US litigation funding and social inflation
The rising costs of legal liability

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The US is the centre of the world’s third-party litigation finance (TPLF) industry, in which investors such as hedge funds and family offices finance legal action against companies. More than half of the USD 17 billion investment into litigation funding globally in 2020 was deployed in the US. Litigation funding companies (LFCs) invest in consumer and commercial litigation by funding legal action in return for a percentage of a successful claim sum. We are concerned that TPLF is an expensive and blunt tool to enable legal disputes, with potentially harmful economic and ethical consequences, particularly when used by vulnerable individuals. Greater protection for consumers is required, as well as better regulation of the industry and more transparency about the involvement of TPLF in a case.

We see TPLF as a contributing factor to the trend of social inflation in the US. US general liability and commercial auto lawsuit data show a strong rise in the frequency of multi-million-dollar claims over the past decade. LFCs back claims in many of these areas, such as trucking accidents, bodily injury, product liability mass tort, medical liability claims etc. We find TPLF contributes to social inflation by incentivising litigants to initiate and prolong lawsuits. Higher claims costs drive up insurance premiums, can reduce the availability of liability cover, and lead to higher uninsured liability risks for US businesses. US casualty insurers have incurred many years of underwriting losses linked to outsize legal awards and are being forced to raise premium rates. Umbrella policies, particularly exposed to large claims, have seen average rate increases of 20% in 1H21. Trucking firms, for example, face a reduction in affordability and availability of insurance. These costs are ultimately paid by consumers.

Concerns about litigation funding centre on its effect on the length, cost and resolution of legal action. We find TPLF contributes to higher awards, longer cases and greater legal expenses. Longer cases increase claim costs, on average, due to higher legal expenses and compound interest on the litigation finance. TPLF also diverts a greater share of legal awards to the funder rather than the plaintiff. We estimate that in US TPLF cases, up to 57% of legal costs and compensation go to lawyers, funders and others, compared with an average of 45% in typical tort liability cases.\(^1\)

Large US litigation funders typically target commercial litigation with a high expectation of success more than “David and Goliath” cases that might expand access to justice. Globally, 75% of TPLF investment supports commercial litigation and mass torts; and two thirds of TPLF settlements for commercial litigation go to large rather than small companies. TPLF investments have produced internal rates of return (IRR) from 25% upward in recent years, outperforming even risky asset classes such as venture capital. The result is an opaque, bottom-up wealth transfer from consumers to sophisticated investors and law firms. Profit-seeking funders can create conflicts of interest and agency problems in attorney-client relationships. There are also major concerns about predatory lending, especially in the lightly regulated consumer segment.

We recommend enhanced disclosure and greater pricing regulation of litigation funding.

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\(^1\) Costs and compensation include legal expenses for plaintiffs and defendants as well as awards. P. Hinton, D. McKnight and L. Powell, “Costs and Compensation of the U.S. Tort System”, U.S. Chamber Institute for Legal Reform, October 2018.
Key takeaways

The US is the world’s largest third-party litigation funding market, accounting for more than half (52%) of global activity.

TPLF investment globally rose 16% year-on-year to USD 17 billion in 2021.

Third-party funding alters the distribution of legal costs in commercial liability cases.

We model the effect of litigation funders’ charges on the total awards in cases. This finds that TPLF investors take a higher share of legal awards, resulting in lower net awards for plaintiffs.

US legal verdicts are becoming more skewed towards large awards as TPLF is used more.

US verdicts of USD 5 million or over are a rising share of large (>USD 1 million) awards in liability cases. The median size of large awards rose by 26% for general liability cases and by 32% for vehicle negligence cases between 2010 and 2019.

Share of verdicts greater than USD 5m among large losses

Median awards, cases greater than USD 1m, in USD millions

Distribution of tort system costs without TPLF (left) and with TPLF (right)

Note: for modelling assumptions, we use 2016 data from the Institute for Legal Reform for legal system costs and 2020 data from Research Nester for realised returns on litigation funding investments. We triangulate these two datasets by holding the award amount fixed. We estimate that plaintiff compensation decreases by 21% relative to the same award in a case without TPLF.

Source: Swiss Re Institute, Institute for Legal Reform, Research Nester
Investment returns from TPLF outperform other risky asset classes.

TPLF-funded cases in all three major liability segments have generated average IRRs of between 20% and 35% in recent years and are forecast to perform similarly in 2021. These outperform returns on risky asset classes such as venture capital and private equity. The costs of such excess returns are paid for by plaintiffs, defendants, and ultimately by consumers.

Average TPLF returns by segment

<table>
<thead>
<tr>
<th>Segment</th>
<th>2019</th>
<th>2020</th>
<th>2021F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal injury</td>
<td>32.7%</td>
<td>24.6%</td>
<td>35.3%</td>
</tr>
<tr>
<td>Commercial litigation</td>
<td>29.5%</td>
<td>26.5%</td>
<td>29.9%</td>
</tr>
<tr>
<td>Mass tort</td>
<td>21.2%</td>
<td>25.5%</td>
<td>26.0%</td>
</tr>
</tbody>
</table>

Source: Morning Investments

Large legal awards to plaintiffs are causing escalating insurance claim losses to defendants’ insurers.

Conning, a US insurance asset manager, estimates the average combined ratio for US general liability in 2020 at 105.7%, and for medical malpractice at 117.5%, the seventh consecutive year of underwriting losses for both lines. In response, insurers are increasing premium rates, limiting policy coverages, and in some cases exiting the market altogether.

US commercial insurance premium trends, 1Q 2010 to 3Q 2021 (year-on-year percentage change)
What is third-party litigation funding?

Individuals and corporations are increasingly turning to third-party capital to fund legal disputes. LFCs supply financing for consumer and commercial litigation, either through non-recourse loans or by accepting legal assets as a form of collateral, which traditional lenders generally do not recognise. Commercial cases and mass torts with large potential awards are their main areas of focus, particularly for large funding companies. However, LFCs also support individual personal injury claims. TPLF has grown in the US since the early 2000s and today most states allow its use.

TPLF involves a third party financing the legal representation of a party in a case. This is an alternative to the party self-funding or using a contingent or conditional fee agreement, in which they only pay lawyers’ fees if their claim is successful. TPLF is provided to consumers and commercial clients:

1. **Commercial litigation funding** is the territory of large LFCs, funding large scale lawsuits on a non-recourse basis in exchange for a share of the recovery. This includes class actions and multi district litigation. The funding can go to corporate plaintiffs (and, less frequently, defendants) or law firms.

2. **Consumer legal funding** provides individuals with cash advances on a non-recourse (no win no fee), fixed interest basis to pay for living expenses during the claim pursuit. The lawsuit acts as the collateral. Focus is on personal injury cases.

Traditional lenders such as banks typically do not fund litigation as they do not accept legal assets as collateral. TPLF is varied and can take equity- or debt-like forms. Funding agreements are directly between the LFC and the plaintiff or a law firm, but funding can be obtained through a litigation funding broker. Funders most commonly provide non-recourse loans against a case, or portfolio of cases, in return for equity-like participation in case outcome proceeds. Investments can occur at all stages of a case lifecycle, from funding legal expenses before a case is filed, to enforcing collection after the verdict.

