

What is third-party litigation funding and how does it affect insurance pricing and affordability?



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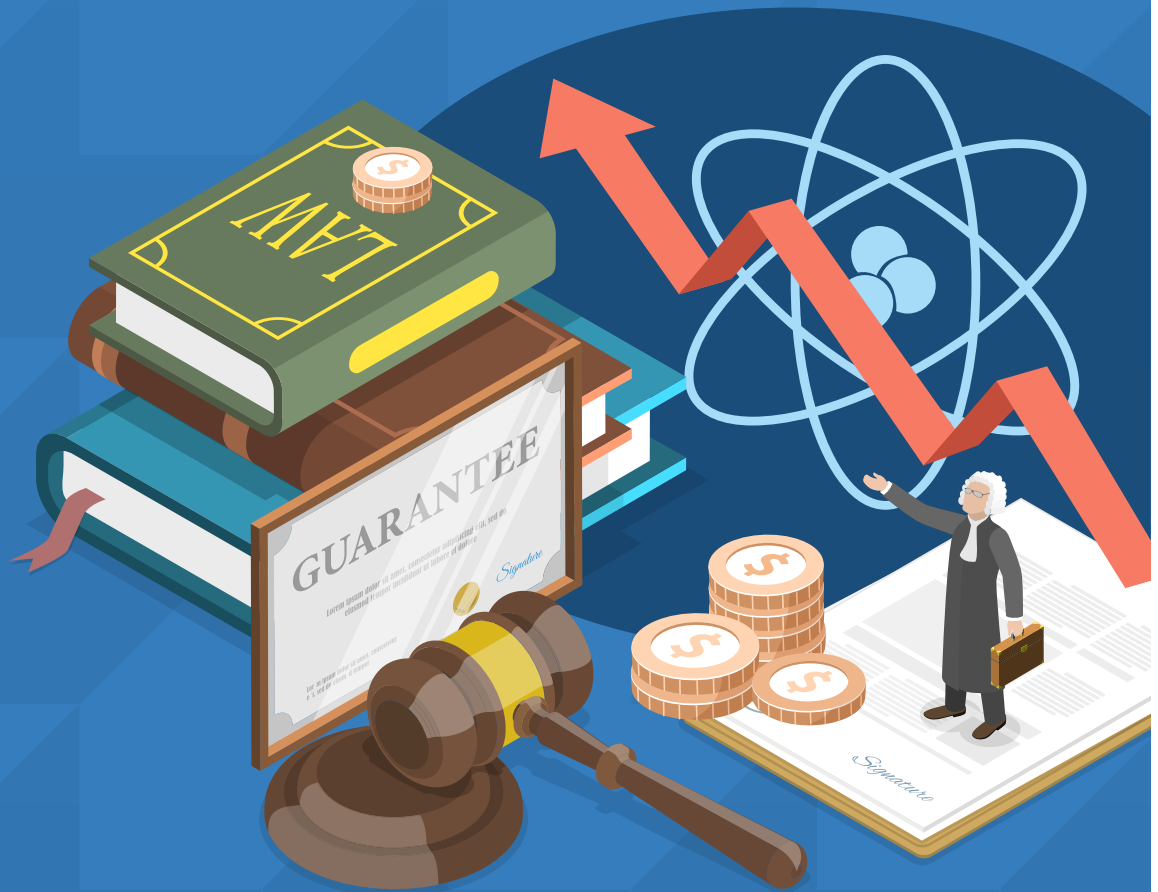


Table of Contents

Page

Executive Summary	2
Key Takeaways	2
Where does the money come from and how is it used?	3
Personal/Consumer Litigation	3
Commercial Litigation	3
Why should insurers and policyholders be concerned about TPLF?	4
Third-party litigation funding has the potential to draw out litigation and costs.....	4
Third-party litigation funding increases the threat of moral hazard.....	5
David vs Goliath is no longer the primary dynamic in third-party litigation funding	5
Third-party involvement in legal cases can put fairness and ethics at risk.....	5
Despite reaping benefits, lawyers have concerns about third-party litigation funding	6
What is the financial impact of third-party litigation funding?	6
A propensity to increase legal costs drives social inflation.....	7
Protecting coverage affordability requires a push for transparency.....	8
Citations	8



