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Article 13

Litigation Funding and the Problem of Agency Cost in Representative Actions

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LITIGATION FUNDING AND THE PROBLEM OF AGENCY COST IN REPRESENTATIVE ACTIONS

*Samuel Issacharoff**

Alternative sources of litigation funding are complicating the already difficult world of complex litigation. While still in its infancy in the United States, the role of equity financing of contingent litigation is now well rooted in Australia, and establishing itself in Canada and the United Kingdom as well. This Article examines the market gaps filled by litigation funders in Australia and then the potential role to be played in the United States. In particular, the Article looks to litigation funding as a way to potentially protect absent class members in class actions and other representative proceedings.

WHY LITIGATION FUNDING?

The funding of legal services is a subject not generally fit for polite company. We know from the Supreme Court that "a lawyer is under an ethical obligation to exercise independent professional judgment on behalf of his client; he must not allow his own interests, financial or otherwise, to influence his professional advice."[1] We have even been told that coerced fee waivers in statutory fee-shifting cases are unlikely to affect the willingness of lawyers to take on such cases—per the Court, there is little evidence that fee waivers will affect the willingness to take cases for impoverished clients, given that "as a practical matter the likelihood of this circumstance arising is remote."[2]

We further know from centuries of inherited English tradition that litigation is an evil to be avoided.[3] The multiple offenses of barratry, maintenance, and champerty were all ways to root out the peril of "officious intermeddling in a suit that no way belongs to one, by main-

* Reiss Professor of Constitutional Law, New York University School of Law. I am deeply indebted to Justice Bernard Murphy of the Federal Court of Australia for first tutoring me on the dynamics of litigation funding. I subsequently profited from insights provided by Sean Coffey, Ashley Keller, Travis Lenkner, Michael Klausner, and Francis McGovern. No views or claims in this Article should be attributed to any of these fine individuals. Thad Eagles and Dohee Min provided excellent research assistance.

1. Evans v. Jeff D., 475 U.S. 717, 728 n.14 (1986).
2. *Id.* at 741 n.34.
3. *See* WALTER K. OLSON, THE LITIGATION EXPLOSION: WHAT HAPPENED WHEN AMERICA UNLEASHED THE LAWSUIT 2 (1991) ("America's common law tradition, like the legal tradition of every great nation, formerly viewed a lawsuit as an evil, at best a necessary evil.").

taining or assisting either party with money or otherwise to prosecute or defend it."[4] When I was first exposed to legal ethics in law school, even the contingency fee was only grudgingly accepted as perhaps a necessity for some misfits, but not really suitable for gentlemen:

> Although a lawyer generally should decline to accept employment on a contingent fee basis by one who is able to pay a reasonable fixed fee, it is not necessarily improper for a lawyer, where justified by the particular circumstances of a case, to enter into a contingent fee contract in a civil case with any client who, after being fully informed of all relevant factors, desires that arrangement.[5]

So with some shock and the same sense of nostalgic regret that attaches to the loss of the horse and buggy, black-and-white television, and dial-up internet connections, I turn to the brave new world of financially structured intermeddling. For those who watch *Downton Abbey* with fleeting hope that respectable British mores will protect us from the vulgarity of modern life, the news from abroad is frightening. In short order, the former colonies have undone the honored Blackstonian traditions. First Australia, then Canada, and now even England—yes, Mother England[6]—all have let the venture capitalists, the investment banks, and the hedge funds into the litigation process.[7] Alone, the United States seems to have claimed a righteous path to maintain barriers, even criminal barriers, against the commercial financing of people having a good legal row.[8]

Now it seems we too are succumbing to the view that litigation is a commercial venture and that legal disputes may properly be commodified.[9] It is of course only a short step from such insults to the noble traditions of the elite bar to complete debasement in something like lawyer advertising. Alas, that too is upon us—and constitutionally protected to boot.

To be more serious about the emerging market for interests in litigation requires trying to figure out what the market for financing provides and why there might be a demand for it. This Article will try to do so primarily by examining one of the wellsprings for the bur-

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4. 4 WILLIAM BLACKSTONE, COMMENTARIES *134–35.

5. MODEL CODE OF PROF'L RESPONSIBILITY EC 2-20 (1980).

6. CHRISTOPHER HODGES ET AL., LITIGATION FUNDING: STATUS AND ISSUES 38 (2012), *available at* http://www.csls.ox.ac.uk/documents/ReportonLitigationFunding.pdf.

7. *Id*. at 6.

8. *Id.* at 46–47.

9. Rachel M. Zahorsky, *Third-Party Litigation Funding Picks Up as UK Investors Eye US Cases*, A.B.A. J. (June 4, 2010), http://www.abajournal.com/news/article/third-party_litigation_funding_picks_up_as_uk_investors_eye_u.s._case/; *see also* Kevin M. LaCroix, *Has the "Litigation Funding Moment" Arrived?*, D&O DIARY (Feb. 4, 2013), http://www.dandodiary.com/2013/02/articles/securities-litigation/has-the-litigation-funding-moment-arrived/.

geoning of litigation finance: the role of funders assuming some of the risks and benefits of representative litigation.[10] The best comparison is between Australia, where litigation funding took off as a way of financing class actions,[11] and the United States, where the relation of funding to class claims remains uncertain.[12] While that is the basic structure of this Article, it is first necessary to examine a few reasons why litigation funding is attractive in any setting.

It has always been the case that parties are free to *borrow* money to finance specific pieces of litigation, as indeed are lawyers in those jurisdictions that permit contingency fees.[13] What litigation funding represents is an attempt to raise money by way of equity rather than debt.[14] If we view the prosecution or defense of a lawsuit as an economic decision to pursue an aim in either obtaining or avoiding liability, then the question becomes how to finance the venture. On this view, the decision to litigate or settle (including by foregoing suit or confessing judgment) is an economic calculus based on the likely returns to the investment of time and resources in a legal dispute.[15] Basic finance theory indicates that firms should balance between underwriting their venture through debt or equity depending on a variety of factors including risk, cash flow, and opportunity costs of other ventures.[16] The prohibitions encompassed in the barratry-champerty-maintenance troika basically restrict the ability to raise money for legal ventures through equity financing.[17] In turn, that means that litigants, and in particular lawyers undertaking the risk of contingency cases, must turn to debt as a way to manage the costs of litigation. As the stakes of the case grow, servicing debt is a major concern for the operation of a contingent market, especially in mass litigation and class actions.

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10. HODGES ET AL., *supra* note 6, at 2.

11. *Id.* at 38.

12. *See* Deborah R. Hensler, *The Future of Mass Litigation: Global Class Actions and Third-Party Litigation Funding*, 79 GEO. WASH. L. REV. 306, 322 (2011).

13. HODGES ET AL., *supra* note 6, at 43–46.

14. William Alden, *Looking to Make a Profit on Lawsuits, Firms Invest in Them*, N.Y. TIMES (Apr. 30, 2012), http://dealbook.nytimes.com/2012/04/30/looking-to-make-a-profit-on-lawsuits-firms-invest-in-them/; *see also* Mary Campbell, *Q&A: We'll See You In Court*, FINALTERNATIVES (May 23, 2013), http://www.finalternatives.com/node/23746 (interview with Jeremy Walton, Partner, Appleby Global).

15. This is the basic economic model of litigation formalized in RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (8th ed. 2011). For an extended discussion of the early models and the impact of strategic behavior and behavioral economics, see my chapter entitled *Why Litigate?* in SAMUEL ISSACHAROFF, CIVIL PROCEDURE 198–222 (3d ed. 2011).

16. *See* Stewart C. Meyers, *Capital Structure*, J. ECON. PERSP., Spring 2001, at 81.