The biggest third-party funders focus on commercial litigation and mass torts. The main areas of focus for TPLF are commercial cases and mass torts, particularly for the largest LFCs. Large lenders prefer these segments because the potential awards are large enough to motivate the expensive due diligence needed to invest successfully in complex cases. However, many smaller LFCs also support individual personal injury claims. Funders are dedicating increasing amounts of capital to law firm lending, which typically provides a law firm with a full recourse loan for a fixed and/or performance-based return, for general business purposes (operating capital). Law firm portfolios are attractive to fund since (1) loans are often backed by personal guarantees, (2) case collateral is highly diversified, and (3) many law firms’ cases tend to be seasoned or have established precedents/bellwethers.

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What is third-party litigation funding?

TPLF has grown in the US since the early 2000s and today most states permit use of TPLF, with some notable exceptions (see box: States and the law). Consumer litigation financing for individual cases in the US deals primarily with personal injury, divorce, and small claims. It has also been used for class action suits and multidistrict litigation (MDL). Commercial litigation financing has focused on disputes involving antitrust, intellectual property, and business contract issues, as well as international arbitration.3

How is TPLF used?

Recipients typically use TPLF to pay legal fees and costs, generate working capital and manage the risk of negative outcomes such as adverse rulings. The scope of TPLF agreements usually includes:

1. funding of fees and expenses associated with the pursuit of a commercial claim;
2. acceleration of a pending commercial claim or an uncollected judgment or award; and
3. cash advances for medical, legal and cost of living expenses for personal injury victims.

A large segment of litigation finance is already provided to clients through contingent fee arrangements with their law firm, which have been in existence for decades in the US.4 However, the typical partnership structure of law firms, and legal ethics rules that generally prohibit non-lawyers from taking ownership interests in law firms, limit their ability to raise third-party equity capital.5 To borrow funds, attorneys must turn to a non-traditional lender that will accept legal assets as collateral.6

### Table 1
Types of cases and typical forms of TPLF

<table>
<thead>
<tr>
<th>Description</th>
<th>Personal injury</th>
<th>Mass tort</th>
<th>Commercial litigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Injured person seeking financial remedy for harms caused by others.</td>
<td>Group of plaintiffs; Class Action or Multi District Litigation (MDL).</td>
<td>Legal issues arising from a commercial relationship, resulting in litigation or arbitration.</td>
<td></td>
</tr>
<tr>
<td>Types of claims</td>
<td>Auto accident (most common), premises liability (e.g., slip and fall), medical malpractice.</td>
<td>Product liability (e.g., pharma, medical device injuries), securities fraud, data breach, accounting fraud, tobacco, asbestos.</td>
<td>Contract disputes, trademark infringements, shareholder/partnership disputes, antitrust, insurance claims.</td>
</tr>
<tr>
<td>Borrower</td>
<td>Individual plaintiff</td>
<td>Mostly law firm</td>
<td>Corporate plaintiff or law firm</td>
</tr>
<tr>
<td>Typical form of third-party funding</td>
<td>Non-recourse cash advance in exchange for a portion of proceeds (equity based) or interest rate (time based). No contractual relation between LFC and attorney.</td>
<td>Non-recourse cash advance to plaintiffs or funding for class counsel to fund case-related services. Can be structured as loan (legal fees &amp; expenses + compound interest) or equity investment (percentage of award).</td>
<td>Non-recourse funding of legal expenses. provided in exchange for a combination of (a) return of funded cost, (b) multiple of funded cost, (c) percentage of net proceeds (equity approach), and (d) interest rate to incorporate time-based return.</td>
</tr>
<tr>
<td>Range of outcomes</td>
<td>Relatively narrow due to rich benchmark data for similar cases.</td>
<td>Narrows as case advances, especially after the initial motions and class certification.</td>
<td>Relatively wide and often binary, possibly resulting in complete loss of investment.</td>
</tr>
</tbody>
</table>

Source: Swiss Re Institute

5 Note: Arizona is the first state to allow non-lawyers to co-own law firms.
What is third-party litigation funding? US litigation funding and social inflation

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The rationale for TPLF is that it can enable access to justice for claimants who would be disadvantaged when pursuing a case due to prohibitive legal costs. There can be a need for third-party funding to allow for a case with a reasonable chance of success to be filed, given the significant expenses needed to bring well-documented cases to court, from pre-trial discovery to expert witnesses. TPLF also can transfer the risk of the uncertain outcome of a dispute to a better-diversified investor. However, TPLF is associated with rising social inflation (see page 13), exposes users to high and often poorly explained costs (see page 16), and can present ethical conflicts (see page 19).

TPLF is linked to access to justice but has ethical and economic consequences.
The TPLF market

TPLF investment globally rose by 16% year-on-year to USD 17 billion in 2021, despite disruptions of legal proceedings from the COVID-19 pandemic. Large LFCs typically target commercial litigation and mass torts. The US accounts for more than half of the global market. Investment is expected to continue to grow strongly, and we estimate it could reach USD 31 billion in 2028. Investors in TPLF include hedge funds, private equity firms, endowments, family offices and sovereign wealth funds, attracted by excess returns that are largely uncorrelated with macroeconomic risks.

TPLF investments globally came to USD 17 billion in 2020.

TPLF investments totalled about USD 17 billion in 2021, up by 16% from 2020, according to estimates by Morning Investments. The growth was a slowdown from previous years and defied COVID-related deal delays and disruptions. The largest share of new investments, about 38%, went into mass tort litigation, followed by commercial litigation (37%) and personal injury (25%) (see Figure 1). The industry is projected to grow quickly, averaging an 8.7% compound annual growth rate (CAGR) between 2020 and 2028, according to the market research firm Research Nester.7 By this growth rate, annual investments would reach approximately USD 31 billion by 2028.

Although TPLF is often associated with support for consumer cases, over two thirds of the settlement value of individual US TPLF cases went to commercial claimants, and a significant majority of those awards went to large enterprises.8 Studies of litigation funding find that it is used to finance arbitration and litigation in areas such as patent law, investment recovery, anti-trust, and bankruptcy, which are mostly removed from consumer claims.9

The US is by far the largest market for funds, accounting for a 52% share of the global market. Australia, the UK and Germany are other large TPLF markets (see Figure 2).10

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7 Growth rate from “Global Litigation Funding Market, 2017–2028”, Research Nester. The market size assessment is from Morning Investments, op. cit.
10 Ibid.
Who are the key players?

Most LFCs are structured as investment funds, with fund managers raising capital from individual and institutional investors. Many funders operate internationally, and the domicile of a fund does not necessarily coincide with the geographies in which cases are funded. Litigation funders typically target cases with a high likelihood of success and the prospect of large awards. Market analysts classify investors by their primary investment focus and approach to litigation funding: (1) dedicated, (2) multi-strategy and (3) ad hoc.

**Dedicated funders** are specialty financial companies that specialise in litigation finance. They are the most popular mechanism for investment in litigation finance.\(^{11}\) Specialty litigation finance funds cater to clients who seek external capital and legal services to prosecute claims and enforce judgments and awards, reducing risk by capitalising legal assets. Most dedicated funders are privately held, but two of the largest, Burford Capital and Omni Bridgeway, are publicly listed, with assets under management (AUM) of USD 4.5 billion and USD 1.7 billion respectively as of 31 December 2020. Harbour Litigation Funding is the largest privately owned dedicated funder.\(^{12}\)

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**Figure 2**
Geographic split of TPLF investments, 2021E

Note: the sum of percentages may not add up to exactly 100% due to rounding.
Source: Research Nester, Swiss Re Institute

**Figure 3**
Largest dedicated LFCs, 2020 assets under management (USD millions)

<table>
<thead>
<tr>
<th>Name</th>
<th>HQ City</th>
<th>AUM (USD millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burford Capital</td>
<td>New York</td>
<td>4,500</td>
</tr>
<tr>
<td>Omni Bridgeway</td>
<td>Sydney</td>
<td>1,700</td>
</tr>
<tr>
<td>Harbour Litigation Funding</td>
<td>London</td>
<td>1,541</td>
</tr>
<tr>
<td>Therium Group Holdings Ltd.</td>
<td>London</td>
<td>1,025</td>
</tr>
<tr>
<td>Longford</td>
<td>Chicago</td>
<td>1,000</td>
</tr>
<tr>
<td>Augusta Ventures</td>
<td>London</td>
<td>709</td>
</tr>
<tr>
<td>Woodford</td>
<td>London</td>
<td>500</td>
</tr>
<tr>
<td>Parabellum Capital, LLC</td>
<td>New York</td>
<td>465</td>
</tr>
<tr>
<td>Litigation Capital Management</td>
<td>Sydney</td>
<td>450</td>
</tr>
<tr>
<td>GLS Capital</td>
<td>Chicago</td>
<td>400</td>
</tr>
<tr>
<td>Validity Finance, LLC</td>
<td>New York</td>
<td>300</td>
</tr>
<tr>
<td>Legalist</td>
<td>San Francisco</td>
<td>160</td>
</tr>
<tr>
<td>Lake Whillans</td>
<td>New York</td>
<td>125</td>
</tr>
<tr>
<td>Balance Legal Capital</td>
<td>London</td>
<td>100</td>
</tr>
<tr>
<td>Deminor</td>
<td>Brussels</td>
<td>49</td>
</tr>
</tbody>
</table>

Note: capital raised is shown where funds under management data is not available. Source: company reports, Swiss Re Institute estimates

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11 Morning Investments, op. cit.
12 Harbour Litigation Funding Ltd, Company website, accessed 7 July 2021.
Multi-strategy funders are diversified investors such as hedge funds that have established a dedicated litigation finance group. D.E. Shaw and Fortress Investment Group are examples of this type. Both are part of the International Legal Finance Association, a trade association launched in 2020.13 Multi-strategy funders both compete with, and invest in, dedicated funders.

Ad hoc funders are diversified investors such as hedge funds that have risk appetite for litigation finance but no dedicated litigation finance practice. Investment managers such as PIMCO have invested in litigation finance firms, while others have invested in cases directly.14 A prominent example is Elliott Management, which in May 2020 decided to fund a suit brought by interactive-video company Eko against streaming service Quibi.15 Other new entrants to the market include hedge funds, private equity firms, endowments and sovereign wealth funds.16

Supply and demand drivers of litigation funding

Growth in the litigation funding market originates from both supply and demand drivers. Supply is being fuelled by the attractive risk/reward profile of litigation funding, the largely uncorrelated nature of returns with macroeconomic trends, and a feedback loop from increased visibility, which draws in additional capital. At the same time, demand is driven by targeted advertising to consumers, increased corporate acceptance of financing as a tool for monetising legal claims and managing legal risk, and greater use of TPLF as working capital by law firms.

Supply drivers

Attractive investment returns are drawing capital to the legal funding space (see Economic consequences of TPLF). Strong investor returns are driven by funders’ ability to identify promising cases, a lack of transparency, the absence of competition from traditional lenders, and increasing jury awards. Since legal outcomes are driven primarily by the particulars of each case rather than macroeconomic factors, litigation awards are relatively uncorrelated with broader financial markets.

Table 2
Features of the asset class and implications for investors

<table>
<thead>
<tr>
<th>Features of asset class</th>
<th>Implications for investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>The market is expanding quickly</td>
<td>Growing demand keeps returns high (beta)</td>
</tr>
<tr>
<td>Relatively uncorrelated to economic and financial market risks</td>
<td>Diversifying asset class</td>
</tr>
<tr>
<td>Assets are illiquid, heterogeneous and opaque</td>
<td>Potential to generate alpha</td>
</tr>
<tr>
<td>Investments typically secured by diversified portfolios of claims</td>
<td>Diversified risk lowers volatility of returns</td>
</tr>
<tr>
<td>Limited competitive pressure from fragmented market and no presence of traditional lenders</td>
<td>Limited competition keeps returns high (beta)</td>
</tr>
</tbody>
</table>

Source: Swiss Re Institute

16 Morning Investments, op. cit.
Demand for new sources of legal funding from law firms, commercial litigants and individual consumer plaintiffs is growing in tandem with the costs and duration of litigation — coupled with the risk of receiving a zero or negative return. Liability costs in the US are the world’s highest in absolute and relative terms. In 2016, the costs and compensation paid in the tort system amounted to USD 429 billion or 2.3% of US gross domestic product (GDP). US law firms’ use of litigation funding has increased strongly in recent years to 36% of firms in 2017, up from only 7% in 2013, according to surveys commissioned by Burford Capital. A broader international survey shows this trend continuing in 2020. Usage is expected to keep growing, as law firms that have yet to use litigation funding anticipate doing so in the coming years. Law firms’ need for capital is rising in tandem with trends such as increasing attorney advertising and investments in data and analytics. Law firms are also investing more in individual cases, spending resources in areas such as discovery, jury selection, and mock trials. The growth in size of mass tort cases, which require significant investment for the plaintiffs’ counsel, is also driving demand for funding.

### Table 3
Drivers of demand for TPLF: a borrowers’ view

<table>
<thead>
<tr>
<th>Drivers of demand for TPLF</th>
<th>Implications for TPLF users</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk transfer</td>
<td>Non-recourse loans transfer risks of adverse case outcome from litigant to investor</td>
</tr>
<tr>
<td>Monetisation of prospective awards</td>
<td>Traditional bank lenders do not accept legal assets as collateral for loans</td>
</tr>
<tr>
<td>Transformation of intangible assets into working capital</td>
<td>Legal claims cause valuation and accounting issues for corporations, who must recognize legal expenses but cannot recognize legal claims as assets</td>
</tr>
<tr>
<td>Cash advances to cover medical and cost of living expenses</td>
<td>Personal injury victims have limited access to credit, especially when losing employment</td>
</tr>
</tbody>
</table>

Source: Swiss Re Institute

### Figure 4
Law firms’ motivation for seeking TPLF

- Lack of funds for legal fees/expenses: 44%
- Hedge risk of litigation: 33%
- Fund operating expenses: 18%
- Other: 6%

Source: 2020 Litigation Finance Survey Report, Lake Whillans

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Corporations use TPLF to manage risk and monetise intangible legal assets.

Companies are also growing to accept legal funding as a tool to monetise legal claims and manage legal risk. Legal assets create accounting issues for corporations. Money spent on litigation is not capitalised but immediately expensed, reducing operating profits. Pending litigation claims do not qualify as assets and so are not reported as intangible assets in financial statements. Furthermore, when legal claims succeed, the associated income is often not treated as operating income but reported as non-operating or one-off items on the income statement, which is less credited in company valuations. According to a survey by Burford Capital, a majority (72%) of in-house attorneys have stated that their companies have failed to pursue meritorious claims for fear of adversely affecting profitability. The added risk and complexity of legal claims has also contributed to a shift towards external financing of legal claims as a way to de-risk corporate financial reporting.

Individual personal injury victims face funding limitations for legal, medical and cost of living expenses. While legal expenses can be funded through contingency fee arrangements, ethical rules prohibit lawyers from providing any financial assistance to clients to meet cost of living expenses. Access to traditional lending is limited for most households, especially in situations where the plaintiff, possibly due to an accident that is the subject matter of litigation, is unemployed. TPLF offers a solution but leaves personal injury victims at risk of committing to predatory terms at a time of legal, financial and often medical distress.

Cash advances to personal injury victims overcome borrowing limitations, but at a high cost.

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19 D. French and S. Isgur, op. cit. See Burford Capital CEO explanation at 32 min.
The economic consequences of TPLF

TPLF is a contributing factor to social inflation, the increase in legal claims above normal economic trends. The frequency of large claims in general liability and commercial auto lawsuits has increased strongly in the past decade. Higher claims costs drive up insurance premiums, reduce the availability of liability cover and lead to higher uninsured legal liability risks. These costs are ultimately paid by consumers. Plaintiffs often do not see the benefit of higher awards, as we estimate up to 57% of TPLF-involved tort costs go to lawyers, funders and others. We estimate that LFCs’ returns are typically higher than long-run returns on venture capital. The result is an opaque, bottom-up wealth transfer from consumers to sophisticated investors, and a less efficient legal system, paid for through higher prices and insurance premiums.

As TPLF has grown, so has the number of large motor and general liability verdicts.

Large awards are becoming more frequent in motor and general liability verdicts.

TPLF is emerging as a significant contributor to large legal claims. This is a key driver of social inflation – the social factors that drive increases in legal claims above and beyond economic trends. Social inflation is strongly visible in the US through a rise in nuclear verdicts (outsized awards for non-economic damages). This has mirrored the growth in the use of litigation finance over the past decade. There has been a consequent escalation in US liability insurance claims concentrated on large verdicts and (large) commercial defendants.

The incidence of large claims is rising quickly

In US vehicle negligence and general liability, the probability distribution of legal awards has become more skewed towards large awards. There is also a trend of accelerating severity in average awards (see Figure 5, left hand side). In a sample of large (above USD 1 million) awards from 2010 to 2019, the share of verdicts that result in awards of more than USD 5 million has risen from 29% to 37% for general liability, and from 22% to 29% for vehicle negligence cases.

Figure 5
US verdicts of USD 5 million or over as a share of large awards (>USD 1 million) (left hand chart)
Median awards for US verdicts of USD 1 million or over, USD millions (right hand chart)

Source: Thomson Reuters Westlaw, Swiss Re Institute
The trend can also be seen in the rising median of large awards (see Figure 5, right hand side). The median award for verdicts larger than USD 1 million rose from USD 8.2 million to USD 10.3 million for general liability awards between 2010 and 2019, and from USD 6.1 million to USD 7.9 million for vehicle negligence cases. Given the higher prevalence of nuclear verdicts, there is an even larger increase in average awards (not shown in figure). Since there is more volatility in this metric, we look at three-year averages, which increased by 224% for general liability awards between 2009 and 2019.

Jury awards for trucking accidents are also far exceeding the broader motor vehicle accident trend. Among verdicts of more than USD 1 million, the average size of trucking claims increased by nearly 1 000% from 2010 to 2018, rising from USD 2.3 million to USD 22.3 million, according to the American Transportation Research Institute (ATRI).22 Nuclear verdicts against trucking companies are driving up insurance premiums. While many of the largest nuclear verdicts have been associated with commercial and professional liability claims, private passenger auto insurance is experiencing similar effects as jury sympathy toward plaintiffs has grown along with the willingness to punish at-fault drivers.23

How does TPLF interact with other drivers of US social inflation?

Litigation funding amplifies some of the existing drivers of social inflation. For example, TPLF is contributing to the surge in attorney advertising, and supporting plaintiff attorneys in investing in new lawsuit strategies, more discovery and mock trials. These drivers interact with other influences on jury trials, as follows.

Use of psychology-based strategies of the trial bar. Plaintiffs' lawyers have made significant changes in how they try lawsuits in the past decade, deploying applied psychology to jury trials and testing their strategies with mock juries.24 Their strategies have shifted from one of developing sympathy with the victim, to stirring anger against the defendant. In recent years, plaintiffs' attorneys have leveraged the so-called "reptile theory". This involves utilising strategies to spark a fight-or-flight reaction among jurors, which pushes them to decide cases based on emotions rather than facts.25 Plaintiffs' attorneys often generate such strong feelings by portraying the corporate defendant as reckless, neglecting safety concerns and only caring about profits. Another strategy is referred to as the "anchoring effect". Jurors have no natural sense of what appropriate compensation for severe damage looks like and tend to anchor their awards around suggested numbers. Lawyers demand large numbers for awards early in the trial, and repeatedly.26 These strategies have been key attributes in the success in generating outsized awards, mostly for non-economic damages. The rise in claims awards has been associated with the increased use of TPLF funding.

Jurors' changing social attitudes. In the US, public attitudes have shifted toward negative views of corporations and greater inclination to redistribute wealth via the court system. Millennials particularly are more sceptical of corporate ethics.27 Surveys reveal the heightened sensitivity of jury decisions to jurors' changing attitudes. For example, one question found that 72% of respondents believed that a case has some merit if it makes it to court. In another question, 42% stated that they would decide a case based on fairness rather than the law. In another question, 45% of jurors admitted that sympathy affects their attitude about a lawsuit, and 35% of jurors would add lawyer fees to a damages award even if a judge specifically tells them not to do so.28 Jurors, especially younger generations, typically use digital media for their news flow, with an inherent bias toward more attention-grabbing (by implication, more expensive)
We see rising inequality as a contributor to more plaintiff-friendly jury attitudes.

**Rising inequality.** We modelled the relationship between US counties’ degree of plaintiff-friendliness, as classified by The Harmonie Group, a US network of lawyers representing the defence bar, and socio-economic variables including median household income, unemployment and the Gini coefficient (a measure of income inequality), using data for more than 3000 counties. We found that lower median household income, higher unemployment, and higher inequality in a county are associated with more plaintiff-friendly courts, on average. US inequality has risen steadily since the 1990s and has particularly increased since the 2017 tax reform and the COVID-19 crisis. As a result, we anticipate a corresponding weakening in socio-economic indicators and a contribution to further growth in plaintiff-friendly jury verdicts.

Television advertising by attorneys in the US has tripled in the past decade.

**Attorney advertising.** US television advertising by attorneys has tripled in the past decade. The rise can be seen in the growing presence of personal injury advertising on the internet, TV, radio and in other communications media like billboards and on the sides of buses. From 2009 to 2019, both the number of ads for legal services and the dollars spent were up about 8% per year across the US. Attorneys are also using digital media advertising. According to PPC Protect, an online marketing security firm, the prices per click paid by law firms for online advertising are the highest prices paid by any advertisers.

Technology and data analytics are also driving attorneys’ approach to claims.

**Technology and data analytics:** Attorneys are leveraging technology and data analytics in their approach to claims. Attorneys access public records of prospective jurors and expert witnesses, including marital, arrest, and property ownership information. They mine social media for information regarding the religious and political party affiliations of prospective jurors. TPLF firms are also increasingly using state-of-the-art data analytics to identify and evaluate funding opportunities. With limited transparency about case details and settlement values, there is value in the size of proprietary data sets creating economies of scale.

Soaring casualty insurance claims costs are causing prolonged underwriting losses

The social inflation-driven surge in large legal awards is generating rapid increases in insurance claim losses. Although primarily affecting commercial insurance products, it is also leading to higher personal auto liability claim costs. To date, the effect is most pronounced on large corporate risks in the umbrella and excess liability space, commercial auto, medical malpractice and directors & officers. The average 2020 combined ratio for general liability was estimated at 105.7% and for medical malpractice at 117.5%, the seventh consecutive year of underwriting losses for both lines. The 2020 commercial auto liability combined ratio was 104.1%, the tenth year of underwriting losses.

Commercial auto prices rose by 10.0% in 2019 and 10.7% 2020, with double-digit price increases continuing until the second quarter of 2021. Pricing in all liability lines has climbed in response to rising concerns about adverse reserves development and social inflation. In 2020, D&O and umbrella rates soared by 15.8% and 22.6%, respectively, while general liability and medical professional liability increased by 7.3% and 8.8%. Umbrella covers are particularly exposed to the increase in large claims and insurance carriers are reducing capacity.

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29 “USA Venue Maps”, The Harmonie Group, 27 August 2021. This map classifies US counties as conservative (defence-friendly), liberal (plaintiff-friendly) or neutral, based on judicial outcomes.
30 X Ante LLC and Swiss Re Institute.
31 S. Carr "The Most Expensive Google Keywords 2021", PPC Protect, 28 January 2021.
34 The Council of Insurance Agents & Brokers and Swiss Re Institute.
In reaction to rising premium rates, trucking fleets are retaining higher risk levels through higher deductibles, self-insurance, expanding use of captives, and lower levels of excess liability coverage. Given the substantial insurance cost increases over the last several years, it appears that the industry has reached a ceiling in its ability to continuously cover annual double-digit increases in insurance premiums, leaving the companies more vulnerable as insurance becomes less affordable and the offered capacity more limited.36

TPLF reduces the efficiency of the tort liability system

On average, more than half (55%) of the costs and compensation paid in the tort system for commercial liability was awarded to plaintiffs in 2016.37 However, in cases where TPLF is involved, we estimate the share received by plaintiffs to be significantly lower. We calculate that in a case funded by TPLF, only 43% of costs and compensation would be awarded to the plaintiff. The share of tort costs that goes to the plaintiff’s legal expenses (including funding costs) is 38% in cases with TPLF, compared to 26% in cases without. This shift of funds is consistent with both the returns earned by litigation funders, and numerous publicised cases of TPLF-funded legal awards.38

To evaluate the possible effects of litigation funding on award size and litigation costs, we triangulated data from the Institute for Legal Reform39 and TPLF data from Research Nester. We focused on commercial and personal liability claims and compared the plaintiff’s returns with and without TPLF. If we assume that the award amount remains the same, we estimate that TPLF reduces plaintiff compensation by more than a fifth (21%) because of higher legal costs. The logical consequence is a lower net award to victims. In addition to the quantitative summary we present, case studies provide real-world evidence, see, for example, Case study: punitive interest rates and the need for consumer protection and Case study: compound monthly interest masks predatory lending rates.

36 American Transportation Research Institute, op. cit.
37 The Institute for Legal Reform includes risk transfer costs (insurer margins) in its calculation of costs and compensation paid in the tort system. We exclude insurer margins since these are not direct costs or compensation.
38 See, for example: public financial filings of Burford Capital and Omni Bridgeway, as well as a funding deal made public in subsequent litigation, summarized in “Pierce Bainbridge Funding Deal Raises Ethical Red Flags”, Law 360, 16 March 2020.
39 P. Hinton, D. McKnight, and L. Powell, op. cit.
We assume that TPLF involvement will on average lead to higher award amounts and total liability costs, given that third-party funding allows plaintiffs to pursue better-prepared cases further and make more effective use of the litigation strategies that have contributed to social inflation. Based on the above data, we estimate that the total award amount using TPLF would need to be 27% higher than without TPLF for a plaintiff to receive the same absolute payment. It is thus notable that tort system costs could increase materially without an increase in take-home payments to victims. The associated increase in liability and defence costs increases business expenses and results in higher costs for consumers. The likely result is somewhere in between, whereby a less efficient legal system decreases plaintiffs’ access to justice and take-home awards, while increasing costs for businesses and, by extension, consumers.

LFCs returns far exceed high-risk equity investments

Returns on TPLF investments have been high in recent years and have far outperformed return expectations for high-risk equity investments. Data from Morning Investments show that the average internal rate of return (IRR) on personal injury cases range from 25% to 35% for the years 2019–2021 (see Table 4), while IRRs for mass torts have been between 20%-25%. Equity-type deals that involve a performance- or outcome-based compensation for the funder have a higher return than debt-based deals. These returns significantly exceed long-term (15-year) returns of 13%, 13%, and 10% for private equity (PE), venture capital (VC), and the S&P 500, which could be considered proxies for return expectations for high-risk types of equity investments. For TPLF investments in 2020, Morning Investments calculates an average risk-adjusted alpha of 918 basis points over long-term average market returns in high-risk equity investments.
Swiss Re Institute  US litigation funding and social inflation  The economic consequences of TPLF

TPLF funder's high success rates, indicating that their risk may be lower than venture capital.

TPLF excess returns compared to private equity or venture capital benchmarks are not justified with higher risk. In fact, LFC portfolios appear less risky than venture capital due to selective underwriting of cases. In venture capital, about 80% of investments do not pay off but occasionally there are big successes. In litigation finance, on the other hand, only 10–15% of cases do not succeed. Although risks may be low, especially across a portfolio of cases, TPLF returns are typically high since funders are able to apply their financial expertise, data analytics and legal experience with complex cases in negotiations with consumer and commercial borrowers.

TPLF is associated with longer cases

The presence of TPLF in a legal case coincides with longer duration of case timelines. According to the United States District Courts, a civil case took 28.6 months on average from filing to trial as of March 2020 (the last quarter before COVID-19 disrupted court proceedings), up from 26.6 months in March 2015. In contrast, Morning Investments data show the average duration of TPLF personal injury cases was 37 months in 2019 and 43 months in 2020. The same data also show a high-level correlation between the average award size and duration of funded cases across the entire TPLF portfolio that Morning Investments analyses.

The faster a case settles, the less expensive the litigation process typically is for both parties. Paying attorneys is not the only expense of litigation: expert witnesses, court costs, travel and lost time from work all add up considerably. The pre-trial discovery process can involve numerous depositions, document discovery, etc. Investing more time and money in discovery and advancing cases further through court proceedings can increase the likelihood of larger awards. For example, based on ATRI’s quantitative analysis of trucking verdicts, the average trucking verdict size would increase by USD 211,000 if the time from crash to verdict rose by two months to 28.6 months from 26.6 months. This equates to about 7% of the average award of USD 3.16 million.

<table>
<thead>
<tr>
<th>Table 4</th>
<th>Average TPLF returns by segment and by year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2019</td>
</tr>
<tr>
<td>Personal injury</td>
<td>32.7%</td>
</tr>
<tr>
<td>Commercial litigation</td>
<td>29.5%</td>
</tr>
<tr>
<td>Mass tort</td>
<td>21.2%</td>
</tr>
</tbody>
</table>

Note: IRRs are for all transactions including both debt and equity-type deals.
Source: Morning Investments

TPLF increases total legal costs and lengthens the settlement timeline.

There is a correlation between award size and trial length in trucking accident cases.

43 Morning Investments, op. cit. See failure rates for mass torts and commercial claims.
45 Morning Investments, op. cit.
46 American Transportation Research Institute, op. cit.
Ethical challenges of litigation funding

Adding LFCs to the attorney-client relationship creates agency problems. These include conflicts of interest, the need to protect attorney-client privilege, LFCs’ financial incentives to influence case management, and questions around shifting of funding costs. Most of these ethical considerations are currently left to self-regulation by attorney and LFC industry associations, but US states are moving to mandate greater disclosure of TPLF arrangements. There are also significant concerns about predatory lending conditions in the opaque and lightly regulated consumer segment.

Three’s a crowd: agency problems and ethical challenges

The involvement of a litigation funder in legal cases can create conflicts of interest between lawyers, funders and clients. Lawyers have a duty to provide clients with independent professional judgment and must not allow a third party to interfere with the exercise of that duty. Funders have a fiduciary duty to their investors, whose interests can conflict with the funded party. Yet TPLF can create a financial interest for a lawyer, or a lawyer may find loyalty divided between the client and the funder. The terms of the funding agreement may give a funder the incentive to settle earlier or later than the client wishes, creating a conflict for the lawyer. There can also be conflicts of interest created by companies funding legal actions against their competitors, or by relationships between witnesses and funders. These agency problems – in which the interests of an agent differ from those of its client – in the client-attorney-funder relationship have the potential to affect the public interest in the judicial system.

Several US district and state courts have been moving to mandate the disclosure of TPLF arrangements. The Northern District of California was the first to institute a standing order requiring automatic disclosure of TPLF in class action suits, and 25 of 94 US District Courts require the disclosure of TPLF arrangements in civil actions. States such as New York do not yet have a statutory obligation to disclose the existence of a litigation funding arrangement to the opposing party or the court. However, if the court learns about the agreement and determines that it is relevant and not protected, then an opposing party could compel disclosure. At the federal level, there has been no regulation to date.

In general regulators do not address behavioural issues in TPLF.

Several US states regulate the content of TPLF contracts to ensure that the client receives specific disclosures from the funder. However, code of conduct issues or conflicts of interest between funder and client are self-regulated by industry trade groups and licensing authorities, not addressed by regulators. We believe litigation funding contracts should be subject to protections comparable to other consumer financial products that benefit from enhanced consumer protection. For example, consumer litigation funding contracts should clearly disclose an annual percentage rate of interest, similar to credit cards and payday loans. (See Call for action). The TPLF trade association publishes behavioural guidance for members.

In 2005, the American Legal Finance Association (ALFA) – a TPLF trade association – introduced behavioural guidance for its members in its Code of Conduct. This has been described as an attempt to forestall the introduction of statutory consumer protections and ethics regulations for TPLF. ALFA identifies ethical risks and requires its members to abide by standards including:

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50 The ALFA Code of Conduct, American Legal Finance Association.
1. not taking any steps to interfere with or influence a litigation;

2. not providing unreasonable amounts of funding beyond the client’s immediate needs or over-fund a case in relation to its perceived value;

3. not participating in the funding of a litigation where another ALFA member already participates.

However, ALFA has no means to enforce the guidance, and many funders are not part of ALFA. It does not have the ability to construct a unified approach to regulation or impose sanctions for failing to meet ethical duties.52

Another largely unregulated area of ethical concern is the lending terms between the LFC and the borrower in the consumer funding segment. Because there is no absolute obligation to repay the LFC, the industry typically manages to avoid regulation under state interest rate ceilings for consumer loans. Consequently, LFCs can charge interest rates that exceed usury rates on a risk-adjusted basis. Even where a plaintiff’s case would almost certainly yield a definite and substantial settlement, an LFC can charge unlimited interest rates. Furthermore, the use of compounded monthly rates, minimum interest periods, the addition of non-recourse fees and other opaque terms makes it difficult for consumers to evaluate the true cost of TPLF advances. Notwithstanding the legal delineation between types of funding agreements, the need for customer protection is based on the elevated vulnerability of consumers at the time of borrowing and the effective interest rates charged (see Case study: punitive interest rates and the need for consumer protection). We see a need for regulation of consumer TPLF lending terms (see Call for action).

Case study: punitive interest rates and the need for consumer protection

Christopher Boling suffered serious injuries in 2008 when vapours escaped from a gas can and ignited. Boling filed suit against the manufacturer of the gas can. Over the course of the litigation, Boling entered into four funding agreements with an LFC. These totalled USD 30,000, which accrued interest at a rate of 4.99% per month (an effective annual rate of 79.4%). When the case was resolved on confidential terms in May 2014, the funder informed Boling that he owed more than USD 340,400.

In June 2014, Boling filed suit against the funder, seeking a judgment that the funding agreements were void and unenforceable. The funding agreements were made public and revealed troubling terms and conditions. Among these were: (1) the funder had the right to examine the case files and inspect correspondence, books and records relating to the suit; (2) the funder was authorised to request several documents, including the plaintiff’s medical records, relating to the claim and recovery in the suit; and (3) limitations to the ability of the plaintiff to hire counsel.53

The district court ruled in favour of Boling and this judgement was affirmed by the US Court of Appeals for the Sixth Circuit. The loan agreements violated Kentucky laws against usury. The terms also raised questions of whether the plaintiff could act independently in litigation. The court had concerns that such agreements “may interfere with or discourage settlement because an injured party may be disinclined to accept a reasonable settlement offer where a large portion of the proceeds would go to the firm providing the loan”.54

53 Christopher Boling v. Prospect Funding Holdings, LLC, United States Court of Appeals for the Sixth Circuit, 25 April 2019.
54 Ibid.
The ABA provides rules for professional conduct to mitigate issues arising from TPLF.

Lawyers who represent clients using funding from third-party LFCs also face professional conduct concerns. TPLF and its contract terms can create ethical hazards that are governed by attorney ethics rules. The American Bar Association (ABA) delineates ethical standards and guidance for attorneys. It specifically cautions on ethical hazards and directs lawyers to seek clarification on specific state-imposed rules governing attorney conduct. For example, the lawyer:

- must avoid and disclose conflicts of interest;
- should not acquire a pecuniary interest in the litigation beyond the fee agreement with the client;
- should review the TPLF contract, explain its ramifications to the client and advise the client that they can seek other legal counsel to advise them on the TPLF contract;
- must not allow the TPLF to interfere in settlement discussions or analysis and should be aware of the influence which the existence of the TPLF contract may have on a client’s willingness to settle.

- The ABA also cautions on issues such as fee sharing, confidentiality, and the protection of attorney/client privilege.

Greater enforcement of legal ethics rules regarding TPLF would be beneficial.

Though ABA ethics rules carry weight and significantly influence attorney behaviour, we believe rules will only have meaningful behavioural effects when they affect licensing and the ability to practice law. Existing state attorney ethics laws cover most aspects of attorney ethics arising in a litigation funding situation, but it would be more effective to consolidate ethical standards for litigation funding matters into one set of standard principles.

Opaque passing of funding expenses on to clients is a further ethical issue.

Most jurisdictions have taken steps to address the ethical issue of attorneys borrowing funds via TPLF and passing the funding expenses—such as origination costs and loan interest—through to their clients. Most countries now explicitly require full disclosure of such arrangements to the client. In addition to obtaining the client’s informed consent, the terms of the financing arrangement must be fair, reasonable, customary, and at a lawful interest rate.

US lawmakers are considering tightening disclosure rules to strengthen oversight of case funding.

US lawmakers and courts are considering how to tighten disclosure rules on funding to strengthen the regulation of these cases. For example, there have been calls to amend the Federal Rules of Civil Procedure to require disclosure third-party funding as part of the initial disclosure in a case. Legitimate funders and plaintiffs would benefit from an appropriate regulatory framework. Courts, funders, lawyers, claimants and defendants would gain from greater legal certainty.

Greater public disclosure would support defendants more transparently.

Stronger disclosure requirements would improve the compliance of both funders and lawyers with their respective ethical codes. ALFA maintains a database called the Investment Management System that tracks consumer legal funding advances made by ALFA members. This could potentially promote more fair and ethical practices by disclosing the existence of a TPLF agreement. To be effective, the disclosure should be made publicly available to inform defendants of the situation of the plaintiff with whom they are negotiating.

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56 See ABA Model Rules 1.8 and 5.4, Model Rules of Professional Conduct.
60 “About ALFA”, American Litigation Finance Association, 17 August 2021.
Fair, efficient and stable legal systems, and access to justice, are necessary conditions for a well-functioning society. TPLF may bring societal benefits in the quest to improve access to justice under certain conditions, but today it is an expensive tool with potentially harmful economic and ethical consequences. Aside from LFCs’ profit motive and potential for conflicts of interest, there are also significant concerns about predatory lending practices, particularly in the lightly regulated consumer segment. We recommend a series of enhancements to the TPLF regulatory structure to support consumer protection and an efficient legal system. We also propose greater provision of alternative funding avenues to TPLF.

Disclosure of funding arrangements to all involved parties

The mere fact that litigation funding may be abused suggests that such agreements should be scrutinised.61 To that end, we support uniform disclosure of litigation funding. In our view, parties have a right to know who has a legal and financial claim against them. Disclosing funding arrangements to courts, opposing parties, arbitration tribunals and counsel would facilitate the assessment of potential conflicts of interest; discussion of cost shifting and allow all parties to realistically assess the prospects for settlement of the case.62 Disclosure also enables litigants to transparently assess parties’ fiduciary duties and calculate attorneys’ fees.63

The best way to achieve uniform rules is through the legislature. In the absence of legislation, TPLF disclosure requirements in the US today differ by jurisdiction, with courts diverging in their conclusions.64 Over 25% of US District Courts have local rules that require the disclosure of third-party funding arrangements in civil actions.65 These rules have the stated purpose of assisting judges in assessing possible recusal or disqualification. In a step toward consistent rules, in March 2021 US lawmakers reintroduced the Litigation Funding Transparency Act, which would require plaintiffs to disclose third-party funding.66 Although it applies only to class actions and MDL, it is a step in the right direction.

TPLF rules and regulations by state

The US system includes overlapping federal and state jurisdictions. Differences between jurisdictions have implications for TPLF transactions. The governing law of the agreement, location of the parties, venue of litigation, and jurisdiction where a judgment may need to be enforced each impact the outcome of TPLF agreements. TPLF regulations can be effected through legislation, court rules, or via case law. There has been a push for TPLF reform, most recently with the re-introduction of the Litigation Funding Transparency Act, which has been proposed with the intent of limiting prolonged litigation. However, much TPLF rulemaking occurs at the state level.

Court rationales for restricting third-party funding vary by state, but are typically due to continued recognition of the torts of maintenance and champerty, or consumer protection regulations such as usury and disclosure requirements. Many states use the Restatement of Torts (second edition) as a guide to tort law, but the specific rules vary by state and evolve with case law. The most attractive states for investing in litigation funding are Florida, Texas, New York, and California. States such as Alabama, Colorado, Kentucky, North Carolina and Pennsylvania, on the other hand, are among those that still restrict the use of TPLF.

Table 5, below, provides a blended overview of federal district court and state court and legislature TPLF rules in a selection of large US states as of October 2021. For example, most disclosure requirements have been set by federal district court judges, while determinations about the application of usury rules are typically made by state courts. Due to the nature of tort law, it is a necessarily subjective summary.

In some states, maintenance and champerty remain a valid defence against use of TPLF.

Table 5
Summary of TPLF rules for a selection of US states

<table>
<thead>
<tr>
<th>State</th>
<th>Permitted?</th>
<th>Disclosure required?</th>
<th>Usury rules apply?</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Yes</td>
<td>Yes (class actions)</td>
<td>No</td>
</tr>
<tr>
<td>Texas</td>
<td>Yes</td>
<td>Partially</td>
<td>No</td>
</tr>
<tr>
<td>Florida</td>
<td>Yes</td>
<td>Partially</td>
<td>No</td>
</tr>
<tr>
<td>New York</td>
<td>Partially</td>
<td>No</td>
<td>Under court review</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>No</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Illinois</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Ohio</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Georgia</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>North Carolina</td>
<td>No</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Michigan</td>
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<tr>
<td>Arizona</td>
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<tr>
<td>Tennessee</td>
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<tr>
<td>Indiana</td>
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<td>Colorado</td>
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<td>Arkansas</td>
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</tr>
<tr>
<td>West Virginia</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Swiss Re Institute

In some states, maintenance and champerty remain a valid defence against use of TPLF.

The Superior Court of Pennsylvania has ruled TPLF invalid in some instances since champerty remains a valid defence. In the 2016 ruling that restricted TPLF, the court explained that “The requisite elements of champerty have all clearly been met in this case. The Litigation Fund Investors are completely unrelated parties who had no legitimate interest in the [litigation]. The Litigation Fund Investors loaned their own money simply to aid in the cost of the litigation, and in return, were promised to be paid

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69 Maintenance is when a party gets involved with a case that it has no legal connection to (typically by funding a plaintiff or defendant in the case), and champerty is maintenance for profit.
70 Morning Investments, op. cit.
“principal, interest, and incentive” out of the proceeds of the litigation.”\textsuperscript{72} Similar prohibitions against maintenance and champerty remain in effect in North Carolina. New York is more permissive of TPLF, but transactions below USD 500 000 violate champerty restrictions.

Many of the states that allow TPLF have started to partially regulate the industry, with a focus on consumer litigation finance.\textsuperscript{73} Some states have invoked usury laws to impose caps on the interest rates that consumer LFCs can charge borrowers. The Colorado Supreme Court, for instance, placed restrictions on TPLF by concluding that the agreements are loans and so subject to the Colorado Uniform Consumer Credit Code. Similar restrictions apply in Maryland, Tennessee, Arkansas, and Indiana, and states such as Maine and Nebraska have placed limits on the interest accumulation period.

Greater transparency and consumer protection in funding terms

The high costs of TPLF affect plaintiffs. Financial terms of funding agreements have a direct impact on their net awards from a case. There is an asymmetry between sophisticated lenders with experience in assessing, underwriting and structuring funding agreements, and borrowers who are typically inexperienced in matters of TPLF and often in a situation of duress. Financiers could be required to disclose case-value estimates to plaintiffs who have obtained non-recourse advances. This policy would help plaintiffs avoid cognitive pitfalls such as the endorsement effect, where the fact that a funder supports a case increases the plaintiff’s belief in the monetary value of a claim.\textsuperscript{74}

Funding terms are often complex, with compounding layers of fees and interest rates, and so are difficult for the borrower to assess ex ante. Avraham and Sebok, in their review of 200 000 funded and unfunded consumer cases between 1999 and 2016, conclude that the results “at minimum support reforms designed to make pricing transparent by removing complex pricing mechanisms.”\textsuperscript{75} They calculated a 43% median rate of return on litigation funding investments after defaults and haircuts.

Usury restrictions can complement simplified pricing mechanisms. Most US states have laws against lending at excessive rates, and some have applied them to TPLF. For example, Arkansas and West Virginia impose annual interest caps on TPLF of 17% and 18% respectively. Some courts have argued against applying usury restrictions to TPLF on the argument that non-recourse funding agreements are not considered a loan, but rather a form of asset purchase or venture capital. But consumer protection against predatory interest rates should not depend on a legal reading of the definition of a loan. The fact that about 10% of borrowers do not need to repay the funder due to defaults provides little comfort for the majority who pay steep interest charges in addition to the full principal owed.\textsuperscript{76} TPLF consumer cash advances are widely marketed as loans and intended as a form of borrowing by the plaintiff rather than a joint business venture. Furthermore, unlike an asset purchase or VC investment, there is no shared participation in the outcome of the litigation beyond repayment of the loan principal plus interest and fees. The consumer protection problem is caused by exorbitant effective interest rates, opaque terms and conditions, and borrowers who lack alternative funding sources.

The fact that TPLF increases the transaction costs of the tort system (see LFC returns far exceed high-risk equity investments), and predominantly benefits corporate cases, makes it a blunt tool to enable access to justice. There is a strong argument for more targeted and efficient alternatives such as legal aid and legal expense insurance.

\textsuperscript{72} WFIC, LLC v. LaBarre, D, Justia: Pennsylvania Case Law, Pennsylvania Superior Court, 2016.
\textsuperscript{74} J. Xiao, “Heuristics, Biases, and Consumer Litigation Funding at the Bargaining Table”, Vanderbilt Law Review, vol 68, no 1 2015, p 261–296.
\textsuperscript{76} R. Avraham & A. Sebok, op. cit.
Case study: compound monthly interest leads to extreme lending rates

In 2014, former NYPD officer and 9/11 first responder Elmer Santiago was awarded USD 3.9 million for injuries suffered and future income lost. Santiago used his Victim’s Compensation Fund award letter as collateral for an advance (or post-settlement funding agreement) until he received his compensation. Santiago received USD 356,000 from RD Legal between 2014 and 2015, prior to his payout in 2016. RD Legal Funding then informed him that he had to pay more than USD 500,000 in interest. Santiago’s attorney claims that RD Legal led him to believe that the interest rate would be charged at 19% per annum, when in fact it was 19% compounded monthly. The New York attorney general and Consumer Financial Protection Bureau then filed a federal lawsuit against RD Legal for misleading 9/11 first responders and others about the terms of advance payments. The case is ongoing as of the date of this publication.

Empirical evidence shows monthly compounded interest rates to be prevalent in TPLF agreements. Avraham and Sebok found monthly-compounded interest rates used in 88% of completed cases. Their study also found that the real price of TPLF for the median case was close to 43% per annum, after accounting for defaults and haircuts. However, the use of compounded monthly rates, minimum interest periods, the addition of non-recourse fees and other opaque terms, make it difficult for consumers to evaluate the true cost of TPLF advances. Moreover, more than half of the transactions between the funder and the consumer were subject to a haircut where the consumer paid a lower rate than contractually obliged. This highlights another area of ethical concerns with consumers facing contract uncertainty.

Legal aid for consumer protection claims

If the goal is to enhance access to justice to underserved demographics such as low-income individuals, TPLF is an expensive and blunt tool. When a victim’s only recourse for pursuing a meritorious claim through the courts is a high interest loan from wealthy investors, it probably does not enhance access to justice significantly and creates a consumer protection problem. To advance justice without burdening plaintiffs, businesses, and consumers with high litigation costs, expanding the funding and scope of legal aid funds such as the US Legal Services Corporation (LSC) can be considered.

Globally, there is precedent for a wider use of legal aid. In Germany and Ireland, for instance, personal injury cases are already eligible for legal aid. In Germany’s cost-shifting regime, plaintiffs keep their full award, and in Ireland they repay the legal aid if they win the case. In jurisdictions such as the US and England, offering non-recourse legal aid loans at minimal interest rates to cases that are deemed to be meritorious and have a reasonable chance of success is a step toward ensuring that everyone is entitled to legal assistance.

Legal expense insurance

Legal expense insurance (LEI) is a policy that protects insured parties – typically a defendant – from costs associated with litigation. The protection covers some or all costs associated with litigation brought against the insured, as well as action that the insured pursues against a third party. Both commercial and personal lines of LEI exist. LEI policies have existed for decades, originating in Europe in the early 20th century. Countries with widespread LEI market penetration include Germany, Japan and Sweden.

LEI can be beneficial to those consumers who lack the disposable income to engage in litigation, but earn too much to qualify for legal aid. By offering such consumers

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78 R. Avraham, A. Sebok, op. cit.
protection from legal expenses, LEI policies can increase access to justice. LEI policies can increase access to justice. Markets where LEI is widespread are found to have higher levels of access to justice than other markets with similar-quality legal systems. Awareness of LEI is rising around the world and several markets, especially in Europe, are witnessing rapid growth in their respective industries. The policy’s long presence and growing popularity is testament to its effectiveness in reducing legal risks.