Executive Summary

With recent annual returns surpassing 20%, it's not difficult to see why investors are making third-party litigation funding (TPLF) one of the fastest-growing alternative asset classes. Litigation can be expensive, but a stake in a winnable lawsuit can be a valuable asset. So, investors, looking to diversify their financial portfolios, front the costs. However, as economists often remind us, there is no free lunch. Evidence indicates that for the end results of this capital infusion into the litigation industry, insurers and policyholders ultimately bear the brunt of the tab.

This niche market, also variously called legal funding, third-party litigation finance, or alternative litigation financing (ALF), provides billions each year in debt or equity capital to clients or law firms. Recipients can be people or corporations. They may use the money to cover personal or medical expenses (in personal litigation), attorney labor and court-related fees, explore riskier legal strategies, and pay for an expert witness or jury consultant. TPLF can come into play at almost any stage of the litigation, including after a court date is set or during the verdict collection process.

Generally, clients and their attorneys—when working on contingency—bear litigation costs, keeping a watchful eye on expenditures and time needed to settle a claim. However, vigilance may decrease when third-party funders get involved with a lawsuit, potentially allowing litigation to draw out and expenses to soar.

Key Takeaways

Global multi-billion-dollar investing firms have made third-party litigation funding their sole or primary business and are experiencing strong growth. As the market lacks transparency, estimates on its size can vary but, according to Swiss Re, more than [half of the \\$17 billion](#) invested into litigation funding globally in 2020 was deployed in the U.S. Swiss Re estimates put the market as high as \$30 billion by 2028. Meanwhile, affordability of insurance coverage, especially for commercial auto products, has come under threat from increases in litigation and claim costs.

Data suggests TPLF may drive [social inflation](#), a term that encapsulates the ways in which insurers' claims costs rise above general economic inflation and shifts in societal preferences over who is best placed to absorb risk. Unlike general economic inflation, which insurers can mitigate using pricing models and loss reserves, social inflation can arise from factors that are challenging to forecast. These factors can include rising legal costs, such as those resulting from an increase in the number of outsized jury awards and legal proceedings that take longer than reasonably expected to resolve.

As part of our commitment to raising awareness of critical issues for insurers and policyholders, Insurance Information Institute (Triple-I) has taken an extensive look into the landscape of TPLF. Our goals are to understand all the stakeholders and their motivations and then drive a substantive conversation about the inherent risks and how to mitigate them for better pricing and affordability outcomes.

Third-party litigation funding:

- Is no longer about David vs Goliath, but about speculative investors getting richer as they focus on cases more likely to win the big settlements.
- Lacks transparency and a sense of fair play—if attorneys can communicate across the table about insurance coverage, why not disclose the involvement of TPLF?
- Creates a moral hazard as sharing the settlement pie in exchange for funding can fuel a desire for wanting a bigger pie to resolve the claim.
- Siphons value from the claims and risk management ecosystem—away from policyholders, claimants, and insurers— and transfers it to attorneys and investors.



Where does the money come from and how is it used?

Banks and traditional lenders do not see a stake in a potentially valuable lawsuit as real collateral because there is an inherent risk of capital loss if the case is lost or settles for less than they might lend. Enter private equity, hedge funds, elite university endowment funds, certain trusts, and other deep-pocketed investors that can afford to take on this risk. In exchange, these investors command very high rewards.

Investing in pending litigation may be done directly with the law firm, a broker, or a company specializing in TPLF. Litigation finance companies and specialty investors looking for investment opportunities may develop relationships with law firms or search databases to find attorneys with promising cases. The way the funds are dispersed and used depends on whether the claims involve personal/consumer litigation versus commercial litigation. While the money in this industry has historically flowed mostly to plaintiffs or their attorneys, corporations are also using TPLF to manage their working capital outlays for legal defense.

“Third-party litigation funding (TPLF) has devastatingly become a multi-billion-dollar global industry, turning lawsuits into investments at the expense of societal good.”

-Sean Kevelighan, CