The Wild West of Finance: Should It Be Tamed or Outlawed?

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Before the emergence of the litigation finance industry, little attention was paid to how injured plaintiffs managed financially while waiting years for their cases to be resolved, or whether those who could not afford to wait suffered disadvantages in the settlement and litigation processes.

Although the idea that "wealth [should not have] the monopoly of justice against poverty" has been embraced as a basic principle in the legal system of the United States, in practice, a wealthy litigant can often outlast, and win against, a poor opponent. If a plaintiff has a good case but no financial resources to pursue it (and, perhaps, insufficient means to pay medical bills and other living expenses), a plaintiff may have no choice but to forgo the suit or accept a defendant's low settlement offer. A plaintiff may not be able to find a lawyer willing to take the case on a contingency fee basis and, even if such an arrangement were available, in most states it is illegal for the lawyer to provide money for the client's living expenses. Furthermore, traditional lenders have not been willing to extend loans with only potential proceeds of a lawsuit as collateral, judging such loans as too risky.

Lending money to plaintiffs to finance their lawsuits has become an industry within the last 10 years. Litigation financing firms make non-recourse loans to plaintiffs in exchange for a share of the proceeds of their lawsuits, if there are any. If a plaintiff loses, nothing is repaid, and the lender loses the money advanced. One lender in the industry has described his business as being "the Wild West of finance." This description is apt because it is not clear how the law controls or whether it should control these transactions.

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A Huge Difference in One Person's Life: An Example

Thomas Knauer, an upstate New York electrician, suffered a serious brain injury when he fell off a high ladder on the job installing electrical service. He and his wife were besieged by creditors while they waited for their workers' compensation case and other litigation to be resolved. The Knauers contacted a litigation financing firm that advanced $13,500 to them, which they would repay with about 50 percent interest per year if, but only if, they collected any money from the defendants or their insurance companies. Mrs. Knauer was very pleased with this arrangement because, in her words, the $13,500 "made a huge difference in my life."

However, in spite of Mrs. Knauer's satisfaction, the described transaction raises a number of legal questions:

(1) Is the agreement an illegal violation of prohibitions against champerty?
(2) Is the agreement an illegal violation of usury statutes?
(3) Is the litigation financing firm a predatory lender taking advantage of an unprotected borrower?
(4) And ultimately, should the litigation financing industry be left alone, regulated to some extent, or regulated out of business?

Revival of Interest in the Champerty Doctrine

Perhaps as far back as the fifth century B.C. in ancient Greece, champerty, an arrangement in which a third party supports another's litigation in exchange for a share of the proceeds, if there are any, has been prohibited by law; however, it is a word that is unfamiliar to most people, including lawyers. The reason for the prohibition against champerty has been the law's desire to discourage a variety of evils: frivolous litigation, quarrels, resistance to settlement, interference in the attorney-client relationship, and suppression of witnesses and evidence. Nevertheless, in the United States, even in states that have maintained the prohibition against champerty for the most part, there have always been exceptions to the prohibition. The most widespread exception is the universal use of the lawyer's contingency fee. Lawyers' agreeing to receive a percentage of the proceeds of a lawsuit as their fees, but only if their clients win, became accepted because allowing an impoverished plaintiff to bring a legitimate cause of action was viewed as more important than preventing the alleged evils of champerty, which could, in any case, be eliminated by rigorous supervision by the courts.

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In the late 1980s and early 1990s, articles about champerty, or investing in other people's lawsuits, started appearing in journals, magazines and newspapers with some regularity. The sudden interest was sparked by a few cases in which plaintiffs invited investors to finance their litigation in exchange for a share of the awards if the plaintiffs won. The case that particularly attracted the public's attention was *Intex Plastic Sales Co. v. Hall*. It attracted the public's attention not only because it involved a champertous, unusual method of financing litigation, but also because it involved waterbeds. When Hall, the inventor of the waterbed, did not have the funds to pursue a patent infringement claim against Intex Plastic Sales Co., a $20 million company selling waterbeds, he agreed to exchange a share of any proceeds recovered from the alleged infringer for an investment group's financial support. Intex had the suit dismissed on the grounds of champerty. Subsequently, Hall gave his investors a share in the waterbed patent itself, instead of in the lawsuit, which is clearly legal and quite common, and he and his investors won an award of damages and interest of almost $6.5 million. Hall succeeded in doing an end run around California's champerty prohibition because patent rights were at stake. Although it is legal to assign rights to a patent, it is not legal to assign rights you have because you were involved in an automobile accident or were assaulted. If his claim had been about almost anything other than a patent, his impecunious condition might have rendered his rights meaningless.

Several years later, in 1997, the highest court in the Commonwealth of Massachusetts considered and rejected its long-held champerty prohibition in a case called *Saladini v. Righellis*. In that case, Ms. Saladini agreed in writing to provide the funds for Mr. Righellis to pursue a legal claim arising out of his interest in Putnam Manor, real property in Cambridge, Massachusetts. In exchange, any recovery would first be used to reimburse Ms. Saladini and then, after the lawyer was paid, she would receive 50 percent of any remaining funds. Ms. Saladini paid Mr. Righellis a total of $19,229. Mr. Righellis settled his lawsuit for $130,000, but he didn't tell Ms. Saladini. When she found out, she filed the lawsuit asking the court to enforce the agreement they had made. Mr. Righellis argued that their agreement was not enforceable because it was champertous and, thus, illegal. The Massachusetts court found in Ms. Saladini's favor, concluding that it would be unfair for Mr. Righellis to receive a windfall at her expense. The court noted that there are other ways to limit frivolous lawsuits and other wrongdoing without limiting the rights of litigants to get financial support from others. This case and others suggested that the prohibition on champerty might be headed for extinction, but that was before litigation financing firms became an Internet industry.

Even Though Litigation Financing Rates Are High, They Are Not Usurious Because the Borrower Does Not Have an Absolute Obligation to Repay

Usury is the act of lending money at an unlawfully high rate of interest. It has been prohibited for thousands of years and treated with opprobrium because of religious or moral beliefs and, perhaps in part, due to anti-Semitism. Today, most states in the United States, at the encouragement of consumer groups, have statutes setting interest rate limits and prohibiting usury. One of the usual requirements for usury is the borrower's absolute obligation to repay and, therefore, litigation financing and other investments cannot be usurious. Investors, for example, may advance funds to a business in exchange for a promise to share in the business' profits. The return on their money may be double or triple or a hundred times what they invested, but they are certainly not guilty of usury because the business did not have an absolute obligation to repay their investment. If the business fails, the investors lose their money. Similarly, the Knauers' agreement to pay 50 percent interest on the $13,500 advanced to them was not usurious. The Knauers did not have an absolute obligation to repay the money; their obligation to repay was contingent on their receiving money from their litigation.

Based on the foregoing reasoning, litigation finance companies were reasonably confident that no matter what they charged for advancing funds to litigants, they were safe from usury claims.

To their dismay, in 2001 an Ohio court declared a litigation funding agreement to be unenforceable because it was usurious. Ms. Rancman, the plaintiff in the case, had been seriously injured when she was a passenger in a car accident with an uninsured drunk driver. While she waited for the insurance company to make a satisfactory settlement offer, she did not have enough money to pay her medical bills and living expenses. So, against the advice of her attorney, the plaintiff entered into contracts with a litigation financing firm agreeing that if she recovered any money from the lawsuit, she would pay back the $6,000 advanced to her with about 280 percent in interest; if she received nothing from the lawsuit, she could keep the $6,000 and pay nothing. She settled her case for $100,000, returned the $6,000 with only 8 percent in interest, and sued the financing firm to have the contract rescinded and declared unfair, deceptive and unconscionable. The court seemed so shocked by the interest rate, that it concluded there was no chance the plaintiff could lose her case. If winning was a sure thing, then there was no circumstance under which Ms. Rancman would not have to repay the $6,000. Thus, the court concluded, the $6,000 was a loan, not a speculative investment, at an unlawful rate of interest. The finance company appealed to the Ohio Supreme Court. The court would not affirm that the money advanced was a loan rather than an investment, so it returned to the champerty prohibition, although neither the plaintiff nor the financing firm had raised the issue of champerty, to declare the contracts void.

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Is Litigation Financing Merely Another Form of Predatory Lending?

Although there is no legal definition of predatory lending, the term usually refers to the following situations: borrowers don't understand the terms of the loan, and all material information is not disclosed to them; lenders put undue pressure on borrowers knowing that borrowers have insufficient resources to make loan payments; and lenders target vulnerable borrowers. These borrowers must seek funds in the subprime market because their credit or income verification is suspect. The prime lending market, on the other hand, serves borrowers with a minimum of debt and good credit ratings. Generally, predatory practices do not occur in the prime lending market because there is greater competition among banks, thrifts and credit unions, which are, in addition to the competition, heavily regulated by state and federal agencies. Furthermore, prime borrowers are more likely to understand the financial transactions and shop around for the best terms. Nevertheless, when the subprime market operates efficiently, it provides opportunities for low-income borrowers to buy homes, cars and other goods by obtaining credit that is unavailable to them in the prime market. Most commentators on credit issues, critics and lenders alike, agree that credit should be available to as many borrowers as possible.

Litigation financing is certainly within the category of subprime lending in that generally the borrowers do not qualify for traditional, prime credit, and the financing firms compensate in their rate of return for the risk of extending credit. Litigation financing does not, however, fall into general descriptions of predatory lending because the borrowers are not being intimidated or fooled, and they also have professionals to help them understand the terms of the financing. The reason these borrowers are in a different position from other subprime borrowers is that, almost by definition, people seeking funds through litigation financing are seeking them to pay their living expenses while they await the outcome of their lawsuits, and they have lawyers who are already familiar with their circumstances. These borrowers do not have to seek out legal help with their agreements with litigation financing firms; the lawyers they already have are going to be involved automatically, and they will have an ethical obligation to provide advice to their clients about the financing. For example, the financing firm is going to contact the borrower's lawyer to make sure that it has all the information about the case so that it can assess its risk and so that the lawyer will keep it informed about the progress of the case and its outcome.

Nevertheless, merely having access to legal advice does not necessarily protect buyers from litigation financing firms that may be charging too much. Ms. Rancman, the Ohio plaintiff, for example, rejected her lawyer's advice and contracted for funds at a 280 percent interest rate. Perhaps she was making the rational decision that without the advanced funds she would have to accept the insurer's low settlement offer; with the funds, she would have the wherewithal to wait for a better offer and wind up with more money, even after paying the financing company its agreed-upon rate. The problem is knowing whether the 280 percent is really too high an interest rate for the risk being undertaken.

Taming the Wild West of Finance

It would be bad policy and unfair to poor plaintiffs with good cases to regulate litigation financing firms out of business. Consumer advocates have noted that very restrictive anti-predatory lending laws that set low limits on interest rates may, instead of protecting subprime borrowers, actually disadvantage them further by reducing their options. However, there are a number of steps that Congress and state legislatures could take to protect choices available to plaintiffs with limited financial resources.

The most obvious kind of regulation that would provide some protection for plaintiffs seeking litigation financing is a disclosure requirement. A disclosure requirement could ensure that financing firms provide their borrowers with clearly written explanations of the rates they are being charged. Some consumer advocates have dismissed disclosure requirements, claiming that they merely provide a defense for unscrupulous lenders; however, given that these plaintiffs/borrowers have legal counsel to advise them in using financial information, disclosure of easily comparable rates would certainly help them choose the litigation financing firm that offered the best deal. One way to provide this protection would be to amend the federal Truth in Lending Act to include litigation financing firms. The Federal Truth in Lending Act was enacted by Congress in 1968 as part of the Consumer Protection Act. Its purpose is to protect consumers in credit transactions by requiring clear disclosure of all the costs and terms involved in such transactions.

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Consumer advocates have argued that instead of regulating subprime lenders out of business, the government should try to encourage traditional lenders to enter the subprime business. One reason these advocates give for traditional lenders' reluctance to enter the subprime market is the unsavory reputation of the subprime industry. That problem certainly exists in the litigation financing world, but representatives of litigation finance firms assert that unscrupulous dealers are not inherent to the industry, and that reputable firms deal directly and closely with plaintiffs/borrowers' attorneys. Similar arguments are made by subprime lenders in automobile loan and home mortgage loan businesses as well as by advocates for low-income borrowers. One way to encourage honest litigation financing firms and to promote competition from more traditional lenders is to collect information from the firms in the industry. Reporting requirements would make data available so that regulators could make assessments about the profitability of the industry and its fair lending/advancing practices. In fact, some litigation financing companies are becoming more transparent in an effort to become more mainstream.

There is little doubt that a litigation financing industry that acts professionally and ethically in attempting to earn a reasonable return for the risk it is undertaking, fills a need that has not been served by more traditional lenders. The industry can be improved by some regulation, but it would be unfortunate if the entire industry became the victim of a political movement of so-called tort reform that dwells on the outlier cases in which plaintiffs receive unwarranted windfalls. By publicizing these cases, politicians and the press ignore the much more numerous situations where fairness and justice are absent because meritorious plaintiffs do not have the funds to sustain routine expenses as well as medical costs during the years that it may take to bring their cases to a final conclusion.

One of the most famous customers of litigation financing was probably Abner Louima, the Haitian immigrant who brought a highly publicized case of police brutality against the New York City Police Department. Three years after the start of his lawsuit, Mr. Louima still had not received any of the proceeds of his settlement, so to pay for living expenses, he obtained an advance of $20,000 from LawCash. He agreed to repay the money plus interest of 16 percent annually if and when he received the settlement. Nine months later, after receiving a settlement of $8.75 million, he repaid LawCash.

This case is not typical in either the size nor the certainty of the award, but that makes it a particularly good example of the useful service litigation finance firms provide to the low and moderate-income community. Mr. Louima, with no assets but his pending case, was not going to be able to receive a loan from a bank at a regulated rate, even though he was going to become in short order a multimillionaire. In the meantime, while he waited for that settlement, he didn't have funds for living expenses. Getting the money from LawCash at a rather high rate of interest makes good financial and practical sense in his case. Who benefits if such a plaintiff does not have enough money for basic living expenses? Only the defendants benefit, whether or not they are in the right in the underlying case. By leveling the playing field, litigation financing supports a legal system that deters negligence and encourages a corporate interest in safety. It should be regulated to eliminate unscrupulous entrepreneurs, but not to eliminate the industry and the otherwise unavailable options it offers.

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In her academic and professional work Professor Martin is currently focusing on litigation financing and patronage employment issues. She has also published academic articles on direct shipment of wine, telecommunication towers, the rent-to-own industry, insider trading, and executive compensation in numerous publications, including the *Columbia Journal of Environmental Law*, *Journal of Law & Politics* of the University of Virginia School of Law, *University of Michigan Journal of Law Reform*, *Berkeley Technology Law Journal*, *Fordham Journal of Corporate & Financial Law*, and other law reviews and refereed publications. Her published work has been cited in opinions of the U.S. Supreme Court, eight of the U.S. Circuit Courts of Appeals, and many other courts around the country. Her work has also been cited in Federal Trade Commission reports, a report of the New South Wales (Australia) Law Reform Commission, and other government documents.

At Hofstra, Professor Martin is the director of the Center for Teaching and Scholarly Excellence. She has served as the chair of the University Senate Planning and Budget Committee and as a member or elected representative of numerous committees. She has received the Beta Alpha Psi Outstanding Service Award, Dean's Service Award, Beta Alpha Psi Faculty Award, Beta Gamma Sigma Faculty Award, and many other awards and grants for service and scholarship. She has initiated a variety of academic programs and courses. In the community, she was the president of the Massapequa Branch of the American Association of University Women, and for many years she has been and still is a member and secretary of the Board of Directors of the Massapequa Philharmonic Orchestra, and a member of the Nassau County Bar Association's Speakers Bureau.