number of provisions aimed at minimizing this risk. For example, the Agreement states that "[t]he Parties acknowledge and mutually represent to each other that it is their common purpose ... to enable the Claimants to pursue their Claim,"[72] as well as, broadly, "that they have a 'common legal interest' in the Claim, [the] Agreement, and any discussion, evaluation and negotiation and other communications and exchanges of information relating thereto."[73]

The parties designate as "Common Interest Material" legal advisers and attorneys' work product protected by any privilege in any jurisdiction, as well as "information ... prepared by the Funder."[74] The parties express their intention that "any Common Interest Material shall at all times remain subject to all applicable privileges and protections from disclosure," and assert that "[i]t is the good faith belief of the [parties] that common interest privilege attaches to the Common Interest Material."[75]

The Agreement also creates a broad category of "Confidential Information" in a clause that provides a glimpse into the information the parties anticipated exchanging.[76] The term encompasses matters such as transactional documents and discussions relating to them; "the existence of the funding ... [and] the identity of the Funder[s;] ... the factual, legal ... [and] economic ... background of the claim; ... the procedural status of the claim; the planned strategies and the tactics[;] ... the expected recover[y;] ... billing arrangements[;] ... litigation risk product[s] [and] information on litigation risk markets[;] ... [and] risk modeling."[77] The Agreement

70. *Id.* § 5.1.
71. *See infra* notes 116-17, 137-40 and accompanying text.
72. Treca Agreement, *supra* note 32, § 4.1.
73. *Id.* § 13.2.
74. *Id.* sched. 3; *see also id.* § 12 ("Confidentiality"); *id.* § 13 ("Information and Privilege").
75. *Id.* § 13.3.
76. *Id.* sched. 3.
77. *Id.*

specifically prohibits any "announcement concerning the existence of th[e] Agreement, the funding of the Claim ..., or the identity of the Funder."[78] In other words, in this Agreement the parties forgo any reputational benefits that may be reaped from making the involvement of a Funder known, especially one that is a market leader. And, neither party may disclose "for a period of seven ... years following [the] termination of th[e] Agreement any Confidential Information or Common Interest Material."[79]

These multiple, elaborate, and at times contradictory provisions capture the tension between the economic imperatives to reduce information asymmetry and the recognition that the law operates to increase it.

F. Negative Covenants, Representations, and Warranties

The Treca Agreement contains a number of negative covenants, representations, and warranties designed to address the problems of extreme uncertainty, information asymmetry, and agency costs.[80] Examples include the Claimants' covenants not to engage in any conduct that is "likely to have a material adverse impact in any way on the Claim [or] the value of the Recovery,"[81] not to execute "any documents which would materially or adversely affect the Claim or the recoverability of the Award,"[82] not to engage in any conduct "that would result in the Funder receiving proportionately less payments or less favourable treatment" as compared with other rights holders in the litigation,[83] and not to "institute any [legal] action ... against any Defendant."[84] By anticipating actions that may

78. *Id.* § 12.3.

79. *Id.* § 12.2.

80. "A representation is a statement of fact as of a moment in time intended to induce reliance." TINA L. STARK, DRAFTING CONTRACTS 12 (2007). A misrepresentation gives rise to a cause of action sounding in tort and allows restitutionary recovery, rescission, and—if fraudulent—punitive damages. *Id.* at 14-15. A warranty is a promise by the maker of a statement that the statement is true. *Id.* at 13. Its breach gives rise to a cause of action sounding in contract and may afford the injured parties damages. *Id.* at 14-15. Therefore, such broad representations and warranties provide the Funder with breach of contract and tort claims.

81. Treca Agreement, *supra* note 32, § 5.2.

82. *Id.* § 10.2(g).

83. *Id.* § 10.2(h).

84. *Id.* § 5.3.

be beneficial to the Claimants but not to the Funders, these provisions address agency costs. Claimants agree not to sell any further portions of the case to other investors without first providing notice to the Funder, nor to do so in a way that is inconsistent with the associated Intercreditor Agreement.[85]

The contract includes a representation that Claimants have received "legal advice in relation to [the] Agreement and all other arrangements between themselves, the Funder and the Nominated Lawyers,"[86] as well as, more broadly, that they have "received independent legal advice on the terms and effect of the Transaction Documents."[87] This language is aimed at a potential charge of a conflict of interest between the Funder and the Claimants.

The Claimants further represent and warrant that they have not made any material omissions;[88] that they have disclosed "all documentation and other information in [their] possession or control relevant to the Claim that is ... likely to be material to the Funder's assessment of the Claim and [that they] believe[ ] ... that the Claim is meritorious and likely to prevail;"[89] and that they did "not fail[ ] to disclose ... any facts ... which ... would ... have led the Funder not to enter into th[e] agreement."[90] These overlapping and somewhat redundant representations and warranties address information asymmetries.

Finally, any attempt to seek relief for breach of the Treca Agreement in a court of law, as opposed to the international arbitration institute specified in the agreement; to seek any other relief or remedies in any forum; or to assert personal jurisdiction over the investors in a U.S. court, all constitute a breach of the Agreement.[91] Instead, the parties opt for confidential international

---

85. *Id.* § 2.1(f). They also covenant not to assign or convey the Agreement or any rights or obligations thereunder. *Id.* § 22.1.

86. *Id.* § 6.1.

87. *Id.* § 10.2(d).

88. *Id.* § 10.2(h). For an example of a court recognizing that a litigation funding agreement may be terminated because of an omission of material fact, see Chevron Corp. v. Doziger, No. 11-cv-00691-LAK, 2012 WL 1711521, at *15-17 (S.D.N.Y. May 14, 2012).

89. Treca Agreement, *supra* note 32, § 10.2(1).

90. *Id.* § 10.2(p).

91. *Id.* §§ 7.8, 23.7-.8. For further discussion of the dispute resolution mechanism in its entirety, see *infra* notes 93-96 and accompanying text.

arbitration and, more broadly, for a highly structured and somewhat unusual dispute resolution mechanism.

All but one of the provisions of the Agreement are governed by the laws of England.[92] The Trustee and the FDA's obligation to provide a valid, perfected, first-ranking security interest is governed by the law of New York.[93] All disputes other than the disputes regarding the value of a noncash award are subject to international arbitration by a three-member panel administered by the International Centre for Dispute Resolution (ICDR).[94] Disputes regarding noncash award value are to be resolved by a single arbitrator, who is an accounting or valuation expert, in an expedited process.[95] The legal seat chosen for any arbitration is London, but the physical location of any proceeding is in the Cayman Islands.[96] As noted, the drafting of the Trust Deed has a separate dispute resolution mechanism.[97]

The champerty doctrine, discussed below, creates a legal gray zone for litigation funding in many jurisdictions;[98] this is a characteristic and, more specifically, a risk factor of litigation as an asset. By tailoring the dispute resolution process and penalizing any attempt to turn to national courts, the parties are endeavoring to reduce and control this risk factor and the uncertainty that the prospect of litigating the Agreement creates. More broadly, these restrictions on using domestic and foreign courts of law are aimed at minimizing the uncertainty relating to the many unsettled and controversial issues regarding the possible interpretation of a third-party litigation funding agreement by American and other courts.[99] They are also more generally aimed at minimizing the uncertainty inherent in dispute resolution by a judge or jury.[100]

---

92. Treca Agreement, *supra* note 32, § 23.1.

93. *Id.*

94. *Id.* § 23.2-.4.

95. *Id.* § 23.4.

96. *Id.* § 23.5.

97. *See id.* § 8.1(d).

98. *See infra* notes 131, 134-35 and accompanying text.

99. *See generally* Steinitz, *supra* note 2, at 1278-82 (putting the United States regulatory environment regarding litigation funding in a global context). On the more relaxed attitudes of international arbitration tribunals towards litigation funding, see generally J.M. Matthews & M. Steinitz, Editorial, *Special Issue: Contingent Fees and Third Party Funding in Investment Arbitration Disputes*, TRANSNAT'L DISP. MGMT., Oct. 2011.

100. Some have described international arbitration as more predictable relative to domestic adjudication by judges, and certainly juries, because of the perceived tendency of

G. Operational Efficiencies

The Treca Agreement seeks to enhance returns to the Funders' investors by minimizing any tax liabilities that may be imposed on the Award. The Claimants commit to structure the Award, as broadly defined,[101] "in the most tax-efficient manner practicable" and to "consider ... commercially reasonable methods," such as a trust, to achieve that purpose.[102] And any taxes that cannot be avoided are to be borne by the Claimants under the Agreement.[103]

Other value enhancements by litigation funders via operational efficiencies can be inferred from the parties' anticipation of information exchange regarding accountants, law firms, advisors, and suppliers; business plans and business relationships; market opportunities and marketing plans; and algorithms, intellectual property, ideas, know-how, knowledge, and research.[104] These represent noncash contributions that the Funder will be bringing to the table.

With this concrete example of Burford's investment in the Chevron/Ecuador litigation, the following Section turns to a general discussion of the economics of litigation finance generally.

II. THE ECONOMICS OF LITIGATION FINANCE

A. The Litigation Finance-Venture Capital Analogy in a Nutshell

The term "venture capital" refers to capital that is pooled, invested in securities, usually stocks, of enterprises in different stages of development, often in their early days, and professionally managed.[105] Venture capital funds (VCFs) raise money from

---

arbitrators—who rely on satisfied attorneys, that is, attorneys who have not lost in their courtroom—to reappoint them in future cases. *See* Stephanie E. Keer & Richard W. Naimark, *Arbitrators Do Not "Split the Baby": Empirical Evidence from International Business Arbitrations*, 18 J. INT'L ARB. 573, 576-78 (2001) (discussing both the perception and the empirical evidence of arbitration decisions).

101. *See supra* note 37 and accompanying text.

102. Treca Agreement, *supra* note 32, § 20.1; *cf.* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2008) (discussing tax implications in the VC context).

103. Treca Agreement, *supra* note 32, § 20.2-.3.

104. *Id.* sched. 3.

105. William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 473 (1990).

individuals and institutions for investment in early-stage businesses that offer high potential returns on investment but carry significant risk of failure.[106] The risk is mitigated through diversification—VCFs develop portfolios of companies, referred to individually as a "portfolio company."[107]

As noted earlier, the term "litigation finance firms" refers to the practice of specialized funds investing in litigation by providing finance in return for an ownership stake in a legal claim and a contingency in the recovery. Like VCFs, which create and manage portfolios of high risk in potentially high-return companies, litigation finance firms develop portfolios of high-risk, high-return litigations.[108]

To state the obvious, both litigation finance and VC are forms of *finance*. Financial contracts, generally speaking, are designed to respond to three problems: uncertainty, information asymmetry, and agency costs. The special character of VC contracting—the essence of which is investment in high-technology, cutting-edge, science-based companies—is that it presents these problems in an extreme form.[109] *The same is true of litigation finance*, the essence of which is investing in legal disputes before all facts and procedural aspects have been ascertained, leading to risks similar to those inherent to VC investing.

Before expounding on these and other similarities, it should be noted that there are also important dissimilarities. The first difference, from which others follow, is simply the nature of the asset

---

106. Francesca Cornelli & Oved Yosha, *Stage Financing and the Role of Convertible Securities*, 70 REV. ECON. STUD. 1, 1 (2003).

107. Sahlman, *supra* note 105, at 474-75. Venture capital firms are usually set up as either open-end funds or closed-end funds. The analysis below applies equally to both. Venture capital is also sometimes provided by "angel investors"—individuals, often times friends or family members—who provide seed funding at very early stages of the enterprise's life. Similarly, individuals—be they family members or professional investors—may provide funding to a litigant with an expectation of making a profit should the litigant prevail.

108. Descriptions of such portfolios can be found in the disclosures of the publicly traded litigation funds. *See, e.g.*, BURFORD CAPITAL INTERIM REPORT 3-4 (2011), *available at* http://www.burfordfinance.com/docs/default-document-library/burford_capital_interim_2011_web.pdf; JURIDICA INVS. LTD., HALF YEARLY REPORT AND UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS 6 (2011), *available at* http://www.juridicainvestments.com/~/media/Files/J/Juridica/pdfs/hy2011-report.pdf.

109. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1069 (2003).

in question. VCFs invest in companies—usually early-stage companies.[110] Litigation finance firms invest in legal claims.[111] One consequence of this difference is that there is more of an understanding and a track record relating to the performance of the former asset but not of the latter one.

Another consequential difference relates to the social utility of the asset in question. The positive social utility of VC is universally accepted: "The venture capital market and firms whose creation and early stages were financed by venture capital are among the crown jewels of the American economy. Beyond representing an important engine of macroeconomic growth and job creation, these firms have been a major force in commercializing cutting-edge science."[112] To name but a few examples of companies that were created with the support of VC, one could list Apple, Intel, FedEx, and Microsoft.[113] Conversely, the social utility of litigation funding is controversial.[114]

Finally, this non-exhaustive list of differences must include the fact that any litigation funding scheme involves not only investors, an investment fund, and an investment, but also attorneys—sometimes acting purely as the representative of the plaintiff and sometimes acting also as investors in the litigation, through contingency fees or other forms of alternative billing schemes. The involvement of an attorney creates a triangular attorney-client-funder relationship, which raises its own set of agency problems. The attorney-client relationship is a regulated relationship, and this regulation further complicates the agency problems:

> Beyond concerns relating to control[,] ... [fragmentation of the attorney's relationship with the client, on the one hand, and the funder, on the other] creates conflicts between an attorney's interest to maximize fees and those of the financier to do the same. These divergent interests may lead one to settle early but the other to proceed to trial .... Similarly, if fee splitting is prohibited and the attorney receives a flat or hourly fee instead of a percentage of the recovery, the attorney has less incentive to properly vet a case as [he] transfer[s] all risk to the funder.

110. *See supra* note 106 and accompanying text.
111. *See supra* notes 7-8 and accompanying text.
112. Gilson, *supra* note 109, at 1068.
113. Sahlman, *supra* note 105, at 482.
114. *See infra* text accompanying notes 124-28.

> This moral hazard can increase if claims are then securitized and further distributed. While both attorneys and funders, as savvy repeat players, have an interest in creating and preserving reputational gains, this interest may pull them in different directions in any given litigation and may not be aligned with the client's interest.[115]

Conflicts of interest are not the only complication created by the triangular attorney-client-funder relationship, which is artificially fragmented through the operation of the rules of legal professional responsibility. Client or attorney communication with the financier, which is necessary for the financier to monitor the litigation, breaks the attorney-client privilege.[116] "[A] lack of such communication creates information asymmetries between the attorney and the funder and lowers the funder's ability to supervise the attorney's work," thereby significantly reducing the potential to have an "agents-watching-agents" effect, namely the potential cross-monitoring of the lawyers and funders.[117]

In sum, the triangular, fragmented attorney-client-funder relationship creates, by design, expanded information asymmetries and has the side effect of magnifying agency costs. The next Subsection further elaborates on how the ethics regime regulating litigation funding must affect our understanding of legal claims as assets. Specifically, it addresses how the path-dependent regulation of third-party funding, originally developed to address the role third-party funding played in land disputes amongst lords in medieval England,[118] affects valuation of legal claims today. It sets the stage for the argument that we should break away from this path and instead connect to the path through which the law governing venture capitalism developed.

---

115. Steinitz, *supra* note 2, at 1324.

116. *E.g.*, Leader Techs. v. Facebook, Inc., 719 F. Supp. 2d 373, 376 (D. Del. 2010).

117. Steinitz, *supra* note 2, at 1324-25 & n.200; *see also* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 850 (1992) (developing the concept of "[a]gents [w]atching [a]gents," which describes situations when the self-interests of one set of agents involves monitoring other agents who have a different set of self-interests that, in turn, may conflict with the interests of the principals); John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 342 (2010) (describing scenarios in which attorneys' and funders' respective self-interests counterbalance each other).

118. Steinitz, *supra* note 2, at 1287.

B. Ethical Bounds to Third-Party Profit Making in Litigation

Litigation funding is a controversial industry. Proponents of litigation funding cite access to justice, leveling of the playing field between plaintiffs and defendants, free speech, and private enforcement of the law as key advantages of the practice.[119] "Third-party funding promotes access to justice by enabling plaintiffs who have meritorious cases to bring litigation they would otherwise be unable to bring and to avoid premature settlements at a discount due to the exhaustion of funds."[120] Funding can level the playing field not only at the level of any given dispute but also on a system-wide level, altering the social function of courts by systemically equalizing the ability of society's "have-nots" to use the courts to affect the path and content of judge-made law via litigation.[121]

First Amendment arguments in support of litigation funding include the recognized notion that the right to sue is a First Amendment right particularly, but not exclusively, in the context of civil rights litigation, as well as the more contentious claim that restricting certain forms of law firm financing is a violation of attorneys' freedoms of speech and association.[122] Last but not least, private law enforcement is the enforcement of the law by private parties pursuing legal action for profit, often times using nonclient financing: "[T]o a unique degree, American law relies upon private

---

119. *See id.* at 1276 n.12, 1303 (commenting on access to justice and on how litigation funding can alter repeat players' power dynamics).

120. *Id.* at 1276 & n.12.

121. *See id.* at 1299-1301, 1303-18 (building upon Marc Galanter's classical essay *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95 (1974)).

122. NAACP v. Button, 371 U.S. 415, 428-29 (1963) (holding that litigation to enforce civil rights is a form of expression protected by the First and Fourteenth Amendments). In a currently pending lawsuit before three federal district courts, the plaintiffs' firm Jacoby & Meyers has sued the states of New York, New Jersey, and Connecticut claiming that state laws prohibiting nonlawyers from owning a stake in law firms unconstitutionally restricts freedom of speech and association as well as interstate commerce. *See* Jacoby & Meyers, LLP v. Presiding Justices, 847 F. Supp. 2d 590, 591-92 (S.D.N.Y. 2012); Complaint at 3-4, Jacoby & Meyers Law Offices, LLP v. Justices of the Supreme Court of N.J., No. 11-cv-02866-JAP (D.N.J. May 18, 2011), ECF No. 1; Complaint at 3-4, Jacoby & Meyers Law Offices, LLP v. Judges of the Conn. Superior Court, No. 11-cv-00817-CFD (D. Conn. Mar. 18, 2011), ECF No. 1; *see also* Case Comment, *Constitutional Law: First Amendment Limitations on State Regulation of the Legal Profession—Litigation as a Protected Form of Expression*, 1963 DUKE L.J. 545, 550-54.

litigants to enforce substantive provisions of law that in other legal systems are left largely to the discretion of public enforcement agencies."[123]

The industry's critics retort with fear of a deluge of nonmeritorious claims, a distaste for nonparty profiteering from litigation, a concern about commodification of causes of action, and an objection to the use of the taxpayer-funded court system for investment purposes.[124] The most vocal opponent of the litigation finance industry in the United States is the U.S. Chamber of Commerce, which describes the practice in these words:

> In a typical case[,] a hedge fund, acting on behalf of already wealthy investors, will seek to accumulate yet more money—not by investing in business enterprise or wealth creation—but by gambling on the outcome of a legal action for damages. They have no interest in the justice or otherwise of [sic] the case—only in the chances of success—as they will demand a share of the damages awarded in return for putting up the stake money.[125]

Another key concern is that third-party funding will diminish clients' control over their claims generally, and in particular in connection with the decision of when and for how much to settle: "The argument against litigation funding based on the client's

---

123. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 669 (1986); *see also* Coffee, *supra* note 117, at 341-42 (arguing that nonprofit groups in Europe should join forces with litigation funders); Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 674-75 (1994).

124. *See, e.g.*, Stephen B. Presser, *A Tale of Two Models: Third Party Litigation in Historical and Ideological Perspective* 27 (Northwestern Univ. Sch. of Law Searle Ctr. on Law, Regulation & Econ. Growth, Pub. Policy Roundtable on Third Party Fin. of Litig., Discussion Draft, Oct. 2009); *see also* VICKI WAYE, TRADING IN LEGAL CLAIMS: LAW, POLICY & FUTURE DIRECTIONS IN AUSTRALIA, UK & US 48 (2008) (discussing commodification of legal claims); Paul H. Rubin, On the Efficiency of Increasing Litigation 10-11 (Sept. 24-25, 2009) (unpublished manuscript), *available at* http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf (arguing that the costs imposed by litigation on defendants are greater than costs borne by plaintiffs, especially when plaintiffs are individuals or class members and defendants are business firms).

125. JOHN BEISNER ET AL., SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES 3 (Oct. 2009), *available at* http://www.instituteforlegalreform.com/sites/default/files/thirdpartylitigationfinancing.pdf (released by the U.S. Chamber Institute for Legal Reform).

diminished control is, in essence, one of separation of ownership and control between the client and the funder (like the attorney in contingency cases)."[126] The Chamber of Commerce report emphasizes that "litigation-financing arrangements undercut the plaintiff's control over his or her own claim because investors inherently desire to protect their investment and will therefore seek to exert control over strategic decisions in the lawsuit."[127]

From the courts' perspective the difficulty posed by litigation funding is that

> organisations like [the funders] play more shadowy roles than lawyers. Their role is not revealed on the court file. Their appearance is not announced in open court.... [T]he court is in a position to supervise litigation conducted by persons who are parties to it; it is less easy to supervise litigation, one side of which is conducted by a party, while on the other side there are only nominal parties, the true controller of that side of the case being beyond the court's direct control.[128]

Despite the controversy, litigation funding is rapidly expanding and is, in all likelihood, here to stay.[129] To date, those studying the young litigation funding industry have focused almost exclusively on the ethics of the practice and its relation to the rules of profes-

---

126. Steinitz, *supra* note 2, at 1323. That article goes on to argue that:

> This is, however, a conceptual confusion that is caused by the tendency to treat third-party funding as identical to attorney funding, in which the party with the purse strings exerts *undue* control. But unlike the case of attorney funding, with litigation funding and claim transfer the client relinquishes full or partial *ownership* over its claim. (In fact, arguably, the attorney and client are now both agents of the funder who co-owns part or the entire claim.) The law should acknowledge that the client relinquishes or should relinquish partial control over the litigation as it transfers partial ownership thereof. This, of course, should be factored into the pricing of the finance in favor of the client.

Id. at 1323-24. The argument herein builds on this view and elaborates on how we can conceptualize and regulate the funder-client relationship once we let go of the path-dependent contingency lawyering analogy and view the funders as real parties in interest.

127. BEISNER ET AL., *supra* note 125, at 7.

128. *Campbells Cash & Carry Pty Ltd. v Fostif Pty Ltd.* (2006) 229 CLR 386, 487 (Austl.) (Callinan, J & Heydon, J, concurring).

129. LLOYD'S, LITIGATION AND BUSINESS: TRANSATLANTIC TRENDS 10 (2008), *available at* http://www.Lloyds.com/~/media/Lloyds/Reports/360/360%20Liability%20Reports/360_Litigationandbusiness.pdf ("Businesses should expect third party litigation funding to rise on both sides of the Atlantic.").

sional responsibility.[130] This Article breaks away from this paradigm. However, before turning to that discussion, it is worth touching on the historical and current ethical constraints on litigation funding in order to reframe those constraints as forces that shape the *economics* of litigation funding.

Where allowed, litigation funding is an exception to the ancient common law prohibition on champerty. A champertous agreement is one in which an owner of a legal claim and a third, unrelated party agree to divide amongst themselves the proceeds of a litigation, if successful. It has also often been referred to pejoratively as an arrangement between an "officious intermeddler" and a litigant whereby "the intermeddler helps pursue the litigant's claim as consideration for receiving part of any judgment proceeds."[131] The origin of the champerty doctrine is in medieval English law, wherein maintenance (the provision of something of value to a litigant in order to support a litigation), champerty (maintenance for a profit), and barratry (the bringing of vexatious litigation) were crimes and torts.[132] During the nineteenth and twentieth centuries these crimes and torts have been abolished throughout the common law world and replaced with legal ethics rules.[133] During the first decade of the twenty-first century the common law world trend to loosen up champerty restrictions—now predominantly an ethical violation—continued.[134]

Nonetheless, champerty is very much a live and operative doctrine in many jurisdictions. In the United States, champerty is

---

130. *E.g.*, Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649, 660-64, 669-81 (2005).

131. Steinitz, *supra* note 2, at 1286-87 (quoting BLACK'S LAW DICTIONARY 262 (9th ed. 2009)).

132. *See* Ari Dobner, Comment, *Litigation for Sale*, 144 U. PA. L. REV. 1529, 1543-45 (1996) (discussing the history of champerty and maintenance laws).

133. For example, in England the crime of champerty has been abolished. *See* Criminal Law Act, 1967, c. 58, § 13, sch. 1 (Eng.). In Australia, champerty and maintenance have been abolished through statutes such as *Maintenance and Champerty Abolition Act 1993* (NSW) and the *Wrongs Act 1958* (Vic) s 32.

134. The two pivotal decisions are the English Court of Appeal's decision in *Arkin v. Borchard Lines Ltd.*, [2005] EWCA (Civ) 655, [16], [45], [2005] 3 All. E.R. 613, which held that third-party funding is acceptable and even desirable as a way of increasing access to justice, and the Australian High Court's decision in *Campbells Cash & Carry Pty Ltd. v Fostif Pty Ltd.* (2006) 229 CLR 386, 434-35 (Austl.), which permitted third-party funding and even approved of the funder having broad powers to control the litigation.

a common law doctrine which varies by state and entails fact-specific, case-by-case analysis: "Of the twenty-eight states that permit maintenance in some form, sixteen explicitly permit maintenance for profit. The remaining states probably permit champerty —it is just that they do not explicitly cite the investment by contract into a stranger's suit as a permissible form of maintenance."[135]

Champerty is not the only ethical hurdle to litigation funding. Law lenders, who provide recourse loans, are subject to usury laws, namely the prohibition on excessive interest rates.[136] Lawyers involved in financed cases must make sure not to run afoul of professional responsibility rules such as the prohibition on fee sharing,[137] the duty to exercise independent professional judgment,[138] and the duty of loyalty to the client.[139] Close attention has particularly been given, in the context of the rise of litigation funding, to the need not to violate or waive attorney-client privilege or the protection of the attorney work-product doctrine when communicating with funders.[140]

Particularly in the United States, ethical rules rooted in the desire to allow plaintiffs to retain maximum control over their claims have naturally led to discussions of the industry in ethical terms, creating a clear obstacle to litigation funding. In economic terms, however, current ethical rules *greatly increase information asymmetries,* and the described conflicts of interest *increase agency costs*, while the nature of legal claims—as *assets*—contributes to *extreme uncertainty*. The following Subsections will show that litigation funding shares those same characteristics with VC, paving the way for the argument that the successful approaches to

---

135. Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 107 (2011); *see also id.* at 98-120 (providing a survey and analysis of the law of maintenance, champerty, and assignment in all fifty-one jurisdictions and concluding that the answer to the question of how states determine whether, and to what degree, nonlawyer third parties may support meritorious litigation is complex and that confusion reigns over the doctrines and their application).

136. Susan Lorde Martin, *Financing Litigation On-Line: Usury and Other Obstacles*, 1 DEPAUL BUS. & COM. L.J. 85, 89-91 (2002).

137. MODEL RULES OF PROF'L CONDUCT R. 5.4(a) (2010).

138. *Id.* R. 5.4(a)-(d).

139. *Id.* R. 1.7 cmt. 1.

140. *See id.* R. 1.6(a) ("A lawyer shall not reveal information relating to the representation of a client."); *id.* cmt. 3 (discussing the attorney work-product doctrine).

structuring VC can be applied, and in some cases adapted, to litigation funding.

C. Information Asymmetry and Agency Costs

Venture capitalists face extreme information asymmetry because the entrepreneurs have all the information about the invention. In particular, the fact that the company's technology often involves cutting-edge science creates substantial information asymmetries in favor of the entrepreneur, a specialist in said science, over the venture capitalist. Information asymmetries between investors and entrepreneurs are further expanded due to the fact that the intentions and abilities of the entrepreneurs are hard to observe and assess.[141]

Litigation financiers face similar asymmetries, because the plaintiffs have private knowledge of the facts, including knowledge of potentially key facts, harmful "smoking gun" documents, potentially harmful or weak witnesses, and the like.[142] Current ethical rules act to reinforce plaintiffs' disincentive to share that private knowledge with anyone other than their attorneys by withholding privilege from communications to nonattorney parties.[143]

The plaintiff's intentions and abilities are as hard to observe as those of an entrepreneur. For example, a plaintiff's willingness or capacity to cooperate effectively with counsel—for instance, by timely producing documents, or by ensuring that witnesses make themselves available for deposition—are unknown to the funder. Whether and to what degree the plaintiff is susceptible to "litigation fatigue" caused by the emotional stress of litigation, or is an effective witness, are similarly unknown. These information asymmetries are compounded by the deliberate information asymmetries that result from the attorney-client privilege, discussed above.

Venture capitalists face extreme agency costs because the success of the venture depends on the efforts of the entrepreneurs, who have been compensated up front.[144] The importance of future managerial

---

141. *See* Gilson, *supra* note 109, at 1076-77.
142. *See supra* notes 116-17 and accompanying text.
143. *See supra* notes 137-40 accompanying text.
144. *See* Gilson, *supra* note 109, at 1083-84.

decisions in the early stage venture creates agency costs that are amplified by the fact that an entrepreneur's interest in the venture, which is now backed by VC, is appropriately understood—in the same manner as litigation—as an option.[145] Therefore, the entrepreneur is now in a conflict of interest vis-à-vis the VC investors with respect to such issues as the desirable level of risk and the investment duration.[146] The entrepreneur will now be inclined to assume more risk and hold the investment longer than she would have had the venture been self-financed. The venture capitalist, by contrast, will be incentivized to liquidate the investment as early as possible.[147] This latter agency problem has been referred to as "grandstanding" or the "early harvesting" problem.[148]

The early harvesting problem in the VC context is identical to the early settlement problem—one of the most commonly cited concerns of both proponents and opponents of litigation funding.[149] Here, the concern is that funders are incentivized to settle early for a discounted but secure amount rather than proceed to a costly trial that may result in a loss or low recovery. They are also incentivized to underinvest in the litigation because they face diminishing returns the longer the litigation proceeds.[150] And the plaintiff, who no longer bears the risk of a loss, may now have an incentive to resist a reasonable and rational early settlement in favor of a late

---

145. *Id.* at 1077; *see also* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 650-52 (1973) (describing corporate stocks in terms of options).

146. Gilson, *supra* note 109, at 1077.

147. *Id.* at 1074.

148. *See id.* at 1074-75; Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133, 133 (1999) (testing, specifically, "the hypothesis that young venture capital firms take companies public earlier than older venture capital firms in order to establish a reputation and successfully raise capital for new funds," and showing, inter alia, that "young venture capital firms have been on the board of directors a shorter period of time ... and time the IPO to precede or coincide with raising money for follow-on funds").

149. Steinitz, *supra* note 2, at 1313; *see also* Nicholas Dietsch, Note, *Litgation Financing in the U.S., the U.K., and Australia: How the Industry Has Evolved in Three Countries*, 38 N. KY. L. REV. 687, 692-93 (2011).

150. Steinitz, *supra* note 2, at 1313; *see also* Macey & Miller, *supra* note 43, at 192-94 (2009) (discussing similar agency problems between contingency fee lawyers and clients in settlement negotiations); Steinitz, *supra* note 2, at 1313 ("Both problems are exacerbated by the fact that [funders] make decisions across a portfolio of cases—trading off a small gain in one case for a larger gain in another case achieved with the same time-investment and reputational costs.").

settlement or even a risky and expensive trial.[151] Litigation financiers also face extreme agency costs because success depends on plaintiffs' cooperation in the prosecution of the case after they have transferred the risk—litigation costs—and a large portion of the rewards—a significant percentage of the recovery.[152] This particular agency problem, or moral hazard, is well known from the insurance context in which insurers take on the burden of litigation but require, via contractual obligations, the cooperation of the insured.[153]

D. Legal Claims as Assets and Extreme Uncertainty

Ventures backed by VC are characterized by great uncertainty and high failure risk and are therefore typically not financed by banks.[154] The general uncertainty inherent in financing is magnified in the VC context because the portfolio company is at an early stage and most of the important decisions bearing on the portfolio company's success remain to be made. The quality of the company's management has yet to be ascertained and investors do not have certainty regarding the technological soundness or science underlying the venture's business.[155] Further, one of the key risks associated with a VC portfolio company's investment returns is their variability.[156] Research has shown that while a small number of VC investments yield a very high return many more result in partial or

---

151. *See* Steinitz, *supra* note 2, at 1313 n.166.

152. *Cf.* JOHN F. DOBBYN, INSURANCE LAW IN A NUTSHELL 317 (4th ed. 2003) (discussing the same agency problem between insurer and insured).

153. *See, e.g.*, *id.*; Michelle Boardman, *Insurers Defend and Third-Parties Fund: A Comparison of Litigation Participation* 15-16 (George Mason Law & Econ. Ctr., Working Paper, 2011) (noting that courts might imply a duty of cooperation even absent a contractual obligation). Insurance funding of defense is a long-standing form of litigation finance as is contingency fee, on the plaintiff's side.

154. *See* PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 127 (1999) [hereinafter GOMPERS & LERNER, THE VENTURE CAPITAL CYCLE] (explaining why traditional sources of financing are unsuitable for VC projects); Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 465 (1996) [hereinafter Gompers & Lerner, *Covenants*] (discussing the high-risk investments of venture capitalists and the tools they use to better manage such investments). In addition, banks do not invest in litigation financing because it is financing provided upfront with no expected cash flow for an extended period of time. I thank Victor Goldberg for this comment.

155. *See* Gilson, *supra* note 109, at 1076-77.

156. *See id.* at 1076.

complete loss. For these reasons, VC returns have been likened to options—both are characterized by a very small chance of a very large payout.[157]

Litigation funding has a similar degree of extreme uncertainty as does VC. In the case of litigation funding, the litigation is usually at an early stage and discovery of facts is preliminary at best. Furthermore, when the subject matter of the litigation requires specialized know-how—for example, in intellectual property cases, which can be technology-centered, or in antitrust cases, which can involve advanced economic theory—or when the case involves new legal frontiers where doctrine and precedent are undeveloped—such as in cross-border human rights and mass tort cases[158]—subject matter uncertainty can increase overall uncertainty in the same manner that scientific uncertainty operates in the VC context.

The client's and the attorney's control over the litigation create further uncertainty for the financier. The attorney's influence over the litigation, as discussed below,[159] is not dissimilar to management's influence over a portfolio company. In other words, the quality of the attorney's decision making, a relative or complete unknown to the funder, contributes to the uncertainty, especially when the attorney has been retained prior to the funder's involvement and without the funder's input.[160]

But the most significant source of uncertainty for litigation funding is the nature of litigation itself. According to a new body of literature that applies financial theory to law, litigation should be

---

157. John H. Cochran, *The Risk and Return of Venture Capital*, 75 J. FIN. ECON. 3, 5 (2005); Gilson, *supra* note 109, at 1076; *see also* Sahlman, *supra* note 105, at 482-83 (emphasizing the great uncertainty regarding returns on individual VC projects). For example, one of the earliest VC investments, American Research and Development Corporation's "ARD," the first-ever professional VCF formed in 1946, invested in Digital Equipment Corporation and yielded a return of more than 70,000 percent. *See* SPENCER E. ANTE, CREATIVE CAPITAL: GEORGES DORIOT AND THE BIRTH OF VENTURE CAPITAL 107-08, 196 (2008).

158. The Supreme Court is, as of this writing, hearing a pivotal case with broad implications as to the question of whether corporations can be held accountable for cross-border human rights and environmental abuses. Kiobel v. Royal Dutch Petroleum Co., 132 S. Ct. 472 (2011). I note this example because the test case described in Part I is a cross-border mass-tort case.

159. *See infra* Part III.A.

160. *See* Steinitz, *supra* note 2, at 1313 (discussing the motives underlying attorney underinvestment in any given litigation).

analyzed as an option, because during the course of a case each party has an option to settle or select trial. This choice suggests the application of an option pricing model to legal valuation: "The case assessment of a civil action follows a random walk like that of a stock. The up-down movement of probability (expectations [of the parties]) is a function of information dissemination."[161]

Similarly, according to financial theorists of law, legal probability is not statistical or objective. It is logical and subjective, changing over the lifetime of a litigation as facts unfold. Thus, while the law and economics literature models probability as an empirical and quantifiable concept, when mathematicians considered the application of probability to legal action they rejected the notion that statistical probability could apply or that such probability was measurable.[162]

Further, while classical economic theory of law assumes that decision standards of deliberative bodies—such as courts and arbitral tribunals—are a fixed point of reference, both financial theorists and behavioral economists of law argue, and show, that the assumption that these bodies apply consistent standards in similar disputes is unrealistic. This is because judicial proceedings are not predictable and because the ability of parties and their lawyers to predict such outcomes are inherently, and deeply, flawed.[163]

In particular, behavioral economic analysis of the law literature, which emerged in the late 1990s and the 2000s and has focused in no small part on litigation, shows that litigation behavior can be expressed in terms of three important "bounds" on human behavior: bounded rationality, willpower, and self-interest.[164] Each of the

161. Robert J. Rhee, *A Price Theory of Legal Bargaining: An Inquiry into the Selection of Settlement and Litigation Under Uncertainty*, 56 EMORY L.J. 619, 664 (2006). A "random walk" is a mathematical expression of a trajectory that consists of taking successive random steps. Karl Pearson first used the expression in *The Problem of the Random Walk*, 72 NATURE 294 (1905). According to Rhee, like stock prices, perceived case values fluctuate based on new information. Rhee, *supra*, at 664.

162. *See* Rhee, *supra* note 161, at 645-50 (distinguishing statistical probability from logical probability—the latter being a relationship between premises, facts, inferences, and conclusions—and discussing the mathematical literature).

163. *See id.* at 637. The decision of a deliberative body "does not exist *ex ante* as a fixed reference point that the parties must discover, but is simply an ex post result that the parties achieve if they opt for trial." *Id.* at 663-64 (emphasis added).

164. Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV.

three bounds has a documented effect on the ability to generate sound predictions of the litigation process.[165]

For example, parties, lawyers, judges, and juries operate based on heuristics and biases, creating uncertainty as to a dispute's outcome. Further, empirical evidence reveals that litigants are not optimal processors of information. Consequently, parties' assessments of the likely outcome of the litigation diverge, rather than converge, as more facts are disclosed—usually, through the discovery regime.[166] It turns out that in reality shared information is likely to be interpreted egocentrically by disputants.[167] Parties tend to "either be overoptimistic in the assessments of cases or construe the fairness of the situation in a self-serving fashion."[168] Self-serving inferences and the sunk costs bias have been shown to explain why certain procedural mechanisms designed to cause more upfront information sharing and evaluation, "like liberalized summary judgment ... standards and mandatory disclosures ... may not have the desired pro-settlement effects" intended.[169]

Several studies have demonstrated that even experienced litigators are not good predictors of claim value. "The results are consistent: lawyers, insurance adjusters, and judges all err by very substantial amounts when asked to estimate either the settlement value or predicted trial outcomes."[170] Empirical research shows that

---

1471, 1476-77 (1998).

165. *See generally* 3 BEHAVIORAL LAW AND ECONOMICS (Jeffrey J. Rachlinski ed., 2009); Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1508, 1511 (1998).

166. *See* Rhee, *supra* note 161, at 653.

167. George Lowenstein & Don A. Moore, *When Ignorance Is Bliss: Information Exchange and Inefficiency in Bargaining*, 33 J. LEGAL STUD. 37, 37 (2004).

168. Langevoort, *supra* note 165, at 1510-11.

169. *Id.* at 1511; *see also* Samuel Issacharoff & George Loewenstein, *Second Thoughts About Summary Judgment*, 100 YALE L.J. 73 (1990); Samuel Issacharoff & George Loewenstein, *Unintended Consequences of Mandatory Disclosure*, 73 TEX. L. REV. 753 (1995); Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 100-01 (1993) (suggesting that once lawyers commit to client representation they may be biased in their construal of information and hence miss warning signs of client fraud); Elizabeth F. Loftus & Willem A. Wagenaar, *Lawyers' Predictions of Success*, 28 JURIMETRICS J. 437, 450 (1988) (discussing the effects of overoptimism on how lawyers assess the probability of success).

170. Stephen C. Yeazell, *Transparency for Civil Settlements: NASDAQ For Lawsuits?* 9 (UCLA Sch. L. & Econ. Research Paper Series, Research Paper No. 08-15, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1161343##.

lawyers tend to be generally overconfident, and especially so in cases in which they initially made highly confident predictions.[171]

Additionally, most lawyers are not experienced trial lawyers since the vast majority of cases settle.[172] They therefore do not have the required experience that would, perhaps, have afforded them the ability to soundly assess the likelihood of how a judge or a jury would decide. The rarity of trials also complicates efforts to value or model litigation outcome because it results in a lack of adequate data upon which lawyers or financiers can rest their predictions.

Furthermore, while there is a huge number of settlements—the market in settlements is estimated to have an annual value of $50 billion, which is similar to the U.S. housing market—this market is unusual in that we have no information about it.[173] Consequently, pricing information for civil settlements badly lags behind information about comparable markets. "Lacking information about comparable transactions, litigants and their lawyers price [settlements] in the dark."[174] Financial economics has conclusively shown that accurate predictions of future prices by individual participants, even in normal markets, are impossible, and

> there is no reason why this truth does not apply with more force to the predictions of legal decisions given that a civil action is not subject to market pricing, is not supported by risk management services or a derivative market, and is one of the most illiquid of assets.[175]

In sum, it appears that parties and their lawyers cannot be expected to accurately predict the decisions of deliberative bodies, accurately assess the risks inherent in litigation, or reliably valuate a claim. In other words—and alluding to one, oft-cited definition of risk and uncertainty, according to which risk exists when alternative future states of the world occur with quantifiable probability,

---

171. *See* Loftus & Wagenaar, *supra* note 169, at 450.

172. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 410 (2004) ("[O]ver 96 percent of civil cases do not go to trial.... [In] 2001 almost 98 percent of federal civil cases were resolved without trial.... [B]ecause many disputes are settled before any complaint is filed, 96 percent or 98 percent may understate the settlement rate.").

173. Yeazell, *supra* note 170, at 6.

174. *Id.* at 2.

175. Rhee, *supra* note 161, at 627.

whereas uncertainty exists when alternative future states of the world occur without quantifiable probability[176]—investing in legal claims is both a risky and a highly uncertain endeavor. Therefore, it is not surprising that emerging evidence, as well as the budding literature, suggests that litigation finance returns are highly variable. Indeed, some have gone so far as characterizing litigation finance in its entirety as "speculative" and "subprime."[177]

The upshot, however, is that case outcomes are not completely random. Although litigation finance is highly uncertain, funders may still be able to enhance value through aggregation of claims in a diversified portfolio and through noncash contributions including investment of human capital such as expertise, enhancing reputation, and monitoring. In this—as in the magnified information asymmetries and agency costs characteristic of litigation funding—litigation funding is similar to venture capital.

With this overview of legal claims as risky and uncertain investments, of the magnified information asymmetries, and of agency costs in mind, the next Part offers solutions adapted from VC. Organizationally, the hallmark solutions are the use of limited partnerships—in which investors are passive limited partners, and the general partner is a company comprised of investment professionals who contribute expertise, more so than funds—and an incentive-aligning compensation scheme. Contractually, the cornerstones are staged financing, the role of management, use of negative covenants, mid-length investment terms with mandatory distributions, and liquidation. Also key are reputation markets.

The next Part focuses on the recommended contract between the litigation funding firm and the plaintiff because this relationship is the heart of the arrangement, is the focus of the concerns surrounding litigation finance, and is a new relationship regarding which there is virtually no publicly available information. But the Part also briefly makes recommendations regarding the litigation funding firm's contractual relationships with its investors and highlights the special role the attorney retention agreement can

176. FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 19-20 (1921).

177. *See, e.g.*, Susan Lorde Martin, *Litigation Financing: Another Subprime Industry that Has a Place in the United States Market*, 53 VILL. L. REV. 83, 95 (2008).

play in supporting the desirable litigation funding firm-plaintiff equilibrium.

III. VENTURE CAPITAL'S LESSONS LEARNED: CONTROLLING EXTREME UNCERTAINTY, INFORMATION ASYMMETRY, AND AGENCY COSTS THROUGH ORGANIZATIONAL AND CONTRACTUAL ARRANGEMENTS

A. Recommended Organizational Structure

Organizational features of VCFs and the choices made in structuring the funds, such as profit-sharing rules and self-liquidation, have long-lasting effects on the behavior of venture capitalists and profound implications for the financed portfolio company and the funds' investors.[178] The key organizational features—limited partnerships, compensation, and noncash contribution—are discussed in this Section.

1. Limited Partnerships and Syndication

Most of the financial literature regards the structure of private equity organizations, and in particular the reliance on limited partnerships with finite durations, as critical to their success.[179] The typical form of organization in the VC market involves institutional investors who rely on VCFs, structured as limited partnerships, to manage their investments.[180] The institutional investors are the passive limited partners, and the general partner (GP) is a money management company that employs professionals with specialized expertise. These professionals select and then monitor the VCF's investments on behalf of the ultimate investors with the expectation of going back to the market to raise additional funds for future

178. *See* Cornelli & Yosha, *supra* note 106, at 3, 26-27.

179. Paul A. Gompers & Josh Lerner, *The Determinants of Corporate Venture Capital Success: Organizational Structure, Incentives, and Complementarities*, *in* CONCENTRATED CORPORATE OWNERSHIP 17, 17, 19-20 (Randall K. Morck ed., 2000) (examining the finance literature's maxim that the structure of VCFs "has been identified as critical to their success," and concluding that the key determinant is the presence of "a strong strategic focus").

180. Gilson, *supra* note 109, at 1070; *see also* Michael J. Halloran et al., *Agreement in Limited Partnership*, *in* 1 VENTURE CAPITAL & PUBLIC OFFERING NEGOTATION 1-1, 1-4 to 1-5 (Michael J. Halloran ed., 3d ed. 2011); Sahlman, *supra* note 105, at 487.

funds.[181] The limited partnership agreement sets the fund's corporate governance arrangements.[182] Pursuant to the laws that govern limited partnerships, the limited partners are precluded from interfering in the day-to-day fund management, especially as it may relate to investments in a given portfolio company.[183] Usually, the investment is then syndicated to include additional VCFs as investors in the fund's portfolio.[184]

2. Compensation

The GP's compensation is composed of a small annual management fee calculated as a low percentage of committed capital—2 percent is common—and "carried interest," which is usually 20 percent of the realized profits.[185] Although superficially homogenous, there are subtle and important differences across the compensation provisions in VCF-investor agreements, with larger, more established VCFs, for example, providing for more variable compensation schemes that are more finely tuned to reflect performance.

The compensation scheme plays a central role in the VC setting because the limited partners cannot use many of the methods of disciplining managers found in corporations—such as a powerful board of directors and the market for corporate control. "[I]ndividual partnership agreements are rarely renegotiated ... [and] compensation is one of the most contentious issues between limited and

181. Gilson, *supra* note 109, at 1071.

182. *Id.*; *see also* Sahlman, *supra* note 105, at 489.

183. Gilson, *supra* note 109, at 1071. This alone solves some conflicts of interest that currently exist in litigation funding but are beyond those that arise in the triangular attorney-client-funder relationship and therefore are not the focus of this Article. For example, the individuals who invest in the litigation funding firm may do so in order to gain access to the confidential information of, or cause trouble to, a competitor who is the target of a funded lawsuit.

184. *Id.* at 1073; *see also* Josh Lerner, *The Syndication of Venture Capital Investments*, 23 FIN. MGMT. 16, 16-17 (1994) (researching the patterns of syndication and explaining the different motivations of syndicating the first round of investments as opposed to later rounds and the conflicts of interest between the lead investor and other investors in later rounds).

185. Gilson, *supra* note 109, at 1072. This is a generic description of the compensation structure. For a more nuanced, empirical analysis of VC compensation agreements, see also Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 172-75 (2009).

general partners of venture funds."[186] If adopted in the litigation funding industry, similar compensation structure will, as detailed in the next Section, align the GP's interests with those of both the investors and the plaintiffs.

3. Noncash Contribution

"The GP's principal contribution to the [VCF] is expertise, not capital."[187] Although not formally—that is, contractually—required, the GP "is also expected to make ... noncash contributions to the portfolio company ... [in the form] of management assistance, ... intensive monitoring of the portfolio company's performance ... and the use of the [GP]'s reputation to give the portfolio company credibility with potential customers, suppliers, and employees."[188] For this reason, "[v]enture capitalists are generally seen as value-added investors who have played a significant role in the development of many entrepreneurial businesses."[189]

This point has far-reaching implications for how we conceptualize the role of litigation funders. Perhaps one of the key insights that the analogy between the two forms of financing provides is the noncash contributions of the GPs to the fund and the investments —that is, the litigations. Given the uncertainty and variability of legal claims, it could be argued that the major value added by the GP to the litigation funding firm is similarly the expertise of the principals. Rather than attempting to restrict this contribution as we do now by frowning upon any shift of control from the plaintiff to the litigation funding firm—and rather than impeding communication between the funder, on the one hand, and the plaintiff and

186. Paul A. Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3, 4 (1999) (internal quotation marks omitted).

187. Gilson, *supra* note 109, at 1071.

188. *Id.* at 1072.

189. Vance H. Fried et al., *Strategy and the Board of Directors in Venture Capital-Backed Firms*, 13 J. BUS. VENTURING 493, 493 (1998); *see also* Christopher B. Barry et al., *The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going-Public Process*, 27 J. FIN. ECON. 447, 449 (1990) (examining a set of IPOs "by [VC]-backed companies between 1978 and 1987," and finding "that venture capitalists specialize their investments in firms to provide intensive monitoring services," and further finding that "[t]he quality of their monitoring services appears to be recognized by capital markets through lower underpricing for IPOs with better monitors").

her lawyer, on the other—the law should endorse and facilitate private ordering that opts into these value-enhancing arrangements. They benefit the *plaintiffs* as much as they do the funder.

The principals of litigation funding firms tend to be seasoned lawyers who build heavily on their reputation and connections within the legal community.[190] Their background and standing as senior lawyers position them to select promising cases, assets that the investors—pension funds, university endowments, wealthy individuals, and so on—do not have specialized expertise in selecting for themselves. They can and do assist in case development,[191] for example making litigation strategy choices and developing novel legal theories. In other words, they can enhance value by reducing unique, case-specific risk. In addition, litigation funding firms appear to be in the early stages of developing subject-matter specializations.[192] Some funds, for example, invest exclusively or predominantly in intellectual property cases.[193] Other funds concentrate on international arbitration and have in fact evolved from firms that specialize in conducting discovery or enforcement in foreign jurisdictions.[194] Some funds emphasize their intention to avoid investing in class actions.[195] Such subject-matter expertise will further enable funders to reduce unique risk.

The personal experience and reputations of these lawyers-*cum*-financiers further position them to monitor both plaintiffs and

---

190. *See* Steinitz, *supra* note 2, at 1300.

191. Lindsay, *supra* note 10 ("Fulbrook, sa[id] Seidel, is different from other litigation funders. 'We not only evaluate a case and fund it by advancing capital, but we also put together integrated human resources to evaluate and enhance claims. We do not just advance money, but also work with the claim after it's funded to try to enhance, to give value. This is a little different than most established funders,' he explain[ed].").

192. *See* Steinitz, *supra* note 2, at 1316-17.

193. These are sometimes referred to as "patent trolls." *See, e.g.*, Caroline Coker Coursey, *Battling the Patent Troll: Tips for Defending Patent Infringement Claims by Non-Manufacturing Patentees*, 33 AM. J. TRIAL ADVOC. 237, 237 (2009).

194. For example, one company based out of London specializes in "cost assessment for international arbitration" and "management of cross border litigation [and] international arbitration for claimants [and] funders." *Services*, GLOBAL ARB. LITIG. SERVICES, http://www.globalarbitrationlitigationservices.com/services.html (last visited Oct. 20, 2012).

195. Juridica, for example, states that it "focus[es] exclusively on business-to-business related claim[s]" and that "[i]t does not invest in personal injury, product liability, mass tort, or class action claims." *About Juridica*, JURIDICA INVESTMENTS LTD., http://www.juridicainvestments.com/about-juridica/investment-policy.aspx (last visited Oct. 20, 2012).

lawyers, thereby reducing the costs of the litigation.[196] Lawyers are in a better position to know how other lawyers may squander resources. If allowed, this is the second key way in which litigation funding firms can enhance value not only for themselves and their investors, but also for the plaintiffs. Finally, the involvement of the litigation funding firm, "if [it becomes] known to the opposing party, [is likely to serve] as a signal ... regarding the strength of the case."[197] This may induce earlier, and therefore more cost-effective, settlements.

Given the strong similarities between the economic problems of VC—which have resulted in the evolution of these organizational structures—and those that characterize litigation funding, litigation funding firms would be well served by organizing similarly. Namely, litigation funding firms should be specialized funds that operate based on the principles of modern portfolio theory. The pooled investments that are litigation funding firms should be organized as limited partnerships. This structure will recognize that the GPs *should* exert disproportionate control over the investments and over their management.[198] Their compensation structure should also be composed of a small management fee and a large uplift in case of success. This compensation structure will align the GP's interests with those of the investors—the GP's disproportionate control over the various investments and over the litigation funding firms notwithstanding—and facilitate the GP's noncash contribution to both investors and plaintiffs. Finally, this structure will isolate investors from their cases, avoiding potential conflicts with defendants.

With this suggested organizational structure in mind, the next Sections will describe in brief the recommended contractual structure for the litigation funding firm-investor contract, the attorney retention agreement, and in length the key contract: the litigation funding firm-plaintiff contract. The emphasis on the litigation funding firm-plaintiff contract is due to its centrality to the claim transfer transaction, the near-complete lack of publicly available information regarding these crucial contracts, and the fact that the

196. *See* Steinitz, *supra* note 2, at 1276, 1336.
197. *Id.* at 1305.
198. *See infra* Part III.B.1.a.

litigation funding firm-investor contract and the retention agreement should be quite similar to the well-documented and -theorized VCF-investor contract and contingency fee agreements, respectively. I will nonetheless describe both briefly, for the sake of completion and in order to show their beneficial effects by way of their "braiding," described below, with the litigation funding firm-plaintiff contract.

B. Recommended Contractual Structure

This Section will detail the recommended structure of the three contracts that govern litigation finance: the litigation funding firm-investor contract, the litigation funding firm-plaintiff contract, and the attorney retention agreement.

1. The Litigation Finance Fund-Investor Contract

The way to achieve the organizational structure recommended above is through the contract between the investors and the litigation funding firm. The litigation funding firm-investor contract should be similar to the VCF-investor contract: a limited partnership agreement. This means that it will be characterized by "[near-] complete control vested in the GP, [a] highly incentivized compensation [scheme], mandatory distribution of realized investments, and mandatory liquidation after a fixed term."[199] These are described briefly below.

a. Control and Compensation

As noted before, the GP's main contribution is its noncash contribution. In order for the investors to benefit from the GP's skill and experience, however, they must give significant discretion and control to the GP. In fact, GPs of VCFs obtain control that is completely disproportionate to both their capital contribution and their carried interest.[200] The consequence is a VCF corporate governance scheme that brings the general corporate governance

199. Gilson, *supra* note 109, at 1087-88.
200. *Id.* at 1088; *see also* Litvak, *supra* note 185, at 173, 175.

problem of the separation of ownership and control to an extreme.[201] Such discretion is counteracted through the compensation structure. Most of the GP's compensation, as discussed above, consists of the carried interest. The distribution of carried interest, which happens only when profits are realized, is simultaneous to the GP and to the investors. The GP's carried interest compensation can be subjected to claw back provisions.[202] Such a compensation structure compensates for the conflicts created by the separation of ownership and control by realigning the interests of the GP and the investors.[203]

b. Mandatory Distributions and Liquidation

The aforesaid compensation structure creates another agency problem: under certain circumstances it may incentivize the GP "to prefer investments of greater risk than the investors" would prefer.[204] One response to this agency problem is the VCF's fixed term. "The ... fixed term assures that at some point [in time] the market will [fix and] measure the GP's performance, making [it] readily observable" to future investors in successor funds.[205] Fixed terms are key to reputation markets, which, in turn, are key for the ability to raise successive funds.[206] Moreover, both "[m]andatory distribution of the proceeds from realized investments and the ... fixed term ... allow the investors to measure the [GP's] performance against [available] alternatives."[207]

The desirability of separation of ownership and control coupled with an incentive-aligning compensation structure are applicable in a straightforward fashion to the recommended litigation funding

201. Gilson, *supra* note 109, at 1088. Also referred to as the Berle-Means problem, this term refers to the fact that shareholders as individuals lack the ability to control a corporation even though in the aggregate they are its owners. The professional management—who are conceptually employees of the shareholders—have greater control over the corporation's resources than do the actual owners. *See generally* ADOLF A. BERLE & GARDNER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 3-5, 64-67 (rev. ed. 1968).

202. Gilson, *supra* note 109, at 1089.

203. *Id.* Gilson describes how this compensation structure creates an incentive for the GP to realize profitable investments prematurely and how so-called "claw back provisions" deal with this particular agency problem. *See id.* at 1072, 1074 (internal quotation marks omitted).

204. *Id.* at 1089.

205. *Id.* at 1090.

206. *See id.*

207. *Id.* at 1089-90; *see also* Sahlman, *supra* note 105, at 499.

firm-investor contract. It is already the case that—at least in some reported cases—investors, in fact, typically do not know which cases the litigation funding firm is invested in.[208] The key difference between the VCF-investor contract and the litigation funding firm-investor contract is the need, in the latter case, for an ethical wall between the investors and the litigation funding firm so that any privileged information provided to the litigation funding firm is preserved, assuming the latter benefits from the attorney-client privilege. Such a wall will obviously increase the information asymmetry between the investors and the litigation funding firm. But the limited partnership structure already accounts for such expanded information asymmetry.

The application of the use of mandatory distribution and liquidation is a bit less straight forward. Although these are beneficial for the investors—and although the average length of a large-scale business dispute litigation is three years,[209] making it naturally suited for midterm investments—any given litigation may take longer. The most obvious example is when an appeal may be required. Therefore, a plaintiff may wish to contract for a commitment to provide additional funds or at least a right of first refusal for funds from the GP's successor funds.

2. The Litigation Finance Fund-Plaintiff Contract

This agreement is the heart of the suggested scheme because at the heart of litigation finance is the transfer of all or part of a claim from the plaintiff to the funder. This section will explore the key features such a contract should include: staged financing, negative covenants, representation in management, highly incentivized compensation, and appropriately timed exit provisions. It will also note the important role of a reputation market as an economic force that further binds, informally and implicitly, the GP.

---

208. *See* Parloff, *supra* note 11.

209. John B. Henry, *Fortune 500: The Total Cost of Litigation Estimated at One-Third Profits*, METROPOLITAN CORP. COUNS., Feb. 1, 2008, at 28, *available at* http://drystonecapital.com/pdf/total_cost_litigation.pdf.

a. Staged Financing

The first recommendation is to contract for staged financing. Staging, a widely used financing technique in VC, refers to the infusion of capital over time.[210] It helps mitigate all three problems: extreme uncertainty, information asymmetry, and agency costs.[211] In staged financing,

> [t]he venture capitalist retains the option to abandon the venture whenever the forward looking net present value of the project is negative. Financing rounds are usually related to significant stages in the development process such as completion of design, pilot production, first profitability results, or the introduction of a second product. At every stage, new information about the venture is released.[212]

Thus, generally speaking, uncertainty is decreased with every further round of investment because new information becomes available.

First round investors are not obligated to participate in later rounds of investment though they may do so, but they would have to negotiate the terms of such later rounds at the time such investments are made, which is usually after certain milestones have been reached. In contrast, the VCF may reserve the right to participate in the later rounds through a right of first refusal provision.[213] Often, the entrepreneur retains the right to seek additional financing from sources other than the VCF if the latter does not wish to further invest or if it is requiring too high a price in order to do so. [214]

Litigation funding can similarly be staged. Examples of relevant milestones in the litigation context would be the survival of a case past an important motion, such as a motion to dismiss, the completion of some or all of the documentary discovery, the completion of a first round of depositions, or the exchange of expert reports. At

---

210. Gilson, *supra* note 109, at 1073.
211. *Id.* at 1078-81.
212. Cornelli & Yosha, *supra* note 106, at 1; *see also* Sahlman, *supra* note 105, at 505.
213. Gilson, *supra* note 109, at 1073.
214. *Id.* at 1079.

each one of these junctures new information is revealed and uncertainty reduced. Financiers may participate in future rounds of investments but the elimination of the right of first refusal may be a desirable modification in the litigation funding context. Such a modification would strengthen the plaintiff vis-à-vis the funder, thus addressing the litigation-specific public policy concerns regarding disproportionate control without disrupting the equilibrium achieved in the VC context.

Beyond shifting exogenous uncertainty from the funder to the entrepreneur or plaintiff, staged financing aligns the interests of the funder and the entrepreneur or plaintiff by tying additional funding to performance and achievements. Endogenous uncertainty, namely uncertainty caused by the entrepreneur's or plaintiff's ability to influence the value of the venture through his or her actions or inaction, is also reduced by staged financing because such staging increases the incentives of the entrepreneur or plaintiff to expand the effort needed to maintain or enhance the value of the venture or litigation.[215] In other words, it reduces agency problems.[216]

The first information asymmetry problem addressed by staged financing is the fact that when deciding between various possible investments—be they startup companies or litigations—a funder has to differentiate between desirable and undesirable investments even though the funder is disadvantaged in comparison to the entrepreneur or plaintiff because the latter have better, private information regarding his or her skills, or about the merit of his or her claim in the case of litigation. It is obviously in the self-interest of the entrepreneur or plaintiff to overstate the quality and likely outcome of the company or of the litigation. "Because the incentive[s] created by staged financing [are] more valuable to a good entrepreneur [or plaintiff] than a bad one," staging operates as a sorting mechanism.[217] The readiness of an entrepreneur or plaintiff

---

215. *Id.* at 1080.

216. *Id.* at 1079-80; *see also* Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461-63 (1995) (finding that "[a]gency costs increase as the tangibility of assets declines, the share of growth options in firm value rises, and asset specific grows;" noting that "higher R&D intensities" function similar to discovery by "lead[ing] to shorter funding durations;" and providing evidence that staging "allows [VCs] to gather information and monitor the progress of firms").

217. Gilson, *supra* note 109, at 1080.

to hold off and receive additional rounds of funding only after milestones have been achieved serves as a signal of skill or of the merits of the case, as applicable. Such a signal is particularly important in the absence of a performance track record in the case of a first-time entrepreneur or a nonrepeat-player plaintiff.[218]

In both contexts, the information asymmetry problem persists beyond the initial selection phase. In fact, the information asymmetry gap is likely to increase over time as the entrepreneur or plaintiff learns more about the company or the litigation. The information asymmetry is even more pronounced in the litigation funding context than in the VC context because of the limitations on communication set by the attorney-client privilege and because of the value-diminishing effect that any disclosure of communication between the attorney and the client to the funder would have if privilege is not extended. Staged financing, by pegging additional funding to the achievement of milestones—and by imposing penalties should the entrepreneur or plaintiff fail to meet those milestones, which have been specified ex ante—renders the entrepreneur's or plaintiff's projections more credible.[219]

Staged financing is also understood by economists as one of three mechanisms that allocate control. The typical VC arrangement allocates to the VCF control over the entrepreneur and the enterprise through at least three mechanisms—one of which is the mechanism of staged funding. The second and third mechanisms are the use of negative covenants and representation on the portfolio company's board of directors.[220] The latter two mechanisms provide for control, and reduce uncertainty, in between financing rounds.[221] The former mechanism provides control at the time of the funding rounds themselves and, by providing an "out," reduces overall uncertainty.[222]

---

218. *Cf.* GOMPERS & LERNER, THE VENTURE CAPITAL CYCLE, *supra* note 154, at 128-30.
219. Gilson, *supra* note 109, at 1081.
220. *Id.* at 1073-74.
221. *Id.* at 1082.
222. *Id.* at 1078-79.

b. Role in Management

The problem of control, from an economics rather than ethics perspective, is that the entrepreneur, and by analogy the plaintiff, exercises discretion and control over the portfolio company's or the litigation's day-to-day decision making.[223] They also have increased information as the company or litigation develops. Furthermore, since no contract between an entrepreneur and a venture capitalist can anticipate every possible disagreement,[224] the venture capitalist typically plays a role in the *operation* of the company.[225] Control in the form of representation on the portfolio company's board of directors often takes the form of "disproportionate representation or even [complete] control of the portfolio company's board of directors."[226]

> Venture capitalists sit on boards of directors, help recruit and compensate key individuals, work with suppliers and customers, help establish tactics and strategy, play a major role in raising capital, and help structure transactions such as mergers and acquisitions. They often assume more direct control by changing management and are sometimes willing to take over day-to-day operations themselves. All of these activities are designed to increase the likelihood of success and improve return on investment.[227]

---

223. *See supra* note 201.

224. As such, the VC and litigation funding contracts are "incomplete contracts." On incomplete contracts, also known as relational contracts, see Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 886-900 (1978), and Ian R. Macneil, *Reflections on Relational Contract Theory After a Neoclassical Seminar*, *in* IMPLICIT DIMENSIONS OF CONTRACT 207, 207-17 (David Campbell et al. eds., 2003).

225. Sahlman, *supra* note 105, at 508 (documenting that lead venture investors spend an average of 100 hours in direct contact with each portfolio company).

226. Gilson, *supra* note 109, at 1082; *see also* Fried et al., *supra* note 189, at 493, 495 (noting that "[o]ne of the most significant value-added activities of the venture capitalist is involvement with strategy," and contrasting boards of VC-backed funds with "board members in public companies who are typically either managers (insiders) or outsiders hand-picked by the CEO. As a result they may emphasize politeness and courtesy at the expense of truth and frankness" (internal quotation marks omitted)).

227. Sahlman, *supra* note 105, at 508; *see also id.* at 506 ("Most agreements call for venture capitalist representation on the company's board of directors .... Often, the agreement calls for other mutually acceptable people to be elected to the board.").

Applying this insight to litigation funding, one could envision a recognized role for the litigation financiers in the day-to-day management of the litigation. Such a role can include the raising of additional funds, helping in formulating legal tactics and litigation strategy, and assisting in structuring the ultimate settlement agreement in the same manner as VCFs help structure key deals executed by portfolio companies.

The influence funders appear to require in particular over the attorney—of both her selection and her strategic decisions—can be viewed as the functional equivalent of the VCF's representation on the portfolio company's board of directors. Therefore, part of the newly allocated control could take the form of approval of the selection of attorneys, who are the "managers" of litigation because they usually make most, if not all, of the tactical and strategic decisions during the course of the litigation. Control allocated to the funder will encourage ongoing monitoring of the investment, namely of the company or the litigation.[228]

As the analysis of the financing of the Ecuadorian plaintiffs in the Chevron/Ecuador dispute in Part I illustrates, control, or at least involvement in and influence over the selection or approval of attorneys, is de facto practiced by some in the industry.[229] Such involve

228. *See* M.J. Goldstein, *Should the Real Parties in Interest Have to Stand Up?—Thoughts About a Disclosure Regime for Third-Party Funding in International Arbitration*, TRANSNAT'L DISP. MGMT., Oct. 2011, at 9-10 ("A decade ago when third-party finance in international arbitration was truly in its infancy ... [funders imposed] contract terms on the financed party that created release points for the financers. Finance contracts ... not infrequently provided that a financer could discontinue financing if developments in the case gave rise to a materially increased risk ... of an unfavorable outcome. Some finance contracts of that era provided that the financed party ... bore an obligation to prosecute the arbitration in a reasonably prudent fashion, and upon breach of this duty the financer could elect to discontinue financing while retaining its interest in the proceeds—this election being provided either expressly or, less transparently, as a principle of the applicable contract law selected by the financer in its standard contract. And some such contracts included as express conditions the commitment of the financed party to seek from the arbitral tribunal an accelerated determination of one or more issues material to the claimant's prospects of ultimate success—so that the financer could reach an early decision point to continue or terminate financing based on re-assessment of the risk.").

229. The Australian legal system has arrived at a similar conclusion and allows for a good measure of funder control. The lead case is the High Court's 2006 decision *Campbells Cash & Carry Pty Ltd. v Fostif Pty Ltd.* (2006) 229 CLR 386 (Austl.), in which a five-to-two majority held that third-party funders may exercise significant control over the litigation, and that this control is not an abuse of process and does not offend the public policy in states that have abolished maintenance and champerty. *Id.* at 388-89. The New York City Bar notes in its

ment, influence, and control can take the form of installing a chosen lawyer, as in the Chevron/Ecuador example; providing a list of preapproved law firms to select from; or passing over a claim due to the existence of a representation not acceptable to the funder.

But the transfer of control has a price for the venture capitalist. The capital structure of VC represents a calculus of the private value for control—namely, it assigns a value to the transfer of control from the entrepreneur to the VCF.[230] Litigation financiers would similarly have to pay for the additional control. Moreover, the pricing of the control in the litigation funding context would have to take into account the extra control—indeed, absolute control—endowed by operation of law to the plaintiff, an endowment that takes the form not only of the champerty doctrine but also the duties of loyalty and independent judgment, which require that the attorney be controlled by the client alone.[231]

c. Negative Covenants

Control is also exercised in VC through the use of negative covenants. Examples of the restriction of the entrepreneur's discretion through the use of negative covenants include restrictions on the entrepreneur's ability to make certain key decisions that may significantly influence the course of business of the venture, or the ability to significantly depart from any business plan approved by the VCF.[232] By analogy, litigation funding contracts can and do include covenants that require approval by, or at least consultation in good faith with, the litigation funding firm before making strategic litigation decisions such as forum selection, the filing of key

---

opinion that a client may agree to permit a financing company to direct the strategy or other aspects of a lawsuit, including whether and for how much to settle, and similarly acknowledges the potential value of funder involvement, but leaves it to private contracting rather than interpret the law as allocating any control to the funder. *See* New York City Bar Ass'n, *supra* note 1, § II.E.

230. *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 252-53, 258-59 (1998) (discussing models that seek to explain the incentive function of capital structure and that calculate the private value for control); *see also* Rhee, *supra* note 161, at 629-38 (discussing the standard economic model of bargaining).

231. *See supra* notes 115-17, 126-27, 131-40 and accompanying text.

232. Gilson, *supra* note 109, at 1074. *But see* Gompers & Lerner, *Covenants*, *supra* note 154, at 472-74.

motions, and the decision to settle. Each level of control, as discussed, will have to be bargained and paid for. Indeed, one can envision legal claims so attractive that a funder will not only foot the bill but also pay an additional cash amount to the plaintiff.

d. Highly Incentivized Compensation, Exit, and Reputation

As mentioned before, the GP's compensation is composed of a small management fee, which represents a small percentage of committed capital and, more significantly, the carried interest, which represents a much larger percent, often twenty. This compensation structure responds to the agency costs and information asymmetry problems by creating a powerful performance incentive that aligns the incentives of the VCF with that of the portfolio company, as the overwhelming majority of the fund managers' compensation depends on the success of the portfolio company.[233] This compensation structure does, however, incentivize the entrepreneur to take on more risk than she would have had the risk/reward balance not been altered by the provision of capital by the VCF. But since the risk has shifted from the entrepreneur to the VCF, the latter now has an incentive to monitor the portfolio company.

In the litigation funding context, such a structure is only a slight modification of the contingency fee, in which there is no management fee at the outset, but it includes a return on investment that is usually a large percentage of the settlement or judgment.[234]

At the conclusion of an investment, a VCF exits by selling the portfolio company or by taking it public. The limited partnerships usually have ten year terms, or medium-term investments.[235] This creates

> a strong incentive [to the GP] to cause the fund's portfolio company investments to become liquid as quickly as possible. Assuming that the GP has invested [all] of a fund's capital by

233. Gilson, *supra* note 109, at 1083.

234. *See* Herbert M. Kritzer, *Seven Dogged Myths Concerning Contingency Fees*, 80 WASH. U. L.Q. 739, 757-59 (2002) (challenging the myth that contingency fees are standardized at a rate of 33 percent and, instead, documenting a broad range of fee arrangements); Rose, *supra* note 11 (documenting the broad range of percentages and associated contingencies in the litigation finance context).

235. Gilson, *supra* note 109, at 1074.

> the midpoint of the fund's life, the GP then must seek to raise additional capital for a new fund in order to remain in the VC business. Because the performance of a GP's prior funds will be an important determinant of its ability to raise capital for a new fund, early harvesting of a fund's investments will be beneficial to the GP.[236]

Whereas VCFs exit during an IPO or the sale of the company, a successful exit for the litigation funder takes the form of either a settlement or a favorable judgment. That means that instead of investment bankers and the markets pricing investments, it is juries, judges, and arbitral tribunals who substitute for markets in the litigation funding arena.[237] And because the average life of a complex business litigation is three years,[238] litigation naturally presents a similar medium-term investment horizon.

The equilibrium struck by the organizational and contractual structure of VC, including the characteristic implicit contractual provisions of such arrangements, is supported and policed first and foremost by the market forces of the greater VC market—including the force of reputation. For example, a claim by an entrepreneur that a venture capitalist declined an IPO when one was offered by a reputable investment banker would quickly circulate through the community and hurt the venture capitalist in the future when competing with other venture capitalists.[239] This is especially true given that the pool of portfolio companies that merit investing in, and the pool of VCFs, are both small. Effective reputation markets are characterized by the following: First, the party that has discretion and whose reputation is in question, namely the investment firm, must be a repeat player. Second, market participants must have similar normative views on what is appropriate behavior on the part of financiers. Third, compliance or breach of the implicit contract, described below, by the litigation funder must be observable.[240]

---

236. *Id.* at 1074-75; *see also* Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, J. APPLIED CORP. FIN., Winter 1999, at 36, 44.

237. *See* Yeazell, *supra* note 170, at 2.

238. *See supra* note 209 and accompanying text.

239. *See* Gilson, *supra* note 109, at 1087.

240. *Id.* at 1086; *see also* D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 157-62 (1998) (discussing the characteristics of the

The analogy between litigation funding and VC helps us see that some of the protection to plaintiffs that counterbalances the transfer of control in the suggested investment structure comes from the "braiding" of the VCF-investor contract with the VCF-entrepreneur contract—especially the braiding of reputation and exit.

"Braiding"—observable in business contexts characterized by high levels of uncertainty such as VC and corporate acquisitions—refers to the intertwining of two or more contracts such that each contract includes provisions that operate as implicit terms in support of the arrangements contained in the other. As a consequence of braiding, the contractual efficiency of both of the braided contracts is increased.[241] Often, formal contracting in one contract is used to create arrangements that render transparent the abilities and character of the parties, thus creating trust. That trust supports a second "braided" contract. Braiding has been observed in situations in which the project's—or, in our case, the litigation's—exact trajectory or goal cannot be defined and predicted with precision, but rather emerges over time and through the parties' joint efforts.[242] Analogously, the manner of the litigation's development is uncertain: costs, duration, and the disposition of pretrial disputes—to name but just a few examples—are unclear and communication and cooperation between two or more parties—the litigation funding firm, the plaintiff, and the lawyers—are required. Also analogous is

---

reputation market for venture capitalists).

241. Gilson, *supra* note 109, at 1091; *see also* Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1386, 1422-23 (2010); *id.* at 1377 ("Parties respond to rising uncertainty by writing contracts that intertwine formal and informal mechanisms ... in a way that allows each to assess the disposition and capacity of the other to respond cooperatively and effectively to unforeseen circumstances. These parties agree on formal contracts for exchanging information about the progress and prospects of their joint activities, and it is this information sharing regime that 'braids' the formal and informal elements of the contract and endogenizes trust.").

242. Gilson et al., *supra* note 241, at 1385; *see also* Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 450-51 (2009) ("In the new arrangements ... the primary output is an innovative 'product,' *one whose characteristics, costs*, and manufacture, *because of uncertainty, cannot be specified ex ante*.... [T]he process of specification and development will be iterative .... Thus, central to these transactions are *communication and cooperation across the two (or more) firms*—the design, specification, and determination of manufacturing characteristics will be the result of repeated interactive collaborative efforts by employees of separate firms with distinct capabilities." (emphasis added)).

the nature of the complex commercial disputes that are invested. These too have imprecise goals, such as whether to go to trial, engage in mediation, or negotiate a settlement, and then what type of relief to pursue.

In the VC context, two forms of braiding are at play: the braiding of the reputation markets and the braiding of exit. The VCF's noncash contribution is most valuable to the portfolio early on in the venture's life. As the venture develops, and the entrepreneurs gain experience and develop their own reputation, the value of the VCF's management experience, reputation, and similar noncash contribution diminishes. As a consequence, the value of the VCF's noncash contribution to a given portfolio company diminishes over time, and the closer that portfolio company gets to a sale or to an IPO, the more profitable it is for the VCF to reinvest its noncash contribution in new ventures with less experience and reputation. Economies of scope, however, create a nexus between cash and noncash contributions because cash contribution acts as a signal that enhances the reputation of the portfolio company. Therefore, "recycling the venture capital fund's noncash contributions also requires recycling its cash contributions."[243] The braiding of exit enables investors to evaluate a GP's capabilities and candor, and therefore align the GP's interests with those of the investors. The need to exit the relationship with the investors forces the VCF also to exit its relationship with the entrepreneur. The VCF's exit from its relationship with the entrepreneur, in turn, gives the entrepreneur a performance incentive.[244]

The operation of the reputation markets is similarly braided. They constrain the GP in its dealings with the entrepreneur because reputation affects the investor-VCF relationships, which are necessary for future fund raising by the GP. The entrepreneur receives a "windfall" in the form of fair play and competence by the GP who wishes to maintain a good reputation in order to succeed in raising new funds.[245]

Like the limited universe of portfolio companies, the universe of commercial disputes large enough to yield the three- to four-times

---

243. Gilson, *supra* note 109, at 1076.

244. *Id.*; *see also* Gilson et al., *supra* note 241, at 1412-15.

245. *See* Gilson, *supra* note 109, at 1072, 1075-76; Gilson et al., *supra* note 241, at 1392-97.

multiplier return, as a third of the settlement or award, is limited. Additionally, a finite list of "Biglaw" firms serve as gatekeepers of such claims.[246] Therefore, the conditions are ripe for a reputation market to emerge.

For the full benefits of the organizational and contractual structure offered herein to inhere in the litigation funding industry, we must witness the emergence of a robust, mature litigation finance reputation market. And for that to happen, transparency regarding both contractual arrangements and a fund's performance is necessary. There are indications that we are headed in that direction. For example, recent negative publicity regarding Burford's investment in the Chevron/Ecuador case in financial publications such as *Fortune* is a reputational cost to the firm and its principals. The intense focus on the industry generally, which is only likely to increase given how much litigation funding is expected to reshape civil litigation, is further reason to believe that the emergence of a reputation market is imminent.[247]

Beyond the need for the three attributes discussed above to be present in the litigation funding reputation market, it is advisable for investors and plaintiffs who wish to benefit from the favorable effect of reputation on their litigation finance contract to prefer specialized, repeat-player firms. Similarly, courts should encourage transparency by refraining from sealing finance contracts when they are subject to litigation, as they currently often do.[248] Finally, good practice guidelines should be developed.

In sum, if litigation funding firms will organize in the same manner as VCFs, as I suggest, the benefits of the braiding of reputation and exit will inhere to both the investors and the plaintiffs in

---

246. *See* Yeazell, *supra* note 170, at 5-6 (estimating the average value of a federal lawsuit settlement as $10,000). *The American Lawyer*'s—the leading trade publication—*Am Law 100* list can fairly be considered the list of gatekeeper "Biglaw" firms. *See The Am Law 100 2011*, AM. LAW. (May 1, 2011), http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202550268433.

247. *See, e.g.*, Richard Lloyd, *The New, New Thing*, AM. LAW. (May 17, 2010), http://www.americanlawyer.com/PubArticleFriendlyTAL.jsp?id=1202457711273 (showing the cover story in the leading trade journal); *supra* note 3 (discussing a series of *New York Times* write-ups).

248. This has been the case, for example, in a recent dispute between Juridica, a litigation finance firm, and a former investee, S & T Oil Equipment & Machinery. *See* S & T Oil Equip. & Mach., Ltd. v. Juridica Invs. Ltd., No. 11-H-0542, 2011 WL 1565996 (S.D. Tex. Apr. 25, 2011), *appeal dismissed*, 456 F. App'x 481 (5th Cir. 2012).

a similar fashion as in the VC context. Both instances of braiding will serve to enhance the efficiency of the litigation funding firm-investor and the litigation funding firm-plaintiff contracts. In addition, the need to go back to the markets and raise successive funds will buttress the protection of plaintiffs, despite the relinquishment of control.

Like the litigation funding firm-investor contract, the attorney retention agreement is important, and implicit, in an analysis of the litigation funding firm-plaintiff's contract. The litigation funding firm-investor contract is braided not only with the litigation funding firm-plaintiff contract but with the attorney retention agreement as well. Therefore, the next Subsection describes briefly this agreement as well as its braiding effects.

3. The Attorney Retention Agreement

Attorneys' retention agreements, also known as engagement letters, are nonmandatory, have come into the mainstream in the past couple of decades, and are underresearched.[249] Nonetheless, some general practices are observable. Retention agreements often include "boiler plate" provisions such as identification of the client and definition of the scope of representation, withdrawal from and closing of representation, and dispute resolution.[250] Some questionable provisions, such as a "right to settle" provision purporting to disallow settlement without the lawyer's consent, also appear with some frequency.[251] Fees, costs, and billing, including clarifications regarding the advancement of costs by the lawyer, are at the heart of even the most concise of retention agreements.[252]

As retention agreements get more complex, they include contingency fee representations and closing calculation clauses, and settlement structures become more common and elaborate. These

---

249. *See* D. Christopher Wells, *Engagement Letters in Transactional Practice: A Reporter's Reflections*, 51 MERCER L. REV. 41, 41 (1999); *see also* William C. Becker, *The Client Retention Agreement—The Engagement Letter*, 23 AKRON L. REV. 323, 323-24 (1990).

250. *See* Wells, *supra* note 249, at 49.

251. Becker, *supra* note 249, at 328 (noting that some of the agreements studied provided that the client would not settle the case without a lawyer's consent or without the consent of both client and lawyer, and characterizing such provisions as questionable given the client's absolute right to decide on settlement, enshrined in the rules of professional responsibility).

252. *Id.* at 329-32.

detail methods for accounting for final distribution to the client when various items are to be deducted from the gross recovery and order of payment. Such agreements also provide for division of fees among lawyers. Last but not least, cooperation clauses that place an affirmative obligation on the client to cooperate with the attorney and, at times, specify the form of cooperation expected—for example, supply of documents and attendance at hearings—appear in both standard and customized agreements.[253]

It is clear that some of these elements would braid the litigation funding firm-plaintiff relationship on the one hand, with the plaintiff-attorney relationship on the other. Cooperation with the attorney would by necessity benefit the litigation funding firm who is similarly concerned with client shirking once risk has been shifted onto the litigation funding firm. The attorney's monitoring of the client benefits the litigation funding firm. The fee arrangements, including negotiating and specifying division of fees, and precise mechanisms for collecting fees out of the settlement or judgment can similarly benefit the funder who has a parallel collection concern and interest in avoiding ex post disputes regarding calculating the division of the spoils.

This is doubly true because a key concern for investors in litigation—especially international arbitration or transnational litigation, as previously discussed—is securing a right in the judgment or award and effecting a collection. Conversely, VCFs do not face such a risk of an entrepreneur running off with the spoils at the time of exit, via sale or IPO, because VCFs hold shares in the portfolio company so any withdrawal necessarily involves compensation for the entrepreneur's equity in the enterprise.[254]

All of this braiding enhances the efficiency of the litigation funding firm-plaintiff relationship as well as that of the attorney and her client. And, as noted before, the more inclusive the attorney-client arrangement is of the funder—for example, if the client authorizes certain types of information to be divulged to the funder either in the retention agreement or ad hoc during the course of the representation—the more all parties can enjoy enhanced efficiency generated by the agents-watching-agents effect. The more lawmak-

253. *See id.* at 328-40.
254. *See* Gilson, *supra* note 109, at 1086.

ers protect attorney and/or client communication with the funder under such doctrines as the common-interest doctrine, the more clients and others will benefit.[255]

CONCLUSION

Preliminarily, the key contribution of the foregoing analysis is that VC contracts can be viewed as a template and springboard for parties contemplating entering into litigation funding arrangements. Despite the absence of publically available samples or forms, a model for similar contracting already exists and there is no need to reinvent the wheel. The litigation funding industry can be spared years of evolution by looking at, and learning from, the VC industry. VC contract theory, practice, and doctrine can guide plaintiffs, lawyers, financiers, and courts on what can be done, what should be done, and how to do it. In particular, many of the concerns raised by critics of litigation funding—pressure to settle early, or late; loss of client control; compromise of attorney's independent judgment—are reframed in one, all-encompassing system of checks and balances that satisfies both ethical and economic concerns.

Just as VCFs purchase shares and thereby become part owners of a portfolio company, litigation funders should be viewed as co-owners of the legal claim and therefore as *real parties in interest*.[256] Some conceptual consequences follow. These conceptual points should guide lawmakers and regulators. *First*, funders *should* ob-

---

255. *But see* Leader Techs., Inc. v. Facebook, Inc., 719 F. Supp. 2d 373, 376 (D. Del. 2010) (refusing to extend the common-interest exception to include a financier); Bray & Gillespie Mgmt. LLC v. Lexington Ins. Co., No. 6:07-CV-222-Orl-35KRS, 2008 WL 5054695, at *3 (M.D. Fla. Nov. 17, 2008) (ruling that the attorney-client privilege between Juridica and Bray & Gillespie had not been established).

256. *See* FED. R. CIV. P. 17(a). At least one U.S. court of appeals has taken that approach when the funder

> financed and controlled the litigation. He was to receive 18.33% of any award the plaintiffs received plus reimbursement for the expenses of the case. Additionally, [the Funder] had to approve the filing of the lawsuit; controlled the selection of the plaintiffs' attorneys; recruited fact and expert witnesses; received, reviewed and approved counsel's bills; and had the ability to veto any settlement agreements.

Abu-Ghāzaleh v. Chaul, 36 So. 3d 691, 693 (Fla. Dist. Ct. App. 2009). Consequently, the court held that given the level of control exerted by the funder, he had risen to the level of "party." *Id.* at 694.

tain control over the funded litigation. *Second*, attorneys *should* take funders' input into account. *Third*, litigation funding firms should be allowed, and required by their investors, to monitor their investment. Lawmakers should facilitate this key function—which enhances value for the client as well as for its co-owner(s)—by extending the attorney-client privilege to the funders and possibly the attorney work-product doctrine to work-product that is developed by the funder, that is legal in nature, and that is in direct relation to the litigation.

Fourth, funders should pay plaintiffs a premium for the control they receive, be compensated through a scheme that aligns their interests with those of the clients, and enhance the value of the claim by providing noncash contributions, including monitoring and reputation.

Fifth, regulators and lawmakers, including judges, should consider the critical role of reputation markets which, in turn, rely on the transparency of the industry. In particular, providing information regarding the performance outcomes of litigation funding firms and their ethical propensities when dealing with plaintiffs and investors will facilitate the emergence of a reputation market that can police the industry and support contractual arrangements. This necessitates choosing transparency over secrecy whenever the option arises. For example, when requested to seal a litigation finance contract, such decision makers can instead follow the precedent set by Judge Kaplan in the Chevron/Ecuador litigation.[257]

Sixth, there is also a cautionary note to both investors and plaintiffs that they should disfavor intermediaries who are not organized as described herein, such as hedge funds that do not specialize in litigation funding, and therefore cannot effectively monitor or reduce unique risk and are not subject to reputation markets.

---

257. *See supra* note 31 and accompanying text. Several consumer financing companies doing business in New York State have entered into a stipulation with the Attorney General of New York that requires the law lending firms who are members of the American Legal Finance Association to follow certain guidelines. *See* Assurance of Discontinuance Pursuant to Executive Law § 63(15), Eliot Spitzer, Att'y Gen. N.Y. (Feb. 17, 2005), *available at* http://www.americanlegalfin.com/alfasite2/documents/ALFAAgreementWith AttorneyGeneral.pdf (showing the American Legal Finance Association's agreement with the Attorney General of New York and the Bureau of Consumer Frauds and Protection to comply with certain business practices).