Heuristics, Biases, and Consumer Litigation Funding at the Bargaining Table

I. INTRODUCTION

Imagine three plaintiffs. The first incurred serious back injuries as a passenger in an automobile collision.[1] The second suffered permanent head injuries as a day laborer in a construction accident.[2] The third experienced a debilitating asthma attack, caused by exposure to floor-cleaning chemicals at her workplace.[3] You now have the chance to advance money to the plaintiff that you believe has the lawsuit with the highest expected value. If the selected plaintiff settles or wins at trial, then you receive the money you gave the plaintiff plus interest that approaches 200% a year.[4] Here is the catch: if the plaintiff neither settles nor wins at trial, then you get nothing. Ready to place your bet?

Traditionally, a variety of sources—plaintiffs, defendants, the parties' attorneys, and defendants' insurers—have financed litigation.[5] "Alternative litigation finance" ("ALF") refers to financing from other sources.[6] In the past decade, ALF has garnered significant attention from news reporters, practicing attorneys, legal scholars, policymakers, and state bar ethics committees.[7] The rising ALF

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1. *See* Odell v. Legal Bucks, LLC, 665 S.E.2d 767, 770 (N.C. Ct. App. 2008) (plaintiff injured in an automobile collision); Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 218 (Ohio 2003) (plaintiff injured as a passenger in a vehicle collision).

2. *See* Echeverria v. Estate of Lindner, No. 018666/2002, 2005 WL 1083704, at *2 (N.Y. Sup. Ct. Mar. 2, 2005) (plaintiff injured in a construction accident while at work).

3. *See* Binyamin Appelbaum, *Lawsuit Loans Add New Risk for the Injured*, N.Y. TIMES, Jan. 16, 2011, http://www.nytimes.com/2011/01/17/business/17lawsuit.html?pagewanted=all&_r=0, *archived at* http://perma.cc/5XF-U3UR (describing a plaintiff who obtained a nonrecourse advance from a consumer litigation financier in order to pursue a disability claim against her former employer for asthma that was allegedly caused by exposure to floor-cleaning chemicals).

4. You get the money you gave the plaintiff plus interest that approaches 200% a year only if the proceeds from the lawsuit exceed that amount; otherwise, you get the maximum proceeds from the lawsuit. The consumer litigation financier gets no more than what the plaintiff receives as proceeds from the lawsuit. STEVEN GARBER, RAND CORP., ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWNS, AND UNKNOWNS 10 (2010).

5. *Id.* at 1.

6. *Id.*

7. *See* JOHN BEISNER ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES 1 (2009) ("Third-party litigation financing . . . has received much attention of late from both proponents and critics, including practicing lawyers, academics, jurists, and policy-makers."); AMERICAN BAR ASSOCIATION COMMISSION ON ETHICS 20/20, WHITE PAPER ON ALTERNATIVE LITIGATION FINANCE 1 (Draft 2011) (footnotes omitted), *available at* http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111019_draft_alf_white_paper_posting.authcheckdam.pdf, *archived at* http://perma.cc/XX33-UVWZ ("[ALF has] become increasingly prominent in recent years, leading to significant attention in the legal and popular press, scrutiny by state bar ethics committees, and scholarly commentary.").

industry currently consists of three segments: (1) financiers that provide funding directly to individual plaintiffs in noncommercial litigation, a practice known as "consumer litigation funding" ("CLF"),[8] (2) financiers that provide funding to plaintiffs' law firms, and (3) financiers that provide funding to the corporate plaintiffs in commercial litigation.[9] This Note focuses on the CLF segment of the ALF industry.

All three plaintiffs described in the introductory hypothetical exemplify actual individuals whom CLF financiers selected to receive litigation funding. A plaintiff who receives a cash advance from a financier is obligated to pay back either (1) the initial advance plus fees or (2) the net proceeds from the lawsuit—whichever amount is lower.[10] The plaintiff never owes more than what is reaped from the lawsuit.[11] The cash advance constitutes a nonrecourse loan[12] because the plaintiff is not liable for repayment if the lawsuit is unsuccessful.[13] In this Note, "litigation funding" and "nonrecourse advance" will be used to refer to CLF and not funding from the other two segments of ALF.

The rapid rise of litigation funding has not gone without criticism. Specifically, some argue that consumers are unable to make rational decisions in obtaining nonrecourse advances due to their insufficient understanding of CLF contracts, while others accuse financiers of exploiting consumers with unjustifiably exorbitant fees.[14] Furthermore, some commentators assert that litigation funding increases frivolous litigation and disincentivizes settlement.[15]

When discussing the effect of nonrecourse advances on settlement, commentators have generally assumed a rational plaintiff.[16] However, behavioral law-and-economics research shows

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8. Other names for consumer litigation funding include "cash advances, legal funding, plaintiff funding, and pre-settlement funding." GARBER, *supra* note 4, at 10.

9. *Id.* at 8–9. Commercial litigation (i.e., business v. business lawsuits) usually involves corporate plaintiffs and defendants.

10. *Id.* at 9–10.

11. *Id.* at 10.

12. While "nonrecourse loan" is a legitimate alternative name for litigation funding, the cash advance may or may not be considered a "loan" under a state's usury laws. See *infra* Section II.C.1 for a discussion of this issue.

13. GARBER, *supra* note 4, at 10.

14. *See infra* Section II.B.

15. *See infra* Section II.B.

16. A rational plaintiff is one who employs deductive logic and maximizes utility, or wealth, when making decisions. Most standard law-and-economics theories of settlement assume that the motives for settlement are purely monetary; thus, when litigants maximize expected utility, they maximize expected wealth. *See* George Loewenstein et al., *Self-Serving Assessments of*

that not all plaintiffs are rational.[17] No commentator has yet analyzed how litigation funding can affect a plaintiff who is irrational (i.e., subject to cognitive biases).[18] This Note provides this missing analysis and suggests that litigation funding may cause an irrational plaintiff to reject a settlement offer—even if the offer maximizes the plaintiff's expected wealth.[19] This Note explores three responses to this problem and argues that financier mandatory information disclosure, which is an asymmetrically paternalistic policy, is the best solution.[20]

Part II provides an overview of the litigation-funding process, the service's benefits, commentators' concerns regarding the service, and the judicial and regulatory responses to these concerns. Part III introduces a behavioral law-and-economics framework for settlement and demonstrates that nonrecourse advances may negatively impact irrational plaintiffs by obstructing fair settlements. Part IV argues that the best approach to this problem is a policy that requires financiers to disclose their case-value estimates to plaintiffs.

II. CURRENT LANDSCAPE OF CONSUMER LITIGATION FUNDING

In the United States, dozens of financiers currently exist in the CLF segment of the ALF industry.[21] In this Part, Section A provides an overview of the CLF process and summarizes the benefits of the service. Section B focuses on concerns that have arisen along with the rapid success of litigation funding. Section C examines the judicial and regulatory responses to these concerns.

Fairness and Pretrial Bargaining, 22 J. LEGAL STUD. 135, 139 (1993) ("[E]xplanations for nonsettlement assume that motives for settlement are purely pecuniary.").

17. *See, e.g.*, Russell Korobkin & Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. 107, 109–10 (1994) (stating that plaintiffs are susceptible to psychological barriers that inhibit settlement).

18. Please note that use of the term "irrational" varies in different scholarly works and disciplines. Here, "irrational" matches the definition of "boundedly rational" in Camerer et al.'s paper on asymmetric paternalism. *See* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1216–19 (2003).

19. *See infra* Part III. Please note that Part III shows that litigation funding *may* lead to a lower settlement rate, but it does not prove definitively that litigation funding *will* result in a lower settlement rate. Whether the existence of a nonrecourse advance at the bargaining table *will* obstruct settlement through a behavioral mechanism and whether the frequency of cognitive errors due to litigation funding *will* reduce overall settlement are both empirical questions.

20. *See infra* Part IV.

21. *See* GARBER, *supra* note 4, at 9 ("[S]everal dozen ALF companies provide money to consumers . . . ."); *About Legal Funding*, AM. LEGAL FIN. ASS'N, http://www.americanlegalfin.com/OfficersAndMembers.asp, *archived at* http://perma.cc/75LS-K6E2 (last visited Oct. 14, 2014) (listing thirty-two companies in the alternative litigation finance industry trade group).

A. Snapshot of the Blooming Consumer-Litigation-Funding Business

In order to apply for litigation funding, an individual must first disclose detailed information about his lawsuit to a financier.[22] In deciding whether to grant a nonrecourse loan, the financier calculates its expected profitability by using factors such as predicted damages, the extent and types of injuries, the likelihood of a quick and favorable settlement or judgment, and any liens or medical bills that must be paid from the lawsuit's proceeds prior to the loan's repayment.[23]

If the financier approves the loan application, then it provides the individual with a cash advance prior to case resolution.[24] In return, the individual agrees via contract to repay the advance and any associated fees out of the net proceeds of the case.[25] The fees are specified in the contract and laid out in a payment schedule or monthly formula.[26] The financier typically advances no more than 20% of the expected proceeds of the lawsuit.[27] The amount of funding varies from $500 to $100,000.[28] Interest rates range from 2 to 15% per month and can approach 200% annually.[29] If the individual loses the case or

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22. Martin J. Estevao, Comment, *The Litigation Financing Industry: Regulation to Protect and Inform Consumers*, 84 U. COLO. L. REV. 467, 474 (2013).

23. *Id.*; *see also The Approval Factors for Funding Personal Injury Lawsuits*, OASIS LEGAL FIN., https://www.oasislegal.com/legal_finance_services/lawsuit_funding_approval_factors, *archived at* http://perma.cc/BA94-RB8N (last visited Sept. 30, 2014) (detailing the "several key approval factors" that make a case suitable for litigation funding).

24. Nicholas Beydler, Comment, *Risky Business: Examining Approaches to Regulating Consumer Litigation Funding*, 80 UMKC L. REV. 1159, 1163 (2012). Some sources include structured settlement (i.e., a cash advance to a plaintiff after he has settled) within consumer litigation funding. However, I do not for the purposes of this Note. *See* GARBER, *supra* note 4, at 9 ("[A]n ALF company contracts with a consumer—sometimes before and sometimes after his or her case is settled.").

25. GARBER, *supra* note 4, at 9–10; Beydler, *supra* note 24, at 1163.

26. GARBER, *supra* note 4, at 9; *see also* ME. REV. STAT. tit. 9-A, § 12-104(2) (2014) (requiring that all litigation-funding contracts contain a disclosure form detailing the total amount owed, which includes the initial advance and fees, laid out in a payment schedule).

27. *See* Appelbaum, *supra* note 3 ("To further limit losses, companies say they generally lend no more than 10 or 20 percent of the amount they expect the borrower to win."); *see also* GARBER, *supra* note 4, at 12 (reporting that two CLF industry leaders have estimated that "advances average less than 10 percent of conservatively estimated values of the underlying legal claims").

28. *See* GARBER, *supra* note 4, at 12 (reporting estimates of cash advances of $1,750 to $20,000); Terry Carter, *Cash Up Front: New Funding Sources Ease Financial Strains on Plaintiffs' Lawyers*, 90 A.B.A. J. 34, 36 (2004) (noting that LawCash, a large and reputable consumer litigation financier, "offers nonrecourse advances ranging from $500 to $100,000").

29. *See* Carter, *supra* note 28, at 34 ("Those cash advances go to plaintiffs before trial or settlement, with monthly interest rates ranging from 2 percent to 4 percent in some states to more than 6 percent in Texas, 8 percent in California, and as high as 15 percent in Nevada. These rates sometimes are compounded and can approach 200 percent annually."); *see also* Binyamin Appelbaum, *Lobby Battle Over Loans for Lawsuits*, N.Y. TIMES, Jan. 16, 2011,

has no lawsuit proceeds left after paying medical expenses, attorney's fees, and other debts that take priority over the financier's interest, then he owes the financier nothing.[30]

Litigation funding benefits cash-strapped individuals. Many people obtain nonrecourse advances as a last resort because they do not qualify for loans from traditional sources such as banks.[31] In this way, litigation funding is analogous to subprime lending, which includes payday loans, vehicle-title loans, and rent-to-own transactions.[32] Many consumers use nonrecourse advances to pay bills, buy food, and make house payments—that is, to keep their lives "intact while they await a complete and fair resolution of their case[s]."[33]

CLF recipients are generally personal-injury plaintiffs with little to no litigation experience.[34] Litigation funding equalizes the bargaining power between these plaintiffs and the defendants they sue, which are typically corporations that are familiar with the judicial system and that have abundant resources at their disposal.[35] A nonrecourse advance can strengthen a plaintiff's bargaining position, deter a defendant from using strategic delay tactics, and increase both litigants' willingness to negotiate a fair outcome.[36] When

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http://www.nytimes.com/2011/03/10/business/10lawsuits.html?pagewanted=all, *archived at* http:// perma.cc/R79R-5HRL (reporting that the costs of a loan to a plaintiff "can exceed 100 percent a year"); Kirby Griffis, *Follow the Money: Litigation Funders Back Your Foes*, METROPOLITAN CORP. COUNS., July 2011, at 1, 6, *available at* http://www.metrocorpcounsel.com/pdf/2011/July/01.pdf, *archived at* http://perma.cc/752K-GRBU (stating that consumer litigation funding can be very expensive with annual interest rates of 36 to 150 percent).

30. GARBER, *supra* note 4, at 9–10; Beydler, *supra* note 24, at 1163.

31. GARBER, *supra* note 4, at 10–12; *see also* Susan Lorde Martin, *Litigation Financing: Another Subprime Industry that Has a Place in the United States Market*, 53 VILL. L. REV. 83, 84–85 (2008) (arguing that litigation funding should be considered a type of subprime financial arrangement that "can empower people without access to more traditional credit sources").

32. Martin, *supra* note 31, at 95.

33. Mariel Rodak, Comment, *It's About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effects on Settlement*, 155 U. PA. L. REV. 503, 514 (2006) (internal quotation marks omitted).

34. *See* Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 85–86 (2010) ("Personal injury lawsuits typically pit cash-strapped, one-time plaintiffs against larger entities, often repeat players such as insurance companies or product manufacturers.").

35. *See* Rodak, *supra* note 33, at 514 ("[A] plaintiff experiencing financial pressure has an incentive to accept a less-than-reasonable settlement offer and may even have to abandon her case."); *see also* Echeverria v. Estate of Lindner, No. 018666/2002, 2005 WL 1083704, at *3 (N.Y. Sup. Ct. Mar. 2, 2005) ("Proponents of the 'settlement advance' business contend it allows an injured, often out of work party, to fight off the pressure for a quick settlement.").

36. *See* sources cited *supra* note 35; Patti Waldmeir, *Why It Is Good to Gamble on Justice*, FIN. TIMES (Aug. 8, 2007, 3:00 AM), http://www.ft.com/intl/cms/s/0/8613d222-4549-11dc-82f5-

defendants cannot use tough bargaining tactics to minimize settlement costs, they are more likely to implement safety-enhancing precautions so as to avoid litigation altogether.[37] Accordingly, plaintiffs' access to litigation funding may have the long-term effect of reducing injuries caused by defendant negligence.[38]

B. Consumer-Litigation-Funding Concerns

Along with litigation funding's rapid success has come criticism. Many commentators, including legal scholars, practitioners, and policymakers, voice concerns about consumer protection and the judicial system.

1. Consumer-Protection Concerns

There are two main consumer-protection concerns: consumers' insufficient understanding of CLF contracts and unjustifiably steep CLF fees. First, commentators assert that consumers lack sufficient understanding of contractual terms and thus are not able to make rational decisions about litigation funding.[39] An inability to understand legal concepts and terminology, to compare CLF fees with fees of other financial services, or to speak, read, and write English may hinder a consumer's comprehension of the CLF contract.[40] Some commentators even accuse financiers of intentionally concealing or obscuring important contractual terms so that consumers cannot

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0000779fd2ac.html#axzz3Cjok RTBb (explaining that litigation funding can deter defendants from "drag[ging] their feet to put pressure on cash-strapped plaintiffs to accept a low offer").

37. Rodak, *supra* note 33, at 516.

38. *See id.* (noting that industry supporters argue that lawsuit financing "encourages a corporate interest in safety . . . [and] serves the general welfare through its deterrent function" (internal quotation marks omitted)). *But see* Andrew F. Daughety & Jennifer F. Reinganum, *The Effect of Third-Party Funding of Plaintiffs on Settlement*, 104 AM. ECON. REV. 2552, 2564 (2014) (using an economic model to show that consumer litigation funding does not affect a defendant's incentive to take precautions).

39. *See* ATT'Y GEN. N.Y., BUREAU OF CONSUMER FRAUDS & PROT., ASSURANCE OF DISCONTINUANCE PURSUANT TO EXECUTIVE LAW § 63(15), at 3 (Feb. 17, 2005), *available at* http://www.americanlegalfin.com/alfasite2/documents/ALFAAgreementWithAttorneyGeneral.pdf, *archived at* http://perma.cc/PZR5-8ZVQ ("The Attorney General is concerned that consumers may not adequately understand the terms of the contracts with the [CLF] Companies and thus may not be able to make a reasoned decision as to whether to enter into such transactions."); Beydler, *supra* note 24, at 1166–67 (noting that CLF contract "language is difficult to understand and is likely contrary to borrowers' expectations").

40. *See* ATT'Y GEN. N.Y., *supra* note 39, at 3 (noting the New York Attorney General's concerns with financier disclosure, legalese, and lack of translation services to the consumer); Beydler, *supra* note 24, at 1166 (noting concerns about financier disclosure, unclear agreement language, and the potential for the misleading of consumers).

decipher the true cost of the advance.[41] Without knowing the actual cost of the advance, consumers cannot rationally decide whether to obtain litigation funding.

Second, while the CLF industry insists that its rates are consistent with the high risk and large overhead expenses involved in the business, commentators argue otherwise.[42] Commentators contend that financiers exploit consumers by charging exorbitant fees.[43] They argue that the risk of nonrepayment is not high enough to justify such steep fees because financiers have the luxury of picking the cases that are most likely to succeed.[44]

2. Judicial-System Concerns

There are two primary concerns about the effects of litigation funding on the judicial system: an increase in frivolous litigation (lawsuits in which the probability of success is low[45]) and a decrease in

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41. *See* Beydler, *supra* note 24, at 1166 ("Some commentators have accused funders of . . . conceal[ing] important information about the terms of the funding agreement."); *see also* John P. Barylick & Jenna W. Hashway, *Litigation Financing: Preying on Plaintiffs*, 59 R.I.B.J., Mar.–Apr. 2011, at 5, 36 ("This is why it is impossible for a plaintiff-borrower (or his or her attorney or accountant) to calculate the APR at the time [of] the [CLF contract] signing, because the APR varies greatly depending on when the loan is repaid.").

42. *See* Rodak, *supra* note 33, at 518 ("[C]ritics worry that litigation financiers are able to target and swindle vulnerable borrowers."); Appelbaum, *supra* note 29 ("[T]he companies argue that they should not be subject to existing consumer protections because the transactions are investments, not loans. They say they must charge high prices to compensate for the risk that plaintiffs will lose."); *see also* Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55, 68 (2004) ("The problem is knowing whether the 180% and 280% rates are really too high [in the litigation-funding industry]."); Rodak, *supra* note 33, at 518 ("[T]here is disagreement over exactly how much risk is involved [with litigation funding]."); Anne Urda, *Legal Funding Gains Steam But Doubts Linger*, LAW360 (Aug. 14, 2008, 12:00 AM), http:// www.law360.com/articles/66244/legal-funding-gains-steam-but-doubts-linger, *archived at* http://perma.cc/JP8Y-BD9V (reporting that Oasis Legal Finance experiences "some kind of loss" 20 to 30% of the time).

43. *See* Fausone v. U.S. Claims, Inc., 915 So.2d 626, 630 (Fla. Dist. Ct. App. 2005) ("[A] person who is the victim of an accident should not be further victimized by loan companies.").

44. *See* Beydler, *supra* note 24, at 1170 ("[S]everal commentators have rejected the notion that consumer litigation funding transactions are particularly risky. . . . [F]unders get to pick only the most promising cases for funding."); Estevao, *supra* note 22, at 482 (noting that loan companies "charge exorbitant rates based on exaggerated risk projections" even for cases in which plaintiffs are likely to win).

45. *See* GARBER, *supra* note 4, at 31 (referring to frivolous suits as those in which "the probability of winning at trial is low"); Geoffrey J. Lysaught & D. Scott Hazelgrove, *Economic Implications of Third-Party Litigation Financing on the U.S. Civil Justice System*, 8 J.L. ECON. & POL'Y 645, 662–63 (2012) (implicitly assuming that frivolous suits are suits that have a low probability of winning in arguing that third-party financing results in an increase in speculative litigation); *see also* Chris Guthrie, *Framing Frivolous Litigation: A Psychological Theory*, 67 U. CHI. L. REV. 163, 185–86 (2000) ("For most litigants and attorneys in the trenches of the civil justice system, however, a frivolous case is simply a case in which the plaintiff has a low

the incidence of settlement. First, critics of litigation funding argue that frivolous litigation will increase because financiers will start inducing potential plaintiffs to file lawsuits instead of only advertising to plaintiffs who have already filed.[46] Additionally, they claim that financiers are attracted to cases with high expected values and thus approve applications involving lawsuits characterized by a huge potential recovery but a small probability of success.[47] For example, a plaintiff may receive funding regardless of whether he has a 75% chance to recover $1,000,000 (a nonfrivolous case) or a 25% chance to recover $3,000,000 (a frivolous case) because the expected value of the case, $750,000, is high.[48] This is possible because a financier can spread the risk of a low-probability case over its entire portfolio of approved cases.[49] In this way, the availability of nonrecourse advances can increase frivolous litigation.

In response, proponents of litigation funding assert three reasons for why frivolous litigation will not increase. First, a financier's interest in recovering the initial advance and associated fees incentivizes the financier to advance money only to plaintiffs with a reasonable probability of a favorable settlement or judgment.[50] A financier's interest in maintaining a good reputation also incentivizes the financier to avoid funding frivolous claims.[51] Finally, as of now, the plaintiff enters into a CLF contract only after retaining an

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probability of prevailing at trial."). Although scholars do not explicitly define "low," they seem to assume that a probability of winning of less than 50% is low.

46. *See* BEISNER ET AL., *supra* note 7, at 6 ("[N]othing prevents a funder from contacting a potential plaintiff and encouraging him or her to file an individual or class action lawsuit.").

47. *See id.* ("[Financiers] have a high appetite for risk and are willing to fund speculative, high-yield cases.").

48. The expected value of the lawsuit is equal to the expected recovery multiplied by the probability of winning ($750,000 = $1,000,000 * .75 = $3,000,000 * .25). *See id.* at 5–6 ("[Financiers] will base their funding decisions on the present value of their expected return, of which the likelihood of a lawsuit's success is only one component. The other component is the potential amount of recovery.").

49. *See id.* at 6 ("[T]hird-party funding companies are able to mitigate their downside risk . . . they can spread the risk of any particular case over their entire portfolio of cases . . . .").

50. *See* Rodak, *supra* note 33, at 518–19 ("[I]t is in a litigation finance company's best interest to advance only to those plaintiffs who, in its determination, have a reasonable chance of succeeding, since its investment will otherwise be for naught."); *see also* Barylick & Hashway, *supra* note 41, at 8 ("[Litigation-funding companies] carefully analyze applicants' cases and accept only those they deem to have a high likelihood of recovery."); Jason Lyon, Comment, *Revolution in Progress: Third-Party Litigation Funding of American Litigation*, 58 UCLA L. REV. 571, 593 (2010) (arguing that a third-party funder's recovery incentives are similar to those of a contingent-fee lawyer, and thus, "similar [financial] constraints will govern which cases are accepted"); Appelbaum, *supra* note 3 (noting that litigation funders "pay lawyers to screen cases, looking for slam-dunks").

51. Lyon, *supra* note 50, at 595.

attorney and filing suit.[52] Attorneys are not likely to take up speculative cases due to their own financial interests.[53]

Second, critics of litigation funding argue that CLF deters settlement because the contractual structure of repayment can explicitly disincentivize a plaintiff from accepting a fair settlement offer.[54] For example, assume that $130,000 is a fair settlement value. Suppose a financier wants repayment of at least $50,000 and therefore contracts for a repayment of 34% of any settlement above $150,000 and 50% of any settlement lower than $150,000. Such an arrangement incentivizes the plaintiff to reject a fair offer of $130,000 in hopes of settling for more than $150,000.

In response, proponents of litigation funding contend that CLF actually facilitates settlement because a nonrecourse advance strengthens the plaintiff's bargaining position and deters the defendant from using delay tactics.[55] Moreover, they claim that the plaintiff seeks to resolve the case as soon as possible in order to avoid accumulating more debt resulting from high interest rates.[56]

C. Judicial and Regulatory Responses

In recent years, state legislatures, courts, and other governing entities have responded to the aforementioned consumer-protection and judicial-system concerns.

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52. Rodak, *supra* note 33, at 519.

53. *See* Lyon, *supra* note 50, at 593 ("[T]he attorney's interest in recovery would prevent her from accepting frivolous claims on a contingency basis."). There is a substantial literature about how an attorney's interests may not align with his client's interests and how this misalignment may affect the decision to settle or go to trial. *See, e.g.*, A. Mitchell Polinsky & Daniel L. Rubinfeld, *Aligning the Interests of Lawyers and Clients*, 5 AM. LAW ECON. REV. 165, 166 (2003) (discussing how lawyer-client interests may not be aligned under different lawyer fee arrangements). However, this potential problem is not the focus of this Note, and thus, this Note assumes that the lawyer acts in his client's best interests.

54. *See* JOHN H. BEISNER & GARY A. RUBIN, U.S. CHAMBER INST. FOR LEGAL REFORM, STOPPING THE SALE ON LAWSUITS: A PROPOSAL TO REGULATE THIRD-PARTY INVESTMENTS IN LITIGATION 5–6 (2012) (giving a numerical example of how contractual structure could disincentivize settlement in a commercial litigation-funding scenario).

55. *See* Rodak, *supra* note 33, at 522 ("Since entering into a litigation finance contract presumably gives the plaintiff the resources and 'threat credibility' to carry her claim to trial, litigation financing may draw an otherwise obstinate defendant to the bargaining table and result in a fairer settlement award.").

56. *Id.* at 522–23; *see also* Lyon, *supra* note 50, at 597 ("Typically, the amount of the funder's recovery increases gradually over time. Plaintiffs who wish to maximize their own recovery can be expected to make every effort to bring their cases to resolution at the earliest possible point in the process." (footnote omitted)).

1. Responses to Consumer-Protection Concerns

Because financiers are not considered "creditors" under disclosure regulations, such as the Truth in Lending Act, no existing regulations could have alleviated the concern that financiers are concealing or obscuring the real cost of litigation funding.[57] As a result, Maine, Ohio, Nebraska, Oklahoma, and Tennessee have enacted legislation regulating CLF contracts.[58] The table below depicts some of the consumer-protection features of these statutes. The first six features were designed to help consumers comprehend the contract and discern the true cost of nonrecourse advances. Additionally, a formal agreement between financiers and the New York Attorney General in 2005 subjected financiers to similar consumer-protection measures.[59]

Table 1. Consumer-Protection Features of State Litigation-Funding Statutes

Requirements for litigation-funding contracts	*ME*	*OH*	*NE*	*OK*	*TN*
Minimum font size	X	X	X	X	X
Itemization of one-time fees and schedule of repayments	X	X	X	X	
Disclosure of annual percentage rate of return	X	X	X		X
A five-day, penalty-free cancellation period from the date of funding	X	X	X	X	X
Written acknowledgment by consumer's attorney that the cost of the advance has been disclosed	X	X	X		X
Translation into consumer's non-English native language	X	X			
Fee cap					X

57. *See* Martin, *supra* note 42, at 68 ("The [CLF] industry, however, is not covered by [the Truth in Lending Act] because litigation financing firms are not 'creditors' within the meaning of the Act."); Beydler, *supra* note 24, at 1166 ("[C]onsumer litigation funders operate outside the reach of statutes that prescribe disclosure requirements for mainstream lenders.").

58. ME. REV. STAT. tit. 9-A, §§ 12-102 to 107 (2014); NEB. REV. STAT. §§ 25-3302 to 3309 (2014); OHIO REV. CODE ANN. § 1349.55 (LexisNexis 2014); OKLA. STAT. tit. 14A, §§ 3-801 to 817 (2014); TENN. CODE ANN. §§ 47-51-101 to 111 (2014); *see also* Mark Bello, *Lawsuit Funding—New Legislation in Ohio*, OHIO TRIAL, Summer 2009, at 28–30 (describing in detail the Ohio CLF legislation). This information is current as of May 18, 2014. Louisiana, Missouri, South Carolina, and Rhode Island are currently considering similar legislation. Lisa A. Rickard, *Tennessee Enacts Law to Rein in Lawsuit Lending Abuses*, U.S. CHAMBER INST. FOR LEGAL REFORM (Apr. 30, 2014), http://www.instituteforlegalreform.com/resource/tennessee-enacts-law-to-rein-in-lawsuit-lending-abuses/, *archived at* http://perma.cc/5ZWR-T49D.

59. ATT'Y GEN. N.Y., *supra* note 39.

Tennessee is the only state so far to have enacted a fee cap for CLF transactions in response to the consumer-protection concern of exorbitant fees.[60] Other governing entities have also addressed this concern. A handful of state courts have brought litigation funding under usury law, which covers loan interest rates and fees.[61] Courts typically require the fulfillment of these elements in order to find a transaction usurious: "(1) an agreement to lend money; (2) the borrower's absolute obligation to repay; (3) a greater compensation for making the loan than is allowed under a usury statute; and (4) an intention to take more for the loan of the money than the law allows."[62]

Arguably, nonrecourse advances (from any segment of the ALF industry) do not fall under usury law because the second element of a usurious transaction is missing.[63] In *Anglo-Dutch Petroleum International, Inc. v. Haskell*, a Texas court held that commercial litigation funding (from financiers in the third segment of the ALF industry) did not qualify as a loan under the state's usury law.[64] Because repayment was contingent on a lawsuit's outcome, the court reasoned that the funding recipient did not have an absolute obligation to repay the financiers.[65] Thus, the second element of usury was not fulfilled.[66]

To date, however, no court has adopted this reasoning in the CLF context. In fact, a few state courts have held that usury law does apply to CLF nonrecourse advances.[67] In *Echeverria v. Estate of Lindner*, a New York trial court found a nonrecourse advance to be a loan under the state's usury law and limited the annual interest rate to 16% on the repayment.[68] In *Lawsuit Financial, L.L.C. v. Curry*, the Michigan Court of Appeals held that a nonrecourse advance was a

60. TENN. CODE ANN. § 47-51-110.

61. *See* Martin, *supra* note 42, at 58–59 (explaining the relationship between litigation funding and usury law).

62. Estevao, *supra* note 22, at 479–80.

63. *See* Martin, *supra* note 42, at 59 ("It is the second element that is arguably missing in the typical litigation financing agreement because the borrower's obligation to repay is contingent on the borrower's success in the litigation."); Estevao, *supra* note 22, at 479 ("Under most states' usury laws, litigation financing agreements do not qualify as true loans because the [litigation-funding company] is denied repayment in the event of an unfavorable judgment or insufficient settlement.").

64. 193 S.W.3d 87, 96–97 (Tex. App. 2006).

65. *Id.*

66. *Id.*

67. *See, e.g.*, Echeverria v. Estate of Lindner, No. 018666/2002, 2005 WL 1083704, at *8 (N.Y. Sup. Ct. Mar. 2, 2005) (applying usury law to a nonrecourse advance).

68. *Id.*

usurious loan under state law and barred the financier from recovering any interest or fees.[69] Similar reasoning was used in *Echeverria* and *Curry*: the risk of nonrepayment for the funding at issue was so low that the borrower's obligation was essentially absolute.[70] In *Odell v. Legal Bucks, LLC*, the North Carolina Court of Appeals found that a nonrecourse advance satisfied the elements of a usury claim because the state's usury law explicitly covered advances as well as loans.[71] In *Oasis Legal Finance Group v. Suthers*, the Colorado Court of Appeals held that nonrecourse advances were loans under the Colorado Uniform Consumer Credit Code,[72] which sets an annual interest rate cap of 45%.[73] The *Suthers* court stated that loans included transactions that created debt contingent on the outcome of an event such as a lawsuit.[74]

Furthermore, under the same reasoning as *Suthers*, the Louisiana Office of the Attorney General issued an opinion letter that classified nonrecourse advances as loans under the Louisiana Consumer Credit Law.[75] Further, the Maryland Commissioner of Financial Regulation issued cease-and-desist orders against several financiers under the implicit assumption that the advances are loans subject to interest-rate caps under state law.[76]

2. Responses to Judicial-System Concerns

As in the case of consumer protection, prior to the enactment of state litigation-funding statutes, no existing regulations could have alleviated the judicial-system concerns of an increase in frivolous litigation and a decrease in overall settlement. The aforementioned Oklahoma and Tennessee statutes have provisions that prohibit financiers from accepting or paying referral fees and from referring

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69. 683 N.W.2d 233, 240 (Mich. Ct. App. 2004).

70. *See id.* at 239 ("[P]laintiff [who was the financier] was entitled to an absolute right of repayment."); *Echeverria*, 2005 WL 1083704, at *8 ("Is it a gamble to loan/invest money to a plaintiff in a Labor Law action where there is strict liability? I think not. In fact, it might be considered a 'sure thing.' ").

71. 665 S.E.2d 767, 778–79 (N.C. Ct. App. 2008).

72. No. 12CA1130, 2013 WL 2299721, at *1 (Colo. App. May 23, 2013). This case is still pending rehearing or a grant of certiorari as of September 13, 2014.

73. Estevao, *supra* note 22, at 479.

74. *Suthers*, 2013 WL 2299721, at *2.

75. Louisiana Consumer Credit Law, La. Att'y Gen. Op. No. 01-160 (2001), 2001 WL 1398739.

76. *See, e.g.*, Nat'l Lawsuit Funding, LLC, No. CFR-FY2012-128, at 2 (Md. Comm'r of Fin. Reg. Oct. 4, 2012), *available at* http://www.dllr.state.md.us/finance/consumers/pdf/nationallawfundingsettle.pdf, *archived at* http://perma.cc/34W8-DSGQ (one of Maryland's cease-and-desist orders to CLF companies).

consumers to any particular law firm or medical services provider;[77] these provisions help to prevent financiers from encouraging consumers with frivolous cases to bring suit. No legislation currently exists to address the effects of litigation funding on settlement.[78]

In the few judicial opinions involving CLF, courts have noted the potential adverse consequences of litigation funding, including frivolous litigation and settlement disincentives. In *Rancman v. Interim Settlement Funding Corp.*, the Ohio Supreme Court stated that a third party, like a financier, could encourage "speculative [or frivolous] litigation" and that the amount owed to the third party could "prolong litigation and reduce settlement incentives."[79] In *Odell*, the North Carolina Court of Appeals sympathized with the plaintiff's concerns "regarding the potential negative effects of litigation funding on a borrower's ability or willingness to settle [the borrower's] underlying claim."[80] In *Echeverria*, the New York trial court acknowledged that litigation funding could encourage frivolous lawsuits and commented that the "potentially bigger problem" associated with such funding is the impediment of fair settlements.[81]

Of the courts mentioned above, only the Ohio Supreme Court has responded directly to the judicial-system concerns of frivolous litigation and settlement disincentives. In *Rancman*, the court voided a CLF contract by pointing to common law prohibitions against maintenance and champerty.[82] The court defined "maintenance" as third-party assistance of a litigant to pursue or defend a case when the third party has no "bona fide interest in the case" and "champerty" as maintenance in exchange for a part of the recovery.[83] The court reasoned that the negative side effects from litigation funding—that is, the impediment of settlement and promotion of frivolous litigation—were the very problems the prohibitions against champerty and maintenance sought to eliminate.[84] However, five years after *Rancman*, in 2008, the Ohio legislature adopted a statute that overruled *Rancman* and allowed third parties to finance litigation.[85]

77. OKLA. STAT. tit. 14A, § 3-814 (2014); TENN. CODE ANN. § 47-51-105 (2014).

78. Research uncovered no regulations addressing this issue as of May 18, 2014.

79. 789 N.E.2d 217, 219, 221 (Ohio 2003).

80. Odell v. Legal Bucks, LLC, 665 S.E.2d 767, 774 (N.C. Ct. App. 2008).

81. Echeverria v. Estate of Lindner, No. 018666/2002, 2005 WL 1083704, at *7 (N.Y. Sup. Ct. Mar. 2, 2005).

82. *Rancman*, 789 N.E.2d at 221.

83. *Id.* at 219.

84. *Id.* at 220–21.

85. OHIO REV. CODE ANN. § 1349.55 (LexisNexis 2014).

No provision of the statute addressed litigation funding's potential adverse effects on the judicial system.[86]

While the state courts in *Odell* and *Echeverria* recognized the potential negative consequences of nonrecourse advances on settlement and frivolous litigation, those courts did not follow the *Rancman* court's approach of using common law doctrines to ban CLF. Instead, the courts in *Odell* and *Echeverria* brought litigation funding under usury law.[87] In *Odell*, the North Carolina Court of Appeals refused to condemn a CLF agreement under the doctrine against champerty and maintenance because the plaintiff provided no evidence that the financier interfered in the plaintiff's legal claim with the intent of "stirring up 'strife and continuing litigation.' "[88] Similarly, in *Echeverria*, the New York trial court did not strike down a CLF agreement under state champerty law because the financier's primary purpose was to profit, not to "bring the suit" or promote speculative litigation.[89] Thus, despite litigation funding's potential adverse effects on the judicial system, both courts declined to ban CLF transactions.

III. CONSUMER LITIGATION FUNDING AND SETTLEMENT

As explained in Part II, proponents and critics of litigation funding disagree about its effects on the judicial system. Due to the hefty monetary and emotional costs of trial, approximately 70% of civil lawsuits settle.[90] Avoiding trial conserves both the judiciary's and the litigants' resources and energy. Therefore, settlement is privately

86. *Id.*; *see supra* Section II.C.1.

87. Echeverria v. Estate of Lindner, No. 018666/2002, 2005 WL 1083704, at *8 (N.Y. Sup. Ct. Mar. 2, 2005); Odell v. Legal Bucks, LLC, 665 S.E.2d 767, 779 (N.C. Ct. App. 2008).

88. 665 S.E.2d at 775 (quoting Smith v. Hartsell, 63 S.E. 172, 174 (N.C. 1908)).

89. 2005 WL 1083704, at *6.

90. *See* Theodore Eisenberg & Charlotte Lanvers, *What Is the Settlement Rate and Why Should We Care?*, 6 J. EMPIRICAL LEGAL STUD. 111, 115 (2009) ("[W]e estimate the aggregate settlement rate across case categories in the two districts to have been 66.9 percent in 2001–2002. The aggregate rate for the EDPA alone was 71.6 percent and for the NDGA alone was 57.8 percent."); Marc Galanter & Mia Cahill, *"Most Cases Settle": Judicial Promotion and Regulation of Settlements*, 46 STAN. L. REV. 1339, 1340 (1994) ("[T]wo-thirds of cases . . . do settle without a definitive judicial ruling . . . ."); Rodak, *supra* note 33, at 520 ("The costs reduced by settlement are not just monetary, though; they also include, among others, the emotional cost of stress related to impending trials and lengthy disputes as well as the opportunity cost of what is forsaken by devoting time to preparing for and attending trial."); *see also* Korobkin & Guthrie, *supra* note 17, at 107–08 ("The high costs of pursuing a claim to a trial verdict have led most commentators to hypothesize that trials represent mistakes . . . .").

beneficial to the parties at hand and socially beneficial to the judicial system.[91]

When discussing the effect of litigation funding on settlement, most commentators have assumed a rational plaintiff.[92] A rational plaintiff is one who employs deductive logic and maximizes utility, or wealth, when making decisions.[93] Presently, only a couple of scholars, in writing about litigation funding in the class-action and commercial-litigation contexts, have briefly noted that plaintiffs can be irrational.[94] Also, the *Rancman* court has inadvertently provided a two-sentence example of how a nonrecourse advance could affect an irrational plaintiff in settlement negotiations. This example will be discussed in Section III.B.2 below. Broadly, however, commentators have neither discussed plaintiff irrationality in the CLF context nor explained the mechanics of how litigation funding could affect an irrational plaintiff. This Part offers such analysis.

This Part focuses on the effect of litigation funding on the behavior of the plaintiff during settlement, rather than on the behavior of the attorney, financier, or defendant, for four reasons. First, the plaintiff has the final authority to accept or reject a settlement offer.[95] Assuming the plaintiff is mentally competent, an attorney must abide by the plaintiff's decision even if the plaintiff makes a cognitive error.[96] Second, while a nonrecourse advance may influence an attorney's case strategy,[97] the plaintiff is the one

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91. Arguably, trial may be socially beneficial in the sense that "society may benefit from the information that would be revealed through [it]." STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 413 (2004). New precedents are set through trial, and judicial holdings may validate social norms. *Id*.

92. *See, e.g.*, Rodak, *supra* note 33, at 522 (discussing the effect of litigation funding on a "rational plaintiff").

93. *See* Camerer et al., *supra* note 18, at 1212 (iterating the components of rationality that most economists would agree on). Most standard law-and-economics theories of settlement assume that the motives for settlement are purely monetary; thus, when litigants maximize expected utility, they maximize expected wealth. Loewenstein et al., *supra* note 16, at 139.

94. *See* Elizabeth C. Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1306–07 (2012) (noting that plaintiffs in class-action litigation can be subject to cognitive biases); Maya Steinitz, *How Much Is That Lawsuit in the Window? Pricing Legal Claims*, 66 VAND. L. REV. 1889, 1910–14 (2013) (noting that plaintiffs involved in commercial litigation finance can be subject to cognitive biases).

95. Russell Korobkin & Chris Guthrie, *Psychology, Economics, and Settlement: A New Look at the Role of the Lawyer*, 76 TEX. L. REV. 77, 113 (1997).

96. MODEL RULES OF PROF'L CONDUCT r. 1.2(a) (2013) ("[A] lawyer shall abide by a client's decisions concerning the objectives of representation . . . ."); *see* Korobkin & Guthrie, *supra* note 95, at 113 (noting that when a client is competent, the lawyer must abide by the client's decision to accept or reject a settlement offer).

97. Some attorneys view litigation funding in a positive light because it relieves the pressure on "cash-strapped" plaintiffs to accept unfairly low offers and allows the attorneys to

ultimately legally responsible for any money owed to the financier. Therefore, the existence of litigation funding is likely to primarily influence the plaintiff's behavior during settlement. Third, financiers generally do not interfere with case resolution.[98] In fact, financiers who are a part of the American Legal Finance Association, a trade union for litigation funders, pledge not to interfere with, participate in, or even attempt to influence the plaintiff's litigation.[99] Finally, defendants pitted against plaintiffs who receive cash advances are typically corporations, such as insurance companies.[100] Corporate defendants are likely risk neutral because they have sophisticated analytical tools[101] and experience with litigation.[102] They are also able to avoid cognitive errors because of the availability of organizational review processes and decisionmaking teams.[103] Thus, while CLF plaintiffs may be irrational, CLF defendants are likely not. For these four reasons, the analysis in the following sections centers on the plaintiff.

Below, Section III.A lays out the standard law-and-economics model of settlement, which assumes a rational plaintiff. Section III.B explains the behavioral law-and-economics framework of settlement—a framework that incorporates insights from cognitive psychology to show that not all plaintiffs are rational—and examines the effect of litigation funding on the behavior of an irrational plaintiff.

"press for the settlement their clients deserve." Gary Chodes, *The Advantages of Legal Funding*, FINDLAW.COM (Mar. 26, 2008), http://practice.findlaw.com/financing-a-law-firm/the-advantages-of-legal-funding.html, *archived at* http://perma.cc/399C-2VWE.

98. Gary Chodes, *Four Myths About Legal Funding*, FINDLAW.COM (Mar. 26, 2008), http://practice.findlaw.com/financing-a-law-firm/four-myths-about-legal-funding.html, *archived at* http://perma.cc/9JLA-J8EM.

99. *Industry Best Practices—ALFA's Code of Conduct*, AM. LEGAL FIN. ASSOC., http://www.americanlegalfin.com/IndustryBestPractices.asp (last visited Sept. 14, 2014), *archived at* http://perma.cc/8NXJ-WGUY.

100. *See* Molot, *supra* note 34, at 85–86 ("Personal injury lawsuits typically pit cash-strapped, one-time plaintiffs against larger entities, often repeat players such as insurance companies or product manufacturers.").

101. *See, e.g.*, Tony Bartleme, *Storm of Money: Insider Tells How Some Insurance Companies Rig the System*, POST COURIER (Dec. 2, 2012, 12:29 AM), http://www.postandcourier.com/article/ 20121202/PC16/121209871, *archived at* http://perma.cc/37GJ-SYEF ("Today, insurers have an array of computer programs that guide the flow of trillions of dollars to and from customers around the world.").

102. *See, e.g.*, Molot, *supra* note 34, at 72 (describing the "repeat-player" defendant as "risk[ ] neutral").

103. *See* Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1214 (2002) (explaining how organizations have the ability to avoid cognitive errors).

A. Standard Law-and-Economics Model of Settlement

The standard law-and-economics model of settlement assumes that both litigants are rational actors.[104] This means that litigants optimally invest in the information needed for a settlement decision, make accurate and logical inferences from the acquired information, and choose to settle only if the option maximizes their expected utility, or wealth.[105] This expected-utility model assumes that litigants will be risk neutral or risk averse in their decisions to settle or go to trial.[106] Trial involves more uncertainty and is thus riskier than settlement. If a plaintiff is risk neutral, then he is indifferent between a $50,000 settlement value and a $50,000 trial value. If a plaintiff is risk averse, or dislikes the uncertainty involved with trial, then he prefers the $50,000 settlement.

Under the standard model, a plaintiff is willing to accept a settlement if the settlement value is greater than or equal to his net expected value of trial.[107] The plaintiff's net expected value of trial is equal to the plaintiff's expected value of trial (i.e., the likelihood of a favorable judgment multiplied by the anticipated award) minus trial costs.[108] On the other side, a defendant is willing to give the plaintiff an amount less than or equal to his net expected value of trial.[109] The

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104. *See* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 1 (1984) (presenting an economic model of litigation in which litigants form rational expectations of the consequences of trial and settlement and then act based upon those expectations); *see also* Korobkin & Guthrie, *supra* note 17, at 108–09 (explaining the standard law-and-economics model of settlement).

105. Russell Korobkin & Chris Guthrie, *Heuristics and Biases at the Bargaining Table*, 87 MARQ. L. REV. 795, 795–96 (2004).

106. *See* Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 113, 119 (1996):

> Current theories of litigation fail to account for the possibility that litigants' decisionmaking under risk and uncertainty may not comport with rational theories of behavior. . . . The [standard] law and economics literature asserts that litigants will make either risk-neutral or risk-averse decisions, depending upon their wealth . . . .

107. *See* Korobkin & Guthrie, *supra* note 17, at 111 ("A plaintiff will be willing to accept a settlement offer in the amount of a favorable judgment multiplied by the likelihood of a favorable judgment, minus trial costs, plus out-of-court settlement costs."); Loewenstein et al., *supra* note 16, at 136 ("[A]ny settlement above the expected value *minus* anticipated costs is desirable for a plaintiff . . . .").

108. *See* sources cited *supra* note 107.

109. *See* Korobkin & Guthrie, *supra* note 17, at 111 ("[A] defendant will be willing to settle for an amount equal to the cost of an adverse trial judgment multiplied by the percentage chance of losing the case, plus trial costs, minus out-of-court settlement costs."); Loewenstein et al., *supra* note 16, at 136 ("[A]ny settlement below the expected value *plus* anticipated costs is desirable for a defendant.").

defendant's net expected value of trial is equal to the plaintiff's expected value of trial plus anticipated trial costs.[110]

For example, suppose trial costs are $10,000 each for the plaintiff and defendant, and the plaintiff has a 50% chance of winning a $100,000 award. The standard model predicts that the plaintiff is willing to accept any amount greater than or equal to $40,000 (i.e., .50*$100,000–$10,000), and the defendant is willing to pay any amount less than or equal to $60,000 (i.e., .50*$100,000+$10,000). Thus, the lawsuit should settle for an amount between $40,000 and $60,000, which is the "viable bargaining range."[111]

The most commonly tested and referenced explanation for bargaining impasse in settlement under the standard model is the Priest-Klein theory.[112] Under this theory, rational litigants possess imperfect information about the case, so litigants estimate the case value with error.[113] A case will not settle if the plaintiff overestimates the expected value of trial, the defendant underestimates the expected value of trial, or both; that is, a case will not settle if the litigants' errors eliminate the viable bargaining range.[114]

Recall the aforementioned example: trial costs are $10,000 each for the plaintiff and defendant, and the plaintiff has a 50% chance of winning a $100,000 award. The viable bargaining range is $40,000 to $60,000. Now assume the defendant underestimates the expected value of trial and believes that the plaintiff has only a 40% chance of winning $100,000. Thus, he is willing to pay the plaintiff any amount less than or equal to $50,000 (i.e., .40*$100,000+$10,000). Also assume that the plaintiff overestimates the expected value of trial and believes that he has a 70% chance of winning $100,000. Therefore, he is willing to accept any amount greater than or equal to $60,000 (i.e., .70*$100,000–$10,000). Because the estimation errors of the plaintiff and defendant together eliminate the viable bargaining range, the case does not settle.

Although bargaining impasse can occur under the Priest-Klein theory, this theory assumes that litigants do not systematically overestimate or underestimate the expected value of trial.[115] This

110. *See* sources cited *supra* note 109.

111. The viable bargaining range can also be called the "settlement zone." *See* Loewenstein et al., *supra* note 16, at 136.

112. *See* Priest & Klein, *supra* note 104, at 1; *see also* Korobkin & Guthrie, *supra* note 17, at 111–14 (explaining the assumptions underlying the Priest-Klein model, which the authors deem to be the best representation of the standard economic account of settlement).

113. Loewenstein et al., *supra* note 16, at 136.

114. *Id.* at 136–37.

115. *Id.* at 139.

means that the direction of the litigants' estimation errors is unpredictable: "it is just as likely that the defendant's expectation [of trial] is greater than the plaintiff['s] expectation[ ] as the reverse."[116] In other words, some errors lead to more settlement; some lead to less settlement. Thus, the average effect of the estimation errors on the settlement rate is zero.

B. Behavioral Law-and-Economics Framework for Settlement

Unlike the standard law-and-economics model, the behavioral law-and-economics model of settlement decisionmaking incorporates insights from cognitive psychology. Under the standard model, people are assumed to have unbounded rationality (i.e., unlimited cognitive abilities) and use faultless deductive logic when making decisions.[117] Studies from cognitive psychology reveal that this is not the case, as people have limited computational skills and flawed memories.[118] Decisionmakers may use mental shortcuts called heuristics to "reduce the complexity and effort involved in the reasoning process."[119] Heuristics may be employed consciously or unconsciously.[120] This Note defines an "irrational" person to be one who employs heuristics.[121]

The use of heuristics sometimes may be reasonable because it saves time and effort in decisionmaking.[122] However, employing these shortcuts may lead to cognitive errors and produce outcomes that do not maximize expected wealth.[123] A plaintiff may use a heuristic in a settlement decision, make a cognitive error, and end up going to trial even when the net expected value of trial is lower than the settlement value.[124] In contrast to the errors referenced in the Priest-Klein

116. Linda Babcock et al., *Creating Convergence: Debiasing Biased Litigants*, 22 LAW & SOC. INQUIRY 913, 920 (1998).

117. *See* Christine Jolls et al., *A Behavioral Approach to Law-and-Economics*, 50 STAN. L. REV. 1471, 1477 ("[H]uman behavior differs in systematic ways from that predicted by the standard economic model of unbounded rationality.").

118. *Id.*

119. Korobkin & Guthrie, *supra* note 105, at 796–97.

120. *Id.*

121. *See supra* note 18.

122. Korobkin & Guthrie, *supra* note 105, at 796–97.

123. *See* Jolls et al., *supra* note 117, at 1477 ("Even when the use of mental shortcuts is rational, it can produce predictable mistakes. . . . [A]ctual decisions often violate the axioms of expected utility theory.").

124. *See* Korobkin & Guthrie, *supra* note 17, at 117:

> Psychological barriers, which are cognitive and perceptual in nature, prevent disputants from acting in a value-maximizing, utilitarian manner. . . . Our general conclusion is that these psychological constructs can cause legal disputes to go to trial

hypothesis, cognitive errors caused by the use of heuristics can result in *systematic* overestimation or underestimation of the expected value of trial.[125] This means that cognitive errors may be so prevalent in one direction that they cause a decrease (or increase) in the overall settlement rate.[126] Fortunately, the direction of these errors can be predicted, making it possible for policies to be implemented to correct the errors.[127]

In a settlement negotiation, the plaintiff must perform two cognitive tasks: judgment and choice.[128] "Judgment" occurs when the plaintiff evaluates his expected payoffs under the options of settlement and trial.[129] When the plaintiff picks an option, he makes a "choice."[130] Although there are many different heuristics that affect each task,[131] this Note focuses on the two heuristics with which litigation funding is most likely to interact: self-serving bias at the judgment stage and framing at the choice stage.

1. From Optimistic to Overoptimistic: Litigation Funding and the Self-Serving Bias

At the judgment stage, litigation funding can increase a plaintiff's self-serving bias and impede settlement. Using experimental studies as evidence, this Section explains how the self-serving bias affects plaintiffs. It then employs a numerical example to show how a nonrecourse advance can exacerbate a plaintiff's self-serving bias through an "endorsement effect" and eliminate the viable bargaining range during settlement.

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even when there is a viable bargaining range and no strategic behavior by the disputants.

125. *See* Loewenstein et al., *supra* note 16, at 138–39 ("[P]laintiffs are likely to systematically overestimate the value of their claims, and defendants are likely to underestimate the value of claims brought against them.").

126. *Id.*

127. *See* Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 GEO. L.J. 67, 71 (2002) ("Because these irrational tendencies are supposedly uniform, pervasive, and predictable, they can be incorporated into behavioral models and used in policy analysis.").

128. Korobkin & Guthrie, *supra* note 105, at 798.

129. *Id.*

130. *Id.*

131. *See id.* at 798–805 (explaining how anchoring and adjustment, availability, and self-serving evaluations can affect judgment while framing, status quo bias, contrast effects, and reactive devaluation can affect choice); *see also* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1124–30 (1974) (describing three heuristics—representativeness, availability, and adjustment from an anchor—that may affect decisionmaking).

Self-serving bias leads people to judge options with uncertain outcomes, such as trial, as more beneficial than the options objectively are.[132] The employment of this heuristic may lead to predictable estimation errors. Systematically, plaintiffs are likely to overestimate, while defendants are likely to underestimate, the expected value of trial.[133]

An experiment based on a Texas tort case provides convincing evidence that the self-serving bias may cause litigants to have systematically different estimates of trial awards and, in turn, systematically different conceptions of fair settlement values—differences that can lead to bargaining breakdown.[134] Subjects in the study were randomly assigned the role of plaintiff or defendant and then given identical case materials (e.g., testimonies, police reports, and maps) abstracted from a real Texas automobile-collision case.[135] Each subject was asked to estimate the amount awarded by the Texas judge, formulate a fair settlement value, and then negotiate with a subject assigned to the role of the other litigant.[136] Finally, the subjects were asked to recall and rate the importance of arguments found in the case materials that were in support of and against their positions.[137]

The award estimates of the subjects in the role of the plaintiff ("plaintiffs") were on average $14,527 higher than the estimates of those in the role of the defendant ("defendants").[138] Accordingly, the settlement values of plaintiffs were on average $17,709 higher than the values of defendants.[139] Both differences were highly statistically significant.[140] A large difference in fair settlement values led to bargaining impasse between the plaintiff and his assigned defendant.[141] Additionally, plaintiffs recalled 1.04 more importance-weighted arguments favoring themselves; defendants recalled 2.79

132. Korobkin & Guthrie, *supra* note 105, at 800–01.

133. *See* Loewenstein et al., *supra* note 16, at 138–39 ("[P]laintiffs are likely to systematically overestimate the value of their claims, and defendants are likely to underestimate the value of claims brought . . . .").

134. *See id.* at 153 ("Our experiment provides strong evidence for the existence of a self-serving bias.").

135. *Id.* at 145.

136. *Id.* at 145–46.

137. *See id.* ("Finally, after the negotiation ended, we asked both parties to recall and rate the importance of arguments favoring both the plaintiff and the defendant.").

138. *Id.* at 150.

139. *Id.*

140. *Id.*

141. *See id.* at 157 ("Self-serving biases create a genuine dilemma for the resolution of legal disputes.").

more importance-weighted arguments favoring themselves.[142] This selective recall of arguments favoring the litigant's own position provides evidence that each party was evaluating trial in a self-serving way.

Those who obtain litigation funding are typically personal-injury plaintiffs and likely susceptible to self-serving bias, just as the aforementioned subjects in the role of the plaintiff were. Prior to obtaining a nonrecourse advance, a plaintiff may initially have (1) no self-serving bias, (2) self-serving bias of a magnitude that is insufficient to eliminate the viable bargaining range, or (3) self-serving bias of a magnitude large enough to impede settlement. In the first two cases where initial self-serving bias does not obstruct settlement, litigation funding—through an "endorsement effect"—can increase the magnitude of the plaintiff's self-serving bias to such a degree that settlement is impeded. From the plaintiff's perspective, the financier's approval of a nonrecourse advance may serve as a stamp of approval or an "endorsement" of the plaintiff's self-serving assessment of the case. A plaintiff may perceive CLF application approval as evidence of the strength of his case or as another "argument" favoring his case. This perception stems from financier statements, such as "[w]e have to believe in the case [we fund]," which in reality reflect financier efforts to bolster its reputation rather than an actual endorsement of the plaintiff's case.[143]

If the endorsement increases the plaintiff's self-serving bias to the degree that the viable bargaining range is eliminated, then the plaintiff may choose to go to trial even when the net expected value of trial is lower than the settlement value. A numerical example of how this works follows. Recall the example in Section III.A: trial costs are $10,000 each for the plaintiff and defendant, and the plaintiff has a 50% chance of winning a $100,000 award. The viable bargaining range is $40,000 to $60,000. Assume the defendant correctly estimates the expected value of trial and is willing to pay the plaintiff any amount less than or equal to $60,000. Suppose that prior to receiving litigation funding, the plaintiff overestimates the expected value of trial because of a moderate degree of self-serving bias and believes that he has a 60% chance of winning $100,000. Thus, he is willing to accept any amount greater than or equal to $50,000 (i.e., .60*$100,000–$10,000). At this point, the plaintiff's initial self-serving bias has narrowed, but

142. *Id.* at 151.

143. *See* Mary Wisniewski, *Legal Financing Helps Little Guys Level the Playing Field*, CHICAGO SUN-TIMES, Nov. 30, 2005, at 73, *available at* LexisNexis (reporting that the president of a CLF company said that the firm has to "believe in the case" in order to finance it).

not eliminated, the viable bargaining range to between $50,000 and $60,000.

Next, suppose the plaintiff obtains a nonrecourse advance and perceives CLF application approval to be an endorsement of his case. This exacerbates the plaintiff's self-serving bias so that he now believes he has an 80% chance of winning $100,000. Thus, the plaintiff is willing to accept any amount greater than or equal to $70,000 (i.e., .80*$100,000–$10,000). Because the plaintiff's overestimation eliminates the viable bargaining range, the case does not settle. In sum, litigation funding can increase self-serving bias on the part of the plaintiff and thus decrease the percentage of cases that settle.

2. Winner or Loser? Litigation Funding and Framing

While litigation funding can negatively affect an irrational plaintiff at the judgment stage via self-serving bias, it can also negatively affect an irrational plaintiff at the choice stage via the framing heuristic. This Section employs experimental studies to explain how the framing heuristic affects plaintiffs. It then provides a numerical example to demonstrate how a nonrecourse advance can impede settlement by causing a fair offer to appear as a loss. Finally, this Section concludes by discussing the illustration in *Rancman* of how litigation funding can adversely affect a plaintiff who is susceptible to framing.

The framing heuristic comes from prospect theory.[144] In the context of litigation, prospect theory states that when parties choose between a certain settlement outcome and an uncertain trial outcome, they evaluate the options relative to a reference point.[145] From the reference point, an outcome may appear to be a "gain" or a "loss."[146] Litigants tend to weigh losses more heavily than gains of the same value,[147] a phenomenon known as "loss aversion."[148] From a "gains

144. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 274–89 (1979). For an easy-to-understand explanation of prospect theory, see Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 NW. U. L. REV. 1115, 1117–19 (2003).

145. *See* Korobkin & Guthrie, *supra* note 105, at 802:

> When choosing between an option with a known outcome and one with an uncertain outcome, research demonstrates that individuals often consider not only the expected value of each choice, but also whether the possible outcomes appear to be "gains" or "losses" relative to a reference point, typically the status quo.

146. *Id.*

147. Guthrie, *supra* note 144, at 1119.

148. Tversky and Kahneman, the founders of prospect theory, discovered and coined "loss aversion." *See* Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependent Model*, 106 Q.J. ECON. 1039, 1039 (1991).

frame," litigants prefer the risk-averse option of settlement.[149] In contrast, from a "loss frame," litigants prefer the risk-seeking option of trial.[150] For example, suppose trial costs are zero, and a plaintiff has a 50% chance of winning a $100,000 award. The defendant offers the plaintiff $50,000 to settle. If the plaintiff views $50,000 as a gain (i.e., the plaintiff's reference point is lower than $50,000), then he will likely choose settlement over trial. If a plaintiff views $50,000 as a loss (i.e., the plaintiff's reference point is higher than $50,000), then he will likely choose trial over settlement.

Some scholars theorize that plaintiffs consistently operate in a gains frame, choosing between a sure positive settlement and the prospect of winning more at trial.[151] These scholars also predict that defendants consistently operate in a loss frame, choosing between a sure negative settlement and the prospect of losing more at trial.[152] This theory assumes that the reference point is the same for all plaintiffs and defendants, but experimental evidence suggests that litigation does not actually provide a consistent frame for the parties involved.

For instance, in one experimental study that utilized a simplified liability scenario involving a real-world automobile accident, all subjects took on the role of the plaintiff.[153] In the hypothetical presented, the plaintiff suffered $28,000 worth of damages in a car accident that was not the plaintiff's fault.[154] The defendant was the responsible party's insurance carrier that had conceded liability.[155] The only thing in dispute was whether the insurance policy limited the carrier's liability to $10,000.[156] Because the plaintiff's attorney told the plaintiff that the case could go either

149. Guthrie, *supra* note 144, at 1118.

150. *Id.* In the settlement context, scholars often conflate loss aversion and risk preferences. In the purest sense, we can measure risk preferences by looking at variance in the potential trial outcome. A person who is risk averse will pay more when the variance is higher in the potential trial outcome; a person who is risk seeking will pay less when the variance is higher in the potential trial outcome. For a study that attempts to examine risk preferences in this way in the context of settlement, see Linda Babcock et al., *Forming Beliefs About Adjudicated Outcomes: Perceptions of Risk and Reservation Values*, 15 INT'L REV. L. & ECON. 289 (1995).

151. *See* Rachlinski, *supra* note 106, at 129 (explaining how litigation naturally supplies a gains frame for plaintiffs and loss frame for defendants).

152. *Id.*

153. Korobkin & Guthrie, *supra* note 17, at 131. It is important to note that the authors eliminated transaction costs of trial, such as discovery costs, in this experimental setting. *Id.* at 124–25.

154. *Id.*

155. *Id.*

156. *Id.*

way at trial,[157] the subjects could infer that the expected value of trial was $19,000 (i.e., .50*$28,000+.50*$10,000).[158]

The subjects of the study were divided into two groups.[159] Group A was told that the plaintiff was driving a $14,000 Toyota Corolla, which was destroyed in the accident, and had incurred $14,000 in medical bills, which the plaintiff's health insurance company had already paid.[160] Group B was told that the plaintiff was driving a $24,000 BMW, which was destroyed in the accident, and had incurred $4,000 in medical bills, which the plaintiff's health insurance company had already paid.[161] All subjects were asked to respond to the defendant's offer of $21,000 to settle the case; they could choose (1) definitely accept, (2) probably accept, (3) undecided, (4) probably reject, or (5) definitely reject.[162]

Under the standard model of settlement, all subjects should have picked choice (1) or (2) because $21,000 is greater than $19,000, and there should have been no significant difference in the average response between the groups. However, Group A subjects responded that they would definitely or probably accept the offer more frequently than Group B subjects, and the difference in the groups' average responses was highly statistically significant.[163] The authors concluded that the difference was due to framing and that the car brands and the already-paid medical bills framed the decision: those in Group A considered the settlement to be a gain because they would end up with $7,000, but those in Group B considered the settlement to be a loss because they would end up with –$3,000.[164] Given that all subjects took on the role of the plaintiff, this study demonstrates that litigation does not necessarily provide a gains frame for all

157. *Id.*

158. In an extension of the experiment to lawyers, Russell Korobkin and Chris Guthrie comment that "[t]he attorney's inability to predict which trial outcome was more likely suggests that the trial option could be described as a fifty percent chance of recovering $28,000 coupled with a fifty percent chance of recovering $10,000; that is, an option with a $19,000 expected value . . . ." Korobkin & Guthrie, *supra* note 95, at 98.

159. Korobkin & Guthrie, *supra* note 17, at 132.

160. *Id.*

161. *Id.*

162. *Id.* at 131–33.

163. *Id.* at 133.

164. *See id.* at 132 ("[A]ccepting the $21,000 offer would leave Group *A* subjects better off financially than they were prior to the accident (–$28,000+$14,000+$21,000 = $7,000). The same offer would leave Group *B* subjects in a worse position than before the accident occurred (–$28,000+$4,000+$21,000 = –$3,000).").

plaintiffs.[165] Instead, the reference point varies from plaintiff to plaintiff.

The reference point is crucial in determining whether a litigant views a settlement value from a gains or loss frame. Research suggests that litigants' goals can determine reference points.[166] A plaintiff can derive his goal from his "reservation price," which is the minimum settlement value that he is willing to accept.[167] If the plaintiff sets the reservation price as his reference point, then he will use it to judge settlement proposals.[168] A plaintiff will view any settlement value less than the reference point as a loss and any value greater as a gain.[169]

Litigation funding can frame a fair settlement offer as a loss by making the net settlement value appear below a plaintiff's reference point. In this way, litigation funding causes the plaintiff to reject the offer and choose the risk-seeking option of trial. A numerical example of how this works follows. Recall the example in Section III.A: trial costs are $10,000 each for the plaintiff and defendant, and the plaintiff has a 50% chance of winning a $100,000 award. The viable bargaining range is $40,000 to $60,000. Assume that both the plaintiff and defendant accurately estimate the expected value of trial to be $50,000. Suppose the plaintiff sets his reservation price (i.e., $40,000) as his goal and, in turn, sets the goal as his reference point. Thus, anything short of $40,000 will be considered a loss. Now suppose the defendant offers $60,000, the maximum amount he is willing to pay.[170] The plaintiff sees this offer as a gain (see Point A in Figure 1), because $60,000 is $20,000 higher than his reference point of $40,000, and therefore accepts the offer. But litigation funding changes this result.

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165. *See* Russell Korobkin, *Psychological Impediments to Mediation Success: Theory and Practice*, 21 OHIO ST. J. ON DISP. RESOL. 281, 310 (2006) ("As the Korobkin and Guthrie experiment discussed above exemplifies, the range of plausible competing reference points can be quite context-specific." (citing Korobkin & Guthrie, *supra* note 17)).

166. *See, e.g.*, Russell Korobkin, *Aspirations and Settlement*, 88 CORNELL L. REV. 1, 29 (2002) (explaining how aspiration levels or goals can serve as reference points).

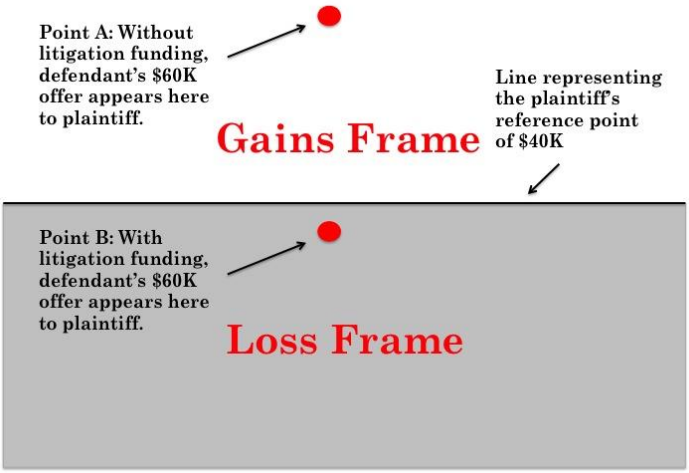
167. *See id.* at 34 (explaining how the reference point could be the reservation value, or goal, or both). This Note uses a special scenario when the aspiration point is equal to the reservation price. However, please note that this is not necessarily the case in all instances. Often, a party's aspiration point exceeds his reservation price.

168. *See id.* at 29 ("Negotiators evaluate settlement proposals from the reference point . . . .").

169. *See id.* ("Deviations down from their aspiration level are perceived as losses, entailing feelings of dissatisfaction, while deviations above their aspiration level are perceived as gains, giving the negotiator a psychological feeling of satisfaction.").

170. Regardless of litigation funding, the defendant's net expected value of trial is $60,000.

Figure 1. Graphic Depiction of the Numerical Example



Imagine that the plaintiff obtains a nonrecourse advance of $18,000 and that the total amount of fees owed to the financier is $22,000. Assume that $22,000 is the total amount of fees regardless of whether the plaintiff settles or goes to trial.[171] To the plaintiff, the net settlement value of a $60,000 offer is $38,000 (i.e., $60,000–$22,000); the plaintiff does not factor in the initial $18,000 advance because the plaintiff keeps the advance regardless of repayment. The net expected value of going to trial is $29,000 (i.e., .50*($100,000–$22,000)–$10,000).[172]

A rational plaintiff will settle rather than go to trial because the $38,000 net settlement value is greater than the $29,000 net expected trial value. However, since the plaintiff is irrational (i.e., susceptible to framing), he will likely choose trial over settlement because $38,000 is lower than his reference point of $40,000. Since $38,000 falls short of the reference point, the offer is viewed in the loss frame, where the plaintiff is risk seeking (see Point B in Figure 1). Therefore, the plaintiff is willing to take a gamble in hopes of winning.[173]

In *Rancman*, the Ohio Supreme Court inadvertently provided a two-sentence example of the aforementioned framing effect that

171. The purpose of this assumption is to ensure that the effect of litigation funding that this example illustrates does not depend on the contractual incentive to settle resulting from higher fees for trial.

172. Recall that because of the nonrecourse nature of litigation funding, the $22,000 gets subtracted out only if the plaintiff wins. In contrast, the trial costs are incurred no matter what.

173. If the plaintiff eventually wins, he obtains $68,000 (i.e., $100,000–$22,000–$10,000).

litigation funding can have on an irrational plaintiff: "Suppose Rancman [the plaintiff] decides that she will settle for nothing less than $80,000 . . . . Because of the obligation to repay the advances, she would refuse to settle until [the defendant] offers $98,000."[174] To put this example in the context of the analysis of this Note, $80,000 is the plaintiff's reference point. The total amount of fees due to the financier is $18,000 (i.e., $98,000–$80,000).[175] The plaintiff will accept a settlement offer only if the offer is at least equal to the reference point (i.e., $80,000) plus the litigation-funding fees (i.e., $18,000). Otherwise, the offer will seem like a loss, and the plaintiff will likely choose to go to trial. In sum, litigation funding can cause a fair settlement offer to appear as a loss and decrease the likelihood that a case will settle.

IV. DEFLATING OVEROPTIMISM AND REFRAMING FAIR SETTLEMENT OFFERS

In Part III, this Note showed that litigation funding may impede settlement in two ways: the exacerbation of self-serving bias and the framing of fair settlement values as losses. Part IV presents three potential solutions to alleviate these negative effects of litigation funding: (1) banning litigation funding, (2) attorneys helping in a system where litigation funding is unregulated, and (3) financier mandatory information disclosure. This Part argues that the third option is the best choice.

Banning litigation funding, a pure paternalistic regulation, would substitute institutional choice for individual choice and prevent the realization of CLF benefits, such as the equalization of bargaining power between poor plaintiffs and wealthy defendants. A system where litigation funding is not regulated would allow for individual choice, and attorneys could help plaintiffs make wealth-maximizing settlement decisions. However, in such a system, the presence of financiers would interfere with attorneys' efforts to deflate overoptimism and reframe fair settlement offers. Thus, the best approach is to mandate the disclosure of financiers' case-value estimates, an asymmetrically paternalistic policy. Such a policy would combat plaintiff irrationality by directly alleviating self-serving bias and indirectly mitigating the effects of framing.

174. Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 221 (Ohio 2003).

175. *Id.* at 221 n.2 ("Th[e] number [$98,000] is the combination of the $80,000 Rancman desires plus the $10,800 and $1,800 premiums she must pay to FSF and Interim [CLF financiers], respectively . . . .").

A. Pure Paternalism: Banning Litigation Funding

Pure paternalistic regulation substitutes institutional (or governmental) choice for individual (or consumer) choice.[176] Behavioral law-and-economics scholars who support such regulation argue that people "will make bad choices even when they have the incentives and information needed to make good ones, and hence, do themselves harm if left to their own devices."[177] Thus, from their perspective, regulation is a device to protect people from hurting themselves.[178] This Section presents a CLF ban, which is a pure paternalistic regulation, as a potential solution to the adverse effects of CLF on irrational plaintiffs and then contends that this approach is ultimately undesirable from a consumer standpoint.

Arguably, nonrecourse advances cause plaintiffs to reject fair settlement values and thus hurt themselves by not maximizing their expected wealth. Banning litigation funding is a pure paternalistic policy that removes this service from the market and, in turn, eliminates CLF's negative effects on irrational plaintiffs. This is comparable to the policy that the Ohio Supreme Court created via its holding in *Rancman*.[179] Because of the concern that litigation funding disincentivizes settlement, the court voided the CLF contract at hand under doctrines against champerty and maintenance.[180]

While an outright ban of litigation funding would resolve concerns about the obstruction of settlement, it has two major weaknesses. First, this policy does not recognize that both rational and irrational plaintiffs obtain litigation funding. An outright CLF ban would benefit irrational plaintiffs but not rational plaintiffs (i.e., those who do not make cognitive errors). In fact, this policy would restrict rational plaintiffs' use of a service that could potentially help them. Second, this policy disregards the benefits of litigation funding to cash-strapped plaintiffs.[181] As discussed in Section II.A, litigation funding is often a plaintiff's last resort to obtain money to meet basic needs and serves to equalize bargaining power between a poor plaintiff and wealthy defendant. Ultimately, an outright CLF ban is

176. *See* Rachlinski, *supra* note 103, at 1165 ("Recognition of the fallibility of human judgment and the research that identifies this fallibility commonly inspire calls for imposing constraints on individual choice.").

177. *Id.* at 1166.

178. *Id.*

179. 789 N.E.2d at 221.

180. *Id.*

181. *See supra* Section II.A.

undesirable because no plaintiff—rational or irrational, indigent or affluent—could reap the benefits of the service.

B. System with No Regulation: Help from Attorneys

A regime of no CLF regulation would allow for individual choice and the realization of the service's benefits, whereas a CLF ban would not. This Section explores a system in which litigation funding is unregulated and attorneys serve to alleviate plaintiffs' cognitive biases. This Section then suggests that a lack of CLF regulation is not optimal because the presence of financers may interfere with attorneys' efforts to debias irrational plaintiffs.

In a world without CLF regulation, irrational plaintiffs ideally would learn to make better future litigation choices by obtaining feedback on past litigation decisions.[182] However, CLF plaintiffs rarely have the opportunity to obtain corrective feedback because they are typically not repeat players in the judicial system. Even if a plaintiff has previously experienced an unfavorable judgment at trial, that plaintiff is more likely to believe he lost due to an unfair judge or jury than due to the plaintiff's own cognitive biases.[183]

Due to their unfamiliarity with litigation, most CLF plaintiffs hire an attorney. Attorneys are trained to carefully and unemotionally analyze lawsuits.[184] Studies have shown that attorneys evaluate cases differently than laypersons.[185] Attorneys often employ expected-value calculations in deciding whether to recommend settlement or trial.[186] Having worked with various clients, attorneys are aware of cognitive biases that can cloud a plaintiff's judgment.[187] Thus, attorneys can help irrational plaintiffs avoid cognitive pitfalls.[188]

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182. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 90–91 (2008) (stating that feedback can help facilitate better human choices); Rachlinski, *supra* note 103, at 1212 ("Several studies suggest that experts who consistently receive unbiased feedback learn to avoid egocentric biases.").

183. Babcock et al., *supra* note 116, at 921.

184. Korobkin & Guthrie, *supra* note 95, at 87.

185. *See, e.g.*, *id.* at 113 ("Our lawyer subjects were not affected to nearly the same degree as our litigant subjects by the framing, anchoring, and equity-seeking variables tested.").

186. *See, e.g.*, *id.* at 101 ("By and large, lawyers indicated that they used expected value calculations to decide whether to recommend settlement or trial.").

187. *See* Ward Edwards & Detlof von Winterfeldt, *Cognitive Illusions and Their Implications for the Law*, 59 S. CAL. L. REV. 225, 273 (1986) ("No lawyer worth his or her salt will accept the client's view of the problem, how it arose, or what is the most attractive solution. The reason is in part that we have intuited the findings of the literature on cognitive illusions . . . .").

188. *See* Rachlinski, *supra* note 103, at 1216 ("Many professionals offer more than just knowledge—they offer a better decisionmaking perspective.").

Merely informing plaintiffs of the effects of self-serving bias and framing will not prevent cognitive errors.[189] In order to deflate a plaintiff's overoptimism, an attorney should encourage the plaintiff to thoroughly consider the weaknesses of the case.[190] An attorney should also anticipate the possibility that litigation funding could exacerbate the plaintiff's self-serving bias and accordingly inform the plaintiff that CLF application approval does not constitute the financier's endorsement of the case.

In order to combat the negative effects of framing, an attorney should recalibrate a plaintiff's reference point so that trial appears to be a loss.[191] The attorney should inform the plaintiff that trial costs are hefty and settlement costs are close to zero.[192] Many personal-injury plaintiffs perceive trial as costless because they are paying their attorney on a contingency-fee basis.[193] However, this perception is wrong since plaintiffs often have to pay some litigation costs out-of-pocket.[194] Moreover, trial is emotionally taxing and time-consuming.[195] By emphasizing these costs when presenting a settlement offer with a value higher than the net expected trial value, the attorney can frame trial as a loss, and loss aversion will likely compel the plaintiff to choose settlement over trial.

A regime of no regulation for litigation funding heavily relies on the ability of attorneys to correct plaintiffs' cognitive errors. Some argue that attorneys are unable to help plaintiffs because attorneys

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189. *See* Linda Babcock & George Loewenstein, *Explaining Bargaining Impasse: The Role of Self-Serving Biases*, 11 J. ECON. PERSP. 109, 115 (1997) ("[B]eing informed of the bias had no effect on the discrepancy in the parties' expectations, nor on the likelihood of settlement."); Korobkin & Guthrie, *supra* note 95, at 115–20 (finding that telling plaintiffs about the effect of framing did not cause a statistically significant increase in the preference for settlement).

190. *See* Babcock et al., *supra* note 116, at 920 ("When subjects consciously considered the weaknesses in their case or reasons that the judge might rule against them, their judgments exhibited no self-serving bias.").

191. *See* Korobkin, *supra* note 165, at 314 ("In order to avoid an impasse that results from the framing of a risky choice, the mediator should attempt to change the reference point from which the disputant evaluates the possibility of settlement, such that settlement appears to be a gain rather than a loss."). Note that the attorney should only emphasize the heavy costs of trial if his client leans toward rejecting a fair settlement offer due to framing.

192. *See id.* at 315 ("An alternative approach is for the mediator to attempt to focus the parties' attention on the differential transaction costs of settlement and continued litigation.").

193. *Id.* Typically, in CLF cases, the consumer is a personal-injury plaintiff whose attorney is representing him on a contingency-fee basis. GARBER, *supra* note 4, at 9.

194. Korobkin, *supra* note 165, at 315.

195. *See* Rodak, *supra* note 33, at 520 ("The costs reduced by settlement are not just monetary, though; they also include, among others, the emotional cost of stress related to impending trials and lengthy disputes as well as the opportunity cost of what is forsaken by devoting time to preparing for and attending trial.").

are susceptible to the same cognitive biases that plague plaintiffs.[196] However, this concern is likely unwarranted. Attorneys are repeat players in the legal system.[197] Each time an attorney brings a case, he has an opportunity to obtain feedback by observing the result. Regardless of whether an attorney attributes his losses to unfair judges and juries or suffers from cognitive biases, he will learn to identify how judges and juries think in order to successfully evaluate future cases and navigate his clients through the legal system.

Perhaps a more realistic concern in a system without CLF regulation is that the presence of financiers may interfere with attorneys' efforts to debias irrational plaintiffs. An irrational plaintiff likely perceives the financier as an expert in case valuation—an expert that is endorsing the plaintiff's case assessment by approving the CLF application. Without regulation, litigation funding may create a "battle of the experts" (attorney v. financier) in the plaintiff's mind and undermine the attorney's efforts to debias the plaintiff. For instance, if the financier approves the plaintiff's CLF application, the attorney may have difficulty maintaining the plaintiff's trust when he attempts to deflate the plaintiff's overoptimistic case-value estimate.

C. Asymmetric Paternalism: Financier Mandatory Information Disclosure

An alternative to both pure paternalistic regulation and no regulation is asymmetrically paternalistic regulation.[198] A policy is asymmetrically paternalistic if it largely benefits irrational actors—by counteracting their cognitive errors—and imposes little to no costs on rational actors. Such a policy does not substitute institutional choice for individual choice but rather attempts to foster better individual choice. This Section contends that a mandatory information-disclosure

196. Andrew J. Wistrich & Jeffrey J. Rachlinski, *How Lawyers' Intuitions Prolong Litigation*, 86 S. CAL. L. REV. 571, 579–80 (2013) ("[L]awyers make overly optimistic assessments of cases that might lead them to litigate when they should settle . . . . Other research suggests that lawyers are prone to making overly risky decisions to avoid losing . . . .").

197. *See* Catherine T. Harris et al., *Does Being a Repeat Player Make a Difference? The Impact of Attorney Experience and Case-Picking on the Outcome of Medical Malpractice Lawsuits*, 8 YALE J. HEALTH POL'Y L. & ETHICS 253, 282 ("The medical malpractice compensation system may be inefficient, but it is rational. Meritorious claims are more likely to be paid than non-meritorious claims. The status of plaintiff's counsel as a repeat player, skilled at evaluating cases, is the basis for the system's rationality.").

198. *See* Camerer et al., *supra* note 18, at 1212 (acknowledging that there are rational and irrational consumers); Jeffrey J. Rachlinski, *Cognitive Errors, Individual Differences, and Paternalism*, 73 U. CHI. L. REV. 207, 208–09 (2006) ("With the notable exceptions of a critique by Greg Mitchell and an article by Colin Camerer and his coauthors endorsing a soft form of paternalism, [behavioral law and economics] wholly embraces that nomothetic assumption.").

policy, which is an asymmetrically paternalistic regulation, is the best response to the negative effects of litigation funding on settlement.

A policy that requires financiers to disclose their case-value estimates to litigation-funding plaintiffs would greatly benefit irrational plaintiffs without imposing costs on rational plaintiffs. This policy should require disclosure only after the CLF contract is final and binding. This would ensure that plaintiffs do not apply for funding solely to get a free second opinion from financiers. For example, in Ohio, where the law allows for a five-day, penalty-free cancellation period, disclosure of the case-value estimate should be required after this period.[199]

Mandatory disclosure would benefit irrational plaintiffs because it would directly alleviate self-serving bias by negating the endorsement effect and indirectly mitigate framing by aligning the opinions of the financier and the attorney in the plaintiff's mind. First, knowledge of the financier's case-value estimate would negate the endorsement effect. Rather than speculating that the financier supports the plaintiff's case assessment, the plaintiff would know the financier's actual case valuation. Second, disclosure of the financier's valuation would end the battle of the experts in the plaintiff's mind. Because both the financier and attorney have experience assessing cases and likely use expected-value calculations in doing so, the financier's estimate would generally confirm the attorney's estimate.[200] The financier's confirmation would bolster the attorney's credibility and create an environment where the attorney could effectively help alleviate a client's cognitive biases. This attorney-financier alignment is important during settlement: the plaintiff should have full confidence in the attorney's case assessment since the attorney—not the financier—sits at the bargaining table with the plaintiff.[201]

Further, mandatory disclosure would not hurt rational plaintiffs. As noted in Part III, rational plaintiffs employ deductive

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199. OHIO REV. CODE ANN. § 1349.55 (West 2014); *see supra* tbl. 1 (showing the state litigation-funding statutes that have this penalty-free cancellation period).

200. *See* Rachlinski, *supra* note 103, at 1216–17 (presenting financial managers and attorneys as examples of professionals who can avoid cognitive pitfalls in decisionmaking).

201. *See* Wistrich & Rachlinski, *supra* note 196, at 578:

> Although decisions about whether and when to settle ultimately belong to the client, lawyers play an important role in the settlement process. They attempt to predict the likely outcome of cases, and advise their clients about which settlement offers to make, when to make them, and which settlement proposals to accept.

The attorney has a duty to deflate overoptimism and reframe fair offers during settlement negotiations so that his client will get the best outcome. *See* MODEL RULES OF PROF'L CONDUCT pmbl. (2013) ("[A] lawyer seeks a result advantageous to the client . . . .").

logic and maximize wealth in making decisions.[202] They do not suffer from self-serving bias when assessing cases. Financiers are also not subject to self-serving bias in the case-valuation process. This is because the financier has no affiliation with, and no obligation to take on, the case at the time the CLF application is evaluated.[203] Thus, compared to plaintiffs and even attorneys, the financiers are in the best position to estimate the case value. Because the case assessments of both rational plaintiffs and financiers are not skewed by cognitive biases, the financiers' case-value estimates would only serve to confirm rational plaintiffs' estimates.

Among the three proposed solutions in this Part, financier mandatory information disclosure is the best response to the potential adverse effects of litigation funding on settlement. In addition to the benefits described above, disclosure may help correct the plaintiff's initial self-serving bias, not just the additional bias induced via the endorsement effect. If a plaintiff initially has self-serving bias, then there would be a discrepancy between his estimate and the financier's estimate. Hearing the financier's estimate would prompt the plaintiff to reconcile this discrepancy by reexamining the strengths and weaknesses of the case. This reexamination may lead the plaintiff to embrace the financier's case assessment, which is unaffected by self-serving bias. Finally, unlike a CLF ban, mandatory information disclosure would allow for individual choice and the realization of CLF benefits, such as the equalization of bargaining power between poor plaintiffs and wealthy defendants.

V. CONCLUSION

Trial is costly.[204] Settlement saves the resources of litigants and the judicial system.[205] Accordingly, it is critical to analyze the effect of nonrecourse advances on settlement when deciding whether to regulate, or even allow, these advances. In the discourse on this issue, most proponents and critics of litigation funding have assumed

202. Camerer et al., *supra* note 18, at 1212.

203. *See* Rachlinski, *supra* note 103, at 1216 (discussing how financial managers can avoid overconfidence problems when selecting investments).

204. *See* Rodak, *supra* note 33, at 520 ("The costs reduced by settlement are not just monetary, though; they also include, among others, the emotional cost of stress related to impending trials and lengthy disputes as well as the opportunity cost of what is forsaken by devoting time to preparing for and attending trial.").

205. *Id.*

a rational plaintiff.[206] Employing a behavioral law-and-economics framework, this Note provides an examination of the effect of litigation funding on irrational plaintiffs. First, this Note shows that a nonrecourse advance may impede settlement at the judgment stage by exacerbating an irrational plaintiff's self-serving bias through an endorsement effect. Second, this Note shows that a nonrecourse advance may impede settlement at the choice stage by causing a fair offer to seem like a loss to an irrational plaintiff who is susceptible to framing.

While an outright ban of litigation funding seems attractive in light of plaintiff irrationality, this Note argues that the less heavy-handed policy of financier mandatory information disclosure is the better solution. Financiers should be required to disclose case-value estimates to plaintiffs who have obtained nonrecourse advances. This policy would help an irrational plaintiff avoid cognitive pitfalls, by negating the endorsement effect, and increase the plaintiff's confidence in his attorney. In this way, disclosure would foster an environment in which attorneys could help effectively deflate overoptimism and reframe fair settlement offers. Moreover, this policy would allow the benefits of litigation funding to be realized because individual consumers could choose whether or not to employ the service. Thus, financier mandatory information disclosure is the ideal approach for addressing litigation funding's potential adverse effects on settlement.

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206. *See, e.g.*, Rodak, *supra* note 33, at 522 (discussing the effect of litigation funding on a "rational plaintiff").

* J.D./Ph.D. in Law and Economics, expected 2017, Vanderbilt University Law School. "For of Him and through Him and to Him are all things, to whom *be* glory forever. Amen." *Romans* 11:36. First and foremost, I give thanks to my Lord and Savior Jesus Christ, from whom I drew the strength to complete this work. I thank my father (Zejun), mother (Zhenmei), and sister (Michelle) for the copious encouragement and love they have given me, especially while I was writing this Note.

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