17. HODGES ET AL., *supra* note 6, at 2.

The problem of reliance on debt financing is then compounded by a further ethical prohibition on allowing anyone other than lawyers to hold a security interest in the proceeds of the practice of law.[18] Again, England long ago did away with such prohibitions, and integrated firms of attorneys and accountants have proved both financially viable and suitable for giving comprehensive financial advice to clients.[19] In the context of funding litigation, this prohibition means that lawyers have to securitize debt based upon the personal assets of the partners in the firm or firms undertaking the representation.[20] In turn, the cost of finance is high because, unlike normal business ventures, loans cannot be securitized against individual cases within the firm's book of business. Worse yet, punitive IRS regulations do not allow lawyers to expense the costs of litigation on an accrual basis. The expenses on any given case must be carried forward until they can be deducted against the gains of success and are simply swallowed whole by the firm if it happens to lose the case.[21]

As a result, lawyers operating on contingency are frequently looking for monetary reserves to help fund litigation without assuming onerous cash-flow burdens from debt and the adverse tax implications of not being able to smooth out profits and losses as they accrue. In such circumstances, lawyers have to seek out a form of equity financing by offering a stake in litigation to those better suited to absorb the cash-flow demands. Because of the prohibition on nonlawyers acquiring a stake in the returns of legal practice, the best (and oftentimes only) source of such financing is other lawyers. Consequently, as basic economics teaches, when the supply to a market demand is artificially constricted in this way, prices will be high.[22] Allowing lawyers to raise money for case prosecution through equity rather than debt should serve to rationalize the economics of legal practice, promote competi-

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18. *See* Ryan S. Christensen, Note, *Roosters in the Henhouse? How Attorney-Accountant Partnerships Would Benefit Consumers and Corporate Clients*, 37 J. Corp. L. 911, 913–14 (2012) (discussing Model Rule 5.4).

19. *Id.* at 916–17.

20. Hodges et al., *supra* note 6, at 46.

21. John P. Quinn et al., Law Firm Accounting and Financial Management § 17.04, at 17-15 (3d ed. 2001) ("Regardless of the method of accounting, if an expenditure is determined to have significant long-term benefit, it may be a nondeductible capital expenditure rather than an ordinary and necessary business expense."). Litigation costs are treated as loans to clients and thus not deductible as current business costs. *Attorneys Audit Technique Guide—Chapter 3*, Internal Revenue Serv., http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Attorneys-Audit-Technique-Guide—-Chapter-3#ch3-corporate (last updated June 26, 2013).

22. *Supply and Demand*, Basic Econ., http://www.basiceconomics.info/supply-and-demand.php (last visited Nov. 27, 2013).

tion, and perhaps even bring down the costs of some forms of legal representation.

It would be a mistake, however, to assume that demand for litigation funding in the United States is driven primarily by the plaintiffs' bar. Rather, the primary initial demand appears to come from institutional actors unfamiliar with the role of being claimants in the legal system, unsure of how to assess legal risk. Consider a multinational firm with an asset such as a contract claim or a patent that might be enforceable in the United States. As a general matter, the firm is likely to be alarmed that its litigation costs in the United States are already higher than in any corresponding market—for reasons that I previously addressed when last invited to the Clifford Symposium.[23] Such a firm will have neither the experience nor the confidence to assess the wisdom of investing in litigation in the United States. And yet the claim might have positive expected value.

In some circumstances, the market figured out a way to securitize legal claims indirectly when the claim comes to define the underlying enterprise. For example, a small innovation shop may have little ongoing business but a strong intellectual property claim to a valuable product. When the legal claim is the most valuable asset of the enterprise, there is no prohibition in the selling off of shares in the firm, even if the practical effect is to securitize a litigation option. We of course refer to such entrepreneurs of legal entitlement as patent trolls: legal versions of mythical cave dwellers, who can mimick human society while posing mortal threats to the honest ability of Mickey Mouse to snatch another 75-year monopoly from millions of would-be Mouseketeers.[24]

Unfortunately, our large hypothetical foreign enterprise cannot sell off pieces of itself for this purpose and it is unlikely to create a new subsidiary solely for this undertaking. Were the firm to cede a percentage of the possible proceeds to someone with the expertise to assess the litigation value of the claim and to monitor the work of prosecuting the claim, the legal claim would become something of realizable value. This is precisely the role that litigation funders are

23. *See generally* Samuel Issacharoff, *Regulating After the Fact*, 56 DEPAUL L. REV. 375 (2007).

24. *See generally* Eldred v. Ashcroft, 537 U.S. 186 (2003) (rejecting a challenge to the Copyright Term Extension Act, which extended copyright protection from the creation of the protected work until seventy years after the author's death). President Obama recently joined in the seemingly universal condemnation of patent trolls. *See* Press Release, Office of the Press Sec'y, Fact Sheet: White House Task Force on High-Tech Patent Issues (June 4, 2013), *available at* http://www.whitehouse.gov/the-press-office/2013/06/04/fact-sheet-white-house-task-force-high-tech-patent-issues.

playing already. They assume the risk and costs of a litigation venture[25] for a structured return that looks very much in sum and substance like a contingency fee.[26]

From the vantage point of the foreign enterprise, the use of a funder to absorb the risks of litigation, monitor the performance of the lawyer-agents, and take on the cash-flow obligations—in whole or in part—is a simple application of the Coasean theory of the firm.[27] There is no particular reason to believe that a foreign enterprise is best suited to assess offensive litigation in terms of costs or likely return. Moreover, the enterprise most likely has a highly developed sense of its internal rate of return on the deployment of its capital—something that is difficult to reproduce in the role of claimant in a foreign legal system.

Normatively, access to any form of litigation funding, even in the form of a contingency fee, turns on the underlying social value of litigation. As the President of the UK Supreme Court recently allowed, "How litigation funding will develop in the years to come is something that we will all watch keenly, because funding is the life-blood of the justice system. . . . [I]t helps maintain our society as an inclusive one . . . . [A]ccess to justice is of the essence in a civilized society."[28]

Even accepting the normative preconditions, a further question in the American context is whether such arrangements can be harnessed to address the serious agency costs associated with representative litigation. Unlike the patent holder or the large foreign multinational, litigation funding in the class action context occurs where there is no real principal standing behind the claims. In the classic negative value cases, the entrepreneurial drive and the capitalization behind the case are generated by class counsel. But the combination of passive principals and active lawyer-agents yields a robust line of cases, most notably *Amchem Products, Inc. v. Windsor*[29] and *Ortiz v. Fibreboard Corp.*,[30] which express strong concerns about the possible mismatch of incentives between lawyers and the mass of passive and nonparticipating class members. For the individual claimant, such as the patent holder or the foreign enterprise, the normal rules about liberty of fi-

25. HODGES ET AL., *supra* note 6, at 2.

26. *See id.* at 9.

27. *Cf.* R. H. Coase, *The Nature of the Firm,* 4 ECONOMICA 386 (1937).

28. Lord David Neuberger, President, Supreme Court of the U.K., From Barretry, Maintenance and Champerty to Litigation Funding: Lecture at the Harbour Litigation Funding First Annual Lecture 22–23 (May 8, 2013) (manuscript available at http://www.supremecourt.gov.uk/docs/speech-130508.pdf).

29. Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 626 (1997).

30. Ortiz v. Fibreboard Corp., 527 U.S. 815, 856 (1999).

nance markets hold and the question is why litigation should not be treated as a corresponding cost of business. For the passive represented parties, however, the question is not simply one of an autonomous liberty to contract, but one of how noncontractual agency relations are structured.

To examine this question, I compare the context in which litigation funding emerged in Australian class actions to the role that litigation funding could play in the United States. I leave aside the discussion of how far the prohibitions on various forms of third-party financing have broken down in the United States—that work has been ably undertaken by others, most notably Jonathan Molot[31] and Anthony Sebok.[32] Rather, I assume for purposes of this Article that the barriers will continue to fall and that the remaining questions concern the role that litigation funding is likely to play in the United States.

II. The View from Down Under

Markets reward entrepreneurial initiative. Starting from this basic intuition, new economic enterprises must find a market niche to fill. In classic "follow the money" fashion, the questions are why Australia was such an attractive site for experimentation with funding, and why class actions in particular were such an early focus of private funders. At its simplest, the success of private funders in Australia was the result of the ability of litigation finance systems to overcome two of the critical obstacles to class actions in that country: the "loser pays" system[33] and the prohibition on contingency fees.[34] The use of private funders corresponds to these two debilitating factors in the development of mass-style litigation in Australia.

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31. *See* Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 Geo. L.J. 65 (2010).

32. *See* Anthony J. Sebok, *The Inauthentic Claim*, 64 Vand. L. Rev. 61 (2011). For an account of the problems in the traditional attorney-client setting caused by third-party litigation funding, see Grace M. Giesel, *Alternative Litigation Finance and the Work-Product Doctrine,* 47 Wake Forest L. Rev. 1083 (2012).

33. George R. Barker, *Third-Party Litigation Funding in Australia and Europe*, 8 J.L. Econ. & Pol'y 451, 468 (2012) ("Australia and the U.K. use the so-called loser pays, or English rule, for the allocation of court costs."); *see also* Anthony Lin, *Australia's Litigation-Funding Giant Looks Abroad*, Law.com (July 6, 2011), http://www.law.com/jsp/article.jsp?id=1202499382901&Australias_LiLitigationFundi_Giant_Looks_Abroad.

34. Paul Von Nessen, *Australian Shareholders Rejoice: Current Developments in Australian Corporate Litigation*, 31 Hastings Int'l & Comp. L. Rev. 647, 668 (2008) ("Australian law, like that of the United Kingdom, does not normally allow for contingency fees for lawyers."); *see also* Robert C. Weber, *IBM GC Says: Beware of Lenders Offering to Finance Your Lawsuit*, Forbes (Feb. 12, 2013), http://www.forbes.com/sites/danielfisher/2013/02/12/ibm-gc-says-beware-of-lenders-offering-to-finance-your-lawsuit/.

First, the loser pays regime makes any mass action (defined by the overriding commonality of the claims among the potential plaintiffs) difficult to get off the ground. By definition, a class action corresponds to a broad-based harm with a significant number of people affected in similar fashion. Under the standards of all legal systems that allow for some form of non-state directed collective litigation, the requirements of many parties and commonality of claims will be the predicate for aggregate proceedings.[35] But the premise of the class action immediately runs into tension with the idea of losing party liability for costs and fees expended by the prevailing party. The more common the injuries and the more diffuse the injured parties (as with a nationwide or international economic fraud), the more unlikely it is that any claimant would come forward to assume the risks associated with not prevailing—and to assume them on behalf of the entire class or mass group—with no possibility for recovery if the case goes sour. If we assume the facts of a small-value consumer claim, for example, the risk associated with the costs of a successful defense far outweigh any possible gain to the named, representative claimant. Judge Richard Posner once wrote in explanation of the economic premises of a class action that, "only a lunatic or a fanatic sues for $30."[36] It would take a particularly fanatical lunatic to do so and assume the risk of millions of dollars in an adverse costs judgment to boot.

Recent developments in Australian class action litigation have pushed even further toward nearly requiring litigation funding as a condition of bringing a class action. In a recent decision of the Federal Court, the court with national jurisdiction over securities class actions, the court required a group of allegedly defrauded investors to post security for the entire potential cost liability should the plaintiff class lose, even though the named litigants constituted only a fraction of the claims in dispute.[37] The trial judge held that requiring this payment would stifle the litigation, as many plaintiffs would be unlikely to participate in the class action either because they would be financially unable to contribute or because their contribution would be disproportionate to the amount they stood to gain.[38] Requiring a security payment would, in the view of the trial court, violate the "traditional rule . . . that natural persons . . . will not, by reason of impecuniousity

35. *See, e.g.*, FED. R. CIV. P. 23(a); *Representative Proceedings*, FED. CT. OF AUSTL., http://www.fedcourt.gov.au/case-management-services/class-actions (last visited June 21, 2013).

36. Carnegie v. Household Int'l, Inc., 376 F.3d 656, 661 (7th Cir. 2004).

37. *Madgwick v Kelly* [2013] FCAFC 61 ¶ 86.

38. *Kelly v Willmott Forests Ltd* [2012] FCA 1446 ¶¶ 119–22. The court noted that this was especially likely because the more people who opted out of the class action, the higher the burden on the remaining plaintiffs, increasing the likelihood that more opt out, and so on. *Id.* ¶ 121.

alone, be barred from continuing with proceedings by the granting of an order for security for costs."[39] The full Federal Court, however, overturned this decision, and held that a class of investors that potentially had a "real capacity to pay" could not claim the protection of rules designed to protect those who were truly impoverished.[40]

Second, the restriction on contingency fees means that the claimants' counsel has a difficult time justifying the risk-reward ratio of mass litigation. In most American class actions, all expenses are borne by class counsel, who in turn expect to recover their capital outlays and the imputed value of their time through a percentage of the recovery—what is termed a common-fund award.[41] Under Australian law, contingency fees are not allowed as such.[42] A lawyer for a prevailing client may get an "uplift" to reflect the risk of nonrecovery from her own client in case of a loss. But that uplift is charged to the opposing party and a 25% uplift is the maximum allowed in no-win, no-fee conditional representation.[43] A large case may justify fees for a great deal of work, but those fees can never exceed 125% of the imputed hourly billing (what in the United States would be termed a lodestar). Australian lawyers are unwilling to assume responsibility for costs both because the upside potential of a modest uplift does not justify out-of-pocket expenses and because of a fear that assuming the cost responsibility for a case will invite fee-shifting against the firm (rather than the client) should the case fail.[44] Accordingly, a case that requires out-of-pocket expenses (exclusive of attorney time) of millions of dollars would allow only the recovery of those expenditures as part of costs, but would not allow any leverage off of that investment. As a result, such claims are limited to those which are near certain to prevail, even apart from the difficulty created by the loser pays rule.

Enter the funders. Litigation funders can cure both of these defects at one time. First, and most readily, the funders can immunize the named class representatives against an adverse judgment and its cost

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39. *Id.* ¶ 20.

40. *Madgwick*, [2013] FCAFC 61 ¶ 86.

41. Charles Silver, *A Restitutionary Theory of Attorneys' Fees in Class Actions*, 76 CORNELL L. REV. 656 (1991); *cf.* Charles Silver & Geoffrey P. Miller, *The Quasi-Class Action Method of Managing Multi-District Litigations: Problems and a Proposal*, 63 VAND. L. REV. 107, 109 (2010).

42. Von Nessen, *supra* note 34, at 668; *see also* Weber, *supra* note 34.

43. CHRISTINE PARKER & ADRIAN EVANS, INSIDE LAWYERS' ETHICS 192 (2007); *see also* Stuart Clark & Christina Harris, *The Push to Reform Class Action Procedure in Australia: Evolution or Revolution?*, 32 MELB. U. L. REV. 775, 789–90 (2008), *available at* http://www.mulr.com.au/issues/32_3/32_3_1.pdf.

44. *See* Monique Lapointe, Note, *Attorney's Fees in Common Fund Actions*, 59 FORDHAM L. REV. 843, 845–46, 846 n.23 (1991).

consequences—in effect, a form of litigation insurance.[45] Second, and most significantly, the funders operate under a completely different risk calculus than do the claimants' counsel. Funders have direct contractual relations with the claimants and advance costs and fee immunization as part of a contractual exchange. The quid that follows from this quo is that funders contractually agree to a recovery of a percentage of the litigation proceeds—in effect a contingency fee. But because the relationship is not one of attorney-client, there is no professional attorney prohibition on such a securitized loan. The only barrier would have been our delightful barratry-champerty-maintenance troika, but those have now been jettisoned under Australian law.[46] The going rate in these funding contracts, seemingly across the board, is 40%, curiously identical to the percentage to which American contingency fees have gravitated.[47] The one difference is that in the United States, court supervision of class actions has brought down that percentage in large cases.[48] In Australia, by contrast, this is treated as purely a matter of private contract.[49]

Funders, however, faced an obstacle not present in the American class action context, or even under Australian class action rules. The

45. There appears to be some uncertainty in Australia about whether firms do offer to underwrite costs to induce class representatives to come forward. It appears to be possible under Australian law for law firms to do so, although plaintiffs' counsel I spoke to said they could not undertake such risk. On the other hand, in private discussions with Australian judges, I repeatedly heard the view that this was already happening, or at least that the judges thought that it must be happening. I did not hear any confirmation from the leading claimants' firms that they engaged in this practice, although they would have an appreciable interest in not advertising their willingness to assume such risks.

46. Michael Legg, U.S. Chamber Inst. for Legal Reform, Litigation Funding in Australia: Identifying and Addressing Conflicts of Interest for Lawyers 3 (2012), *available at* http://www.instituteforlegalreform.com/sites/default/files/Litigation_Funding_in_Australia.pdf; *see also* Ian C. Pilarczyk, *What is Barratry? A Far from Frivolous Question!*, Sundry Topics on the Majesty and Mystery of Law (Sept. 11, 2012) ("[Barratry] has likewise falled into desuetude in a number of other common law jurisdictions, such as Australia."), http://iancpilarczyk.com/2012/09/what-is-barratry-a-far-from-frivolous-question/.

47. The latest development seems to be an effort by law firms in Australia to create a related funding entity in order to perform the role of counsel and funder. John Emmerig & Michael Legg, *Do-It-Yourself Funding for Class Actions in Australia Takes an Interesting Twist*, Jones Day (June 2013), http://www.jonesday.com/do-it-yourself-funding-for-class-actions-in-australia-takes-an-interesting-twist/.

48. *See* Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees in Class Action Settlements: An Empirical Study*, 1 J. Empirical Legal Stud. 27, 30 (2004) ; *see also* Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. Empirical Legal Stud. 811, 837–39 (demonstrating that "fee percentage is strongly and inversely associated with settlement size"). Fitzpatrick's research shows that when settlements reached $100 million, fee percentages "plunged" below 20%, and at $500 million, most were under even 10%. *Id.* at 839–40.

49. Jasminka Kalajdzic et al., *Justice for Profit: A Comparative Analysis of Australian, Canadian and U.S. Third Party Litigation Funding*, 61 Am. J. Comp. L. 93, 109 (2013).

certification of a class action in the United States requires the assignment of a monopoly on representation to class counsel. Some may opt out, but for the members of the certified class there is a court-enforced exclusivity of representation. When a certified class recovers a judgment, it is only class counsel that may seek a fee for the representation.[50] The investment in the litigation brings a reward to the class as the principal, and the lawyers seek compensation as the dutiful agent of the class. Under the common-fund theory born of restitutionary principles, no class member may be heard to complain that no fee is owed for the services to which she was a passive beneficiary.[51] The principle is that no class member gets something for nothing.

In order for the Australian litigation finance system to work, the funders must realize the economies of scale of full litigation returns on their expenditures. This means that they must be able to resist free riding on their investment. One manifestation of this is the funders' concern that in any class action, the returns to the class may be realized by their backer. In the United States this is done through the plaintiffs' counsel advancing costs and then seeking a common-fund recovery—the effect of which is that the court in awarding fees thwarts free riding by forcing the class as a whole to compensate counsel.[52] This cannot be done in Australia because funding is a matter of private contract between the funders and claimants on an individual basis. Since the court does not provide an enforceable monopoly on representation, exclusivity in the provision of benefits is a real problem.

Fortunately for the funders, Australian class action law provided the solution. Australian courts now allow for a class to be defined not in terms of the underlying transaction but in terms of the commonality of the class in how they want to prosecute the claims.[53] In a securities

50. I leave to the side the various ways in which other attorneys might seek compensation for benefits independently conferred upon the class, a minor issue. I also leave to the side the emergence of a bar of strategic objectors who threaten to derail the completion of the litigation unless they are paid off, a major issue.

51. Silver, *supra* note 41, at 664.

52. Lapointe, *supra* note 44, at 844–45.

53. Australian class certification is presumed from the pleadings and does not have hurdles such as the American requirement that common issues predominate over individual issues. STUART CLARK & COLIN LOVEDAY, CLAYTON UTZ, CLASS ACTIONS IN AUSTRALIA: AN OVERVIEW 2 (2004), *available at* http://www.claytonutz.com/docs/Class%20Actions_Aug04.pdf. For funders, this has allowed a class to be defined as a "closed class" of all persons with a common legal claim who have contracted with the same funder—with the object being to prevent free riders. *See* Ken Fowlie & Ben Phi, *Shareholder Class Actions in Australia: Current State of Play*, SLATER & GORDON LAWS. 2–3, http://www.slatergordon.com.au/files/editor_upload/File/flyers/Shareholder%20Class%20Actions.pdf (last visited June 18, 2013); *see also* Deborah R. Hensler, Notes on (Some of) the Effects of Alternative Litigation Financing on Large-Scale Litigation 2 (Apr.

fraud claim, for example, a class may be certified as comprised of all persons who bought Widget securities between January 1, 2006, and December 31, 2006, *and* who are contractual clients of ABC Funders. Courts have recognized such a class definition as proper and have defined class counsel as representing that group, thereby bringing the funding relationship into the formal structure of class litigation. Once so constituted, the class is in effect the creature of the underlying financing contract, and the funders assume the role of the employers of class counsel, who in effect relinquish control of the case in exchange for no longer facing the risk of getting no compensation.

Unsurprisingly, as funded class actions mature, a secondary market has developed in what are termed "outside" or "open" class actions: a second class of those with no contractual relation to the funders (now termed the "inside" or "closed" class) who in turn hope to piggy-back on the litigation efforts of the primary class.[54] This duplication of litigation results in judicial resources being wasted either in the litigation of separate proceedings, or in trying to manage the separate proceedings efficiently through stays or consolidations, and in defendants being less likely to settle because settlement will not resolve all potential claims arising out of the cause of action.[55]

Because the outside class cannot overcome the disincentives to prosecution of the claims, the strategy has to depend on the existence of a class that is properly incentivized through the independent funders. The lack of a unified class, however, restores the possibility of free riding by members of the "open class" who may benefit from

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2012) (unpublished manuscript), *available at* http://www.law.gwu.edu/News/20112012events/Documents/ALF%20Event%20Submissions/Hensler%20ALF%20Submission.pdf ("The class in a third-party funded class action is defined as all class members who have suffered injuries or loss arising out of the same facts and law *and have retained the lawyer who is receiving third-party funding*.").

54. The emergence of "closed" and "open" classes complicates the class action picture and introduces strategic complexity into trying to negotiate settlements. Already there are efforts to resolve the inefficiency by charging a common fund recovery to the members of the open class, in order to compensate properly the parties who assumed the risks of the litigation. Hensler, *supra* note 53, at 1–2. This approach will especially help consumer class actions because litigation funders are unwilling to fund unless they can get most members and members cannot bring their claims without funding, but it would also begin to collapse the distinction between the Australian system and the common fund doctrine in the United States. For recent examples of such complicated class arrangements, see *Competing Class Actions and Litigation Committees*, SHAREHOLDER (IMF (Austl.) Ltd., Sydney, Austl.), Mar. 2009, at 1, *available at* http://www.imf.com.au/pdf/TheShareholder_IMF0903.pdf; Vince Morabito, *Clashing Classes Down Under—Evaluating Australia's Competing Class Actions Through Empirical and Comparative Perspectives*, 27 CONN. J. INT'L L. 245 (2012).

55. *See* Michael Legg, *Reconciling Litigation Funding and the Opt Out Group Definition in Federal Court of Australia Class Actions—The Need for a Legislative Common Fund Approach*, 30 CIV. JUST. Q. 52, 61–62 (2011) (listing examples of multiple closed class actions).

the desire of a defendant to gain a comprehensive release from litigation, even with those who are not obligated to compensate properly the parties who assumed the risks of the litigation.[56] Thus far, this problem has arisen in the securities fraud context, where there may be larger financial actors willing to assume some of the burdens of litigation. This will not translate well to the mass consumer context in which litigation funders are unlikely to be able to contract with enough individual class members and in which class members cannot bring their claims without funding.

Efforts to circumvent the funding problem by asking for a court order to apportion costs among all beneficiaries of class efforts have floundered thus far.[57] In *Modtech Engineering Pty Ltd. v GPT Management Holdings Ltd.*,[58] the settlement agreement stipulated that the attorneys' costs and funder's commission would be deducted from the entire damage award before individual awards were calculated, meaning that all members, whether they signed contracts with the firm and the funders or not, would have their awards reduced on a pro rata basis.[59] The Federal Court found that this was appropriate as to the attorneys' fees, as the legal costs were fixed, and "should be borne by those who benefitted,"[60] but inappropriate when applied to the funder's commission, as the funders had made a commercial decision to fund the litigation and assume the risk of adverse costs despite the fact that not all of the class members had signed their agreement, and those individuals should not be forced into a contract to which they did not agree.[61] In effect, the strategy was a backdoor into a common-fund regime, which remains an ongoing project among Australian courts, attorneys, and academics.[62]

Additionally, the liberalization of the class definition could not remedy the moral hazard problem associated with investing the privately held legal claims. Funders have to overcome a potential information problem with regard to the claims of the individuals who have every incentive to withhold adverse information prior to the funding com-

56. *See, e.g.*, *id.* at 53; Hensler, *supra* note 53, at 1–2.

57. A similar strategy was first attempted by a class that was not funded by a third party, where attorneys structured the settlement such that funding members received a much larger award than nonfunding members. However the Full Federal Court struck this settlement down in part, ironically, *because* it was not funded by a third party, and therefore the funding award was arbitrary and unfair, rather than being set by the market. *Australian Sec. and Invs. Comm'n v Richards* [2013] FCAFC 89.

58. *Modtech Eng'g Pty Ltd. v GPT Mgmt. Holdings Ltd.* [2013] FCA 626.

59. *Id.* ¶ 22.

60. *Id.* ¶ 24.

61. *Id.* ¶¶ 55–57.

62. For more on potential implementations of this regime, see Legg, *supra* note 55 at 70–72.

mitment. This is a variant of the problem faced in the United States by plaintiffs' counsel when they have to decide whether to accept a portfolio of claims offered by referring lawyers (such as the purveyors of the late-night advertisements); there is simply no way of knowing what is in the mix of cases or how much work has been done to screen the cases effectively.

Despite the problems, funding is slowly creating a real class action regime in Australia, overcoming the major barriers of cost liability of the named plaintiff and lack of contingency fees. To some extent the funders are in a better position to assess cases than lawyers accepting a referral in the United States. First, because the funders will be financing the litigation, including a large part of the costs of counsel, there is more dependency on the part of the lawyers seeking funding for a case to make suitable representations on the quality of the claims. Further, Australia has tighter initial pleading rules than the United States, so a claim on file will have more information and more of a developed fact record than would be necessary in the United States.[63]

This informational protection against moral hazard works best for certain kinds of legal claims. Funders are reasonably suited to assess the liability prospects at the front end of the litigation. However, they are poorly positioned to assess the bona fides of long-term occupational individual injuries (i.e., the damages side of the equation), which is critical since the funders are recovering a percentage of the quantum assessed as damages or recovered through settlement.[64] Therefore, it would stand to reason that funders would gravitate to areas of law where damages are assessable on an aggregate basis, and where individual variations would simply be a determination of the allocation of the gross award, rather than defining the recovery in terms of calculating individual damages claims. Thus, it is not surprising that the funders have concentrated initially on economic harm cases (primarily securities cases) in which the harm is defined market wide. Only recently have funders entered the arena of mass physical harm cases in Australia, such as the class action case arising from the devastating flood in Queensland.[65] Even here, the case is notable for

63. S. Stuart Clark & Christina Harris, *Multi-Plaintiff Litigation in Australia: A Comparative Perspective*, 11 DUKE J. COMP. & INT'L L. 289, 313 (2001).

64. *See* LEGG, *supra* note 46, at 28–29.

65. *See* Stephen Johnson & Petrina Berry, *Qld Floods Class Action 'Could Set Record,'* SYDNEY MORNING HERALD (Jan. 21, 2013), http://news.smh.com.au/breaking-news-national/qld-floods-class-action-could-set-record-20130121-2d1xd.html. *See generally* C.E. HOLMES, QUEENSLAND FLOODS COMM'N OF INQUIRY, FINAL REPORT (2012), *available at* http://floodcommission.qld.gov.au/__data/assets/pdf_file/0007/11698/QFCI-Final-Report-March-2012.pdf.

the devastation caused by a single event corresponding to a discrete act of claimed negligence.

The market for litigation funding is relatively new and immature. There are only five or six firms in Australia that are capitalized to handle these investments, although there do appear to be some new entrants exploring the market.[66] As a result, the funders can afford to be highly selective in the cases they take, which explains the high success rate in financed cases to date.[67] Perhaps because of the thin market, funders appear to have the upper hand in negotiations with traditional claimants' firms. Funders control their exposure by sequencing their payments to class counsel, rather than delivering their financial commitment in block form at the threshold of litigation. The disbursements are sequenced as the litigation matures.[68] Moreover, litigation funders typically assume all the contingency risk in a case by paying on a noncontingent basis.[69] The funders pay attorneys' hourly fees as they accrue during the litigation, which further cements the control the funders have over the case.

A curious by-product is that Australian claimant's counsel relinquishes a great deal of entrepreneurial risk in the case. The attorneys of record are paid a substantial part of their fees by the funders,[70] who become the primary party at risk. Because the funders are paying hourly lawyer fees, they have incentives to limit costs and even to internalize the costs of the case. This means that the claimants' counsel are in the position of having to report to the funders on the progress of the case and on decisions of what steps to take next, if for no other reason than to secure the next quantum of funding. It seems inescapable that the funders would not in turn demand the right to participate in reviewing and approving litigation decisions.[71] The simple and well-recognized principle is that "he who pays the piper [picks] the tune."[72] Funders try to limit their out-of-pocket costs by having in-house attorneys of the funders do the legal work themselves,[73] by trying to discourage areas of legal work that they believe will be unfruitful, and even by entering into settlement negotiations with the

66. HODGES ET AL., *supra* note 6, at 49; *see also* SIMON DLUZNIAK, IMF (AUSTRALIA) LTD, LITIGATION FUNDING AND INSURANCE 2 (2009), *available at* http://www.imf.com.au/docs/default-source/site-documents/paper—-dluzniak.

67. Lin, *supra* note 33.

68. *See* Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455, 467 (2012).

69. LEGG, *supra* note 46, at 4.

70. *See* HODGES ET AL, *supra* note 6, at 10.

71. LEGG, *supra* note 46, at 28–29.

72. *Id.* at 28.

73. HODGES ET AL., *supra* note 6, at 75–76.

defendant themselves. It does not take great imagination to see that this brings them very close to being the real attorneys in the case in all but name.[74]

The result is a curious re-creation of a divided bar. The class lawyers are those who go to court, much like barristers in the law courts, although their ranks come from solicitors. The funders then function as the solicitors who mobilize the litigation and give instructions. To the extent that contingency fees are thought to better align the incentives of counsel with their clients, the payment to counsel by the funders diminishes the limited contingency incentives of class counsel, as would be normal in the United States. In its place, the financial intermediary becomes the party at risk with complicated incentives to limit litigation outlays while trying to achieve a favorable litigation result.

III. Lawyer-Driven Class Actions in the United States

The Australian experience allows us to reexamine the role that lawyers have come to play in American class actions. As things stand, lawyers effectively perform the critical functions of case organization and management. Lawyers are the gatekeepers who control case selection. They manage the interactions with clients and they assume the responsibilities for financial underwriting of the litigation. One could imagine a system in which state regulators could decide the threshold questions of whether private counsel should handle the case, as is done with relator suits under *qui tam* statutes. Similarly, there could be intermediaries who act as the mobilizers of litigation, as when a union can serve to direct the case.[75] And most certainly there are innumerable ways in which financial markets could assume the role of financing entrepreneurial litigation, just as bankers have provided the seed money for all manner of economic venture. While these are all roles that we have come to associate with lawyers, there is no obvious reason why all the roles should be integrated. Clearly, funders represent a challenge to the traditional monopoly over one aspect of the case in ways that may liberalize the market for capital and rationalize the economics of class litigation.

But the question of the potential role of funders does not turn simply on the rules regulating the role of class counsel. More significant is the question of identifying the market niche that would provide an

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74. *See* Legg, *supra* note 46, at 28–32.

75. *See, e.g.*, UAW v. Brock, 477 U.S. 274, 290 (1986) ("We therefore . . . hold that the UAW has standing to litigate this action.").

inducement to participate and might, in turn, prompt reforms of class action procedure to achieve some beneficial result. At first glance, the comparison to Australia does not seem propitious for litigation finance entry into this market. Because the American rule already forces each party to bear its own litigation costs, and because contingency fee recovery is well established (*particularly* in the class action setting), the immediate market advantages that funders had in Australia are not present.[76] Key to the success of funders in Australia was the regulation that prevented certain lawyers—those who could not leverage their investments sufficiently to assume the indemnification of class representatives or underwrite the high cost of mass litigation—from competing in the litigation finance market, at least thus far.

That risk-return void is not present in U.S. class representation. Lawyers are well accustomed to pricing contingency risk, and they readily enter into representations of mind-numbing expense and complexity. Class representation may not be a game for the faint of heart or light of wallet. Nonetheless, the battles for control of mass cases in front of the Judicial Panel on Multidistrict Litigation[77] or at class certification hearings indicates that there is a robust if concentrated bar willing to assume the risks and potential rewards of large-stakes litigation.

Presumably, however, funders could still enter the market for underwriting the costs of class representation. Key to such entry would be the willingness to compete head-to-head with lawyers for the returns on underwriting mass litigation. Entry into this market would be more difficult than in Australia, where the funders are shielded from competition from the bar. But this does not mean that there are no potential points of entry in the United States. Nor does it mean that there is not tension in the American class action market that could not be addressed by the infusion of new sources of litigation capital, particularly as regards the high start-up costs of mass litigation.

There are concerns that the "usual characters" tend to dominate certain classes of aggregate litigation and that the established resources of some major players help create an entrenched bar. Under

76. *See* Janet C. Alexander, An Introduction to Class Action Procedure in the United States 10–11 (Jan. 1, 2000) (unpublished manuscript), *available at* http://law.duke.edu/grouplit/papers/classactionalexander.pdf.

77. *See generally* Tammy B. Webb & Ina D. Chang, *Drawing the Line Between Class Action and Quasi-Class Action*, A.B.A. SEC. LITIG. (Nov. 13, 2012), http://apps.americanbar.org/litigation/committees/masstorts/articles/fall2012-1112-drawing-the-line-class-action-quasi-class-action.html.

Rule 23(a)(4) of the Federal Rules of Civil Procedure, courts are instructed to ascertain the adequacy of representation afforded absent class members.[78] This requirement is most often associated with the representation provided by class counsel, as opposed to the generally passive named class representatives. The judicial focus is on whether class counsel are in some sense conflicted, thereby compromising the "structural assurance[s] of fair[ness]"[79] to all members of the putative class, and whether class counsel have the experience and resources necessary to wage battle against a usually better heeled defendant. To the extent that funders could expand the amount of capital available for litigation, perhaps some of the barriers to entry would fall, and with it some of the costs of representation. Perhaps—or perhaps not. It is simply not clear whether there is a market void as in Australia—one crying out for economic rationalization.

The more difficult question is whether the presence of independent funders may serve as a buffer on some of the agency costs associated with complete lawyer control over the litigation. I have spent a great deal of time on the question of the legitimacy of governance in the context of representational litigation, both in my academic writing[80] and in my role in the American Law Institute's project on aggregate litigation.[81] The major class action cases of the past fifteen years have returned time and again to the problem of how to ensure the faithfulness of the class representatives to the interests of the passive class members who lack the ability or incentive to monitor the litigation activities of those who act on their behalf. This theme unifies the disparate technical questions presented in cases from *Amchem*[82] and *Ortiz*[83] over a decade ago, to *Wal-Mart Stores, Inc. v. Dukes*[84] and *Smith v. Bayer*[85] more recently.[86]

If we consider the question of representational fidelity to the interests of the absent class members as a matter of agency cost endemic to

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78. FED. R. CIV. P. 23(a)(4).

79. *E.g.*, Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 627 (1997) ("The settling parties, in sum, achieved a global compromise with no structural assurance of fair and adequate representation for the diverse groups and individuals affected.").

80. *See, e.g.*, Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337; *see also* Samuel Issacharoff, *The Governance Problem in Aggregate Litigation*, 81 FORDHAM L. REV. 3165 (2013).

81. *See* AM. L. INST., PRINCIPLES OF THE LAW OF AGGREGATE LITIGATION (2010).

82. *Amchem Prods.*, 521 U.S. 591.

83. Ortiz v. Fibreboard Corp., 527 U.S. 815 (1999).

84. Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011).

85. Smith v. Bayer Corp., 131 S. Ct. 2368 (2011).

86. For further discussion of the ability to bind the absent class to the litigation decisions of a class action, see Samuel Issacharoff, *Assembling Class Actions*, 90 WASH. U. L. REV. 699 (2013).

all principal-agent relations, the question becomes: What strategies are available to reduce the potential for agency cost? Over the past twenty years, there have been three efforts to police the agency cost in litigation, each with mixed results, but each addressing the same problem of active lawyers and passive class members.

The first approach was to find a class member to empower with oversight functions. The 1983 Third Circuit Task Force report on attorneys' fees, reported by my colleague Arthur Miller, proposed to empower some class member(s) to negotiate the fees of class representation at the start of the litigation and to assume some supervisory authority through the progression of the case.[87] That proposal foundered on the fact that in most small-value class actions, no class member cares whether class counsel gets $2 or $3 from a $10 recovery on a $20 claim, and no class member will invest any time to monitor the work of class counsel given the limited stake.[88] The centrality of the negative value justification for small stakes class actions compromised any effort to elevate any individual or individuals from the class into the role of agents watching agents—a theme to which I will shortly turn.

A variant on the Third Circuit effort came with the 1995 Private Securities Litigation Reform Act (PSLRA).[89] Instead of selecting a class representative because of her typicality, the PSLRA sought to harness the self-interest of a single class member precisely because of atypicality. The PSLRA substituted the lead plaintiff (defined generally as the investor with the greatest stake in the contested securities transactions—usually a retirement fund or some other institutional player) as the intermediary between the class and class counsel.[90] The basic idea was that the self-interest of the player with the largest stake would provide the incentives to oversee the work of class counsel.[91] The rest of the class could then free ride on the work of the lead plaintiff.

The Class Action Fairness Act of 2005 (CAFA) tried to create an alternative intermediary.[92] Instead of choosing a party distinctly at

87. Court Awarded Attorney Fees, Report of the Third Circuit Task Force, 108 F.R.D. 237 (1985).

88. *Id.* at 255.

89. Private Securities Litigation Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

90. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2012).

91. *Third Circuit Task Force Report on Selection of Counsel*, 74 TEMP. L. REV. 689, 752–53 (2001).

92. Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4 (codified as amended in scattered sections of 28 U.S.C.).

risk, as with the lead plaintiff under the PSLRA, CAFA sought to harness the structural independence of state attorneys general as intermediaries.[93] If the PSLRA model turned on harnessed self-interest, CAFA invited a preexisting commitment to the public interest to serve as a check on agent misbehavior. Under CAFA, any class action settlement brought into federal court because of its nationwide market impact has to be accompanied with notice to all the attorneys general of the state of residence of any class member.[94] The hope was that having public officials review the actions taken on behalf of their constituents would prompt vigilant oversight, and deter misconduct for fear of that oversight.

Finally, there are efforts to increase the vigilance of courts beyond their role as normally passive recipients of party arguments under the adversarial system. Despite the formal requirements of judicial independence from the interests of any one party, there have been efforts to reconceptualize the role of the judge as serving as a fiduciary for the class that comes into being as a result of judicial dictate.[95] In part, this impulse to compel greater judicial oversight of the interests of absent class members motivated the 2003 reforms of Rule 23 in requiring greater formal attention to the selection and compensation of class counsel.[96]

Each of these strategies seeks to dampen the perceived concentration of power in the hands of class counsel. Each is an attempt to reduce perceived agency cost through the introduction of incentivized intermediaries. The strategy is one of interposing intermediary agents to watch over the primary agents, a strategy that Dan Ortiz and I referred to as "governing through intermediaries."[97] The basic intuition is that the same lack of ability that leads people to seek out agents (ranging the gamut from auto mechanics to dentists to lawyers, and so forth) also limits the ability to monitor and assess the performance of

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93. 28 U.S.C. § 1715(a) (2012).

94. *Id.* § 1715(b); *see also* Steven M. Puiszis, *Developing Trends with the Class Action Fairness Act of 2005*, 40 J. MARSHALL L. REV. 115, 117 (2006).

95. *See* Reynolds v. Beneficial Nat'l Bank, 288 F.3d 277, 279–80 (7th Cir. 2002) ("We and other courts have gone so far as to term the district judge in the settlement phase of a class action suit a fiduciary of the class, who is subject therefore to the high duty of care that the law requires of fiduciaries."); *see also* Chris Brummer, Note, *Sharpening the Sword: Class Certification, Appellate Review, and the Role of the Fiduciary Judge in Class Action Lawsuits*, 104 COLUM. L. REV. 1042 (2004).

96. *See* Peter J. Beshar & Megan A. Jones, *The New Class Action Rules*, N.Y. L.J. (Dec. 4, 2003), *available at* http://www.gibsondunn.com/fstore/documents/pubs/NYLJ_Class_Action_Rules.pdf.

97. Samuel Issacharoff & Daniel R. Ortiz, *Governing Through Intermediaries*, 85 VA. L. REV. 1627 (1999).

those agents. The natural response is to look for heuristics or other intermediaries to help solve the problem of monitoring agents. For example, we have tremendous difficulties in monitoring the performance of our elected representatives. The sheer volume of legislation and proposed legislation, together with the technical details of line item revisions and complexity, all make it impossible to really assess how well our representatives are doing their jobs and satisfying our wishes.[98] In turn, we rely on a species of "superagents"[99] to monitor the performance of our agents and inform our next series of electoral choices. In the electoral arena, these intermediary entrepreneurs may be political parties, newspaper editorial endorsements, and similar easy-cuing devices that allow us to navigate the decisional byways that afflict our lives.

As I like to remind my first-year students, however, one of the few veritable truths of life is that every gatekeeper in life will at some point become a toll collector. Each of the identified agents imposes its own set of potential agency costs, unique to its particular concerns. In the case of the PSLRA, for example, the creation of an intermediary power to select counsel quickly gave rise to charges of pay-to-play with large public employee pension funds allegedly having the power to extract campaign contributions or other forms of contributions.[100] In any event, large institutional investors are unlikely to take the lead role unless they have a sufficient stake and are concerned about the formula for distributing the litigation proceeds.[101]

In similar fashion, the CAFA invitation for oversight by attorneys general has rarely been accepted, largely because public officials confront scarce resources and have little political incentive to run around the country monitoring low-value class settlements of marginal concern to their constituents.[102] Even more problematic is the inherent tension between the duties of a class representative to protect zealously the interests of absent class members and the broader constitu-

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98. *See* Press Release, Nat'l Conference of State Legislatures, New Laws Ring in the New Year (Dec. 27, 2011), *available at* http://www.ncsl.org/press-room/new-laws-ring-in-the-new-year.aspx.

99. This is the term that Dan Ortiz and I applied to this problem of agents watching agents (presumably in turn watching further agents). Issacharoff & Ortiz, *supra* note 97, at 1631.

100. *See, e.g.*, Karen Donovan, *Legal Reform Turns a Steward Into an Activist*, N.Y. TIMES, Apr. 16, 2005, at C1; Kenneth Lovett, *Pension Pay-to-Play: Law Firms Gave Controllers Big Bucks, Then Got $518M in Fees from State Fund*, N.Y. DAILY NEWS, Oct. 8, 2009, at 10.

101. *See* Written Statement of Keith Johnson, Chief Legal Counsel, State of Wis. Inv. Bd., to the Third Circuit Task Force on Selection of Class Counsel 2–3 (May 5, 2001), *available at* http://www.ca3.uscourts.gov/sites/ca3/files/keithjohnson.pdf.

102. *See* Catherine M. Sharkey, *CAFA Settlement Notice Provision: Optimal Regulatory Policy?*, 156 U. PA. L. REV. 1971, 1974–75 (2008).

ent concerns of public officials. The gap between the two creates a new domain for agency costs, including the political objectives of attorneys general that may be at significant remove from those of the class.[103] The clearest example comes with attorneys general whose primary intervention in proposed class action settlements is to demand that a portion of the class recovery escheat to the state.[104]

Finally, for reasons rehearsed in prior scholarship, judges are poorly positioned to serve as effective fiduciaries. Most notably judges are unlikely to have the case knowledge to assess the wisdom of litigation and settlement decisions independent of the representations made to them by the parties.[105] Most class actions settle[106]—as do most cases overall—and the settlement approval process generally features former adversaries who are now friends of the deal, and an increasing array of unsavory strategic objectors who want only to raise pro forma concerns in hope of getting paid to go away.

Enter the funders? In the Australian context, funders filled a niche that prevented efficient use of class actions. If a central weakness in American class actions is the lack of effective mechanisms to check the perceived high risk of agency cost,—or at least, if the caselaw yields the impression that this is a persistent problem in American class action litigation—the question is whether third-party litigation funding might fill the gap. At least conceptually, third-party funders could provide elements of the three mechanisms already in place under the PSLRA, CAFA and Rule 23. Like the lead plaintiff under the PSLRA, a third-party funder with "skin in the game" has an incentive to monitor the performance of the lawyer-agents, but unlike either the attorneys general or the courts, the funders should have access to information throughout the prosecution of the case, not just at the end. Further, unlike even a well-positioned lead plaintiff under the PSLRA, the return to the funder is presumably a percentage of the class counsel's fees, which are in turn dependent on the overall size of the recovery. The direct tie to the overall performance of the case may yield better incentives and actually narrow the agency gap between the class and its agents. This is a proposition well advanced by Elizabeth Burch:

103. Margaret H. Lemos, *Aggregate Litigation Goes Public: Representative Suits by State Attorneys General*, 126 HARV. L. REV. 486, 530 (2012).

104. *Id.* at 513–17.

105. *See* Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 B.Y.U. L. REV. 1239, 1282.

106. Charles B. Casper, *The Class Action Fairness Act's Impact on Settlements*, ANTITRUST, Fall 2005, at 26, 26.

> Allowing third parties, like commercial-claims lenders, to invest in the litigation's outcome by contracting directly with plaintiffs generates two positive effects. First, it disentangles—at least in part—the lawyer's role as investor from her role as a fiduciary and advisor. When litigating no longer threatens the law firm's solvency or ability to take on other matters, the attorney's loyalty no longer divides between self-preservation and her clients: She can afford to be a faithful representative. Second, assigning a financier a percentage of the plaintiffs' winnings converts that financier into a sizeable stakeholder and incentivizes it to monitor the attorneys and the litigation's costs.[107]

Let me conclude this Article by opening a discussion that has not yet, at least to my knowledge, emerged in the literature. The question may seem shocking, but it follows from the proposition that a significant issue in class action practice is one of agency cost. What follows is quite simple: Should courts require class counsel to secure some measure of third-party funding? This may not be a realistic issue at present because the litigation funding industry in the United States is too small to accommodate the immediate demand that would be created,[108] yielding a bonanza for funders and an unwarranted tax on legitimate class counsel.

But in the spirit of the exercise, I suggest that courts, which are uncertain about the propriety of a proposed class action, or are concerned about the headless class problem, could seek to bring in funders as a way to get an incentivized monitor on the return to the class.[109] By and large, courts are likely to be shocked or even horrified by the presence of funding entities acting behind courtroom law-

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107. Elizabeth Chamblee Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1316 (2012). Although Burch discusses alternative financing arrangements between class counsel and third-party funders, I address exclusively making the funders a contingent beneficiary of the size of the recovery. I do so because the focus is not only on expanding the source of capital to overcome cash-flow problems for the plaintiffs' firm, but also to incentivize a maximum of monitoring.

108. *See* Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1271 (2011) ("Litigation finance in the United States is in its infancy, however."). Litigation funding is not done as much in the United States. HODGES ET AL., *supra* note 6, at 38. But the number of firms coming to the United States is growing. Vanessa O'Connell, *Funds Spring Up to Invest in High-Stakes Litigation*, WALL ST. J., Oct. 3, 2011, at B1.

109. This proposal is not entirely without precedent. In the early stages of experimenting with auctions for the selection of counsel in class action cases, Judge Vaughn Walker required proof of either malpractice insurance or bonding as a condition for being a participant in the auction process. That requirement appears to have been intended to weed out weak bidders without resources who could only accept lowball offers to settle. The aim here is to push further in the direction of incentivizing a co-venturer who would need to monitor class counsel performance. *Cf.* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 105–16 (1991).

yers and introducing the prospect of unaccountable decision making in litigated disputes. But perhaps if litigation funding were brought into the open and harnessed to address the perceived current difficulties in class representation, the fear of the unknown might yield to the introduction of a new market mechanism to manage representative litigation.

There are numerous parallels in which regulators seek to compel third-party participation as a way of bringing in an intermediary with the incentive to monitor conduct that official bodies have trouble patrolling. Think about bail bondsmen who, at least in the movies, routinely hire Robert DeNiro or Katherine Heigl to enforce the limits of time out of jail. Or think of the innumerable bonding and insurance requirements for mining and construction and other highly regulated activities.[110] Some part of those requirements are guarantees of solvency in case of harms that require compensating victims, particularly to guarantee the security of outsiders to the undertaking who have no contractual mechanism to protect themselves. But a major part of the outside bonding and insurance requirement is to create an incentivized monitor of the underlying activity deemed likely to produce costly misconduct.

To give one recent example, consider the proposed regulatory responses to the Deepwater Horizon disaster in the Gulf of Mexico. There are of course a series of prohibitions that will follow, and a series of specific technical requirements that in retrospect would have prevented the missteps giving rise to the spill. Undoubtedly these are important responses, and undoubtedly as well they will have some element of Clauswitz's general dutifully preparing to fight the last war. But one of the interesting proposals of the National Commission of the BP Deepwater Horizon Oil Spill and Offshore Drilling was to increase the insurance requirements for offshore activity.[111] To date, there has been no solvency issue in the ability of British Petroleum, Halliburton, Transocean, and the major actors to cover the costs, penalties and fines of the damage in the Gulf. Rather, the purpose is to introduce another incentivized monitor into what will always be risky activity.

110. *See generally* Mary Ellen West, 25A SUMMARY PA. JUR. 2D *Environmental Law* § 11:66 (2013).

111. NAT'L COMM'N ON THE BP DEEPWATER HORIZON OIL SPILL & OFFSHORE DRILLING, DEEP WATER: THE GULF OIL DISASTER AND THE FUTURE OF OFFSHORE DRILLING 285 (2011), *available at* http://www.oilspillcommission.gov/sites/default/files/documents/DEEPWATER_ReReporttothePreside_FINAL.pdf.

On this view, third-party litigation funding may reduce the agency risk in representative litigation not so much by opening the pool of capital available for the prosecution of class claims, but by introducing a genuinely motivated monitor of class counsel performance with interests that align, albeit imperfectly, with those of the represented class. The approach clearly differs from the PSLRA, CAFA, or the 2003 amendments to Rule 23 in inviting a market actor to serve as an intermediary agent. But we are already well down the path of entrepreneurial litigation and the emergence of a new set of institutional actors opens up a new prospect for revisiting one of the central issues in class action litigation.

IV. Conclusion

So far the debates over third-party funders have turned mostly on whether the practice should be allowed in the United States. Some argue that it is just another source of excess litigation.[112] Others may worry about the further erosion of standards of professionalism.[113] Without wanting to jump the shark, I think it is time to advance the discussion to see what might be the potential market benefits of new forms of litigation finance. It is never too soon to start thinking about the future.

112. *See, e.g.*, John Beisner et al., U.S. Chamber Inst. for Legal Reform, Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States 5 (2009).
113. *See, e.g.*, *id.* at 8; Weber, *supra* note 34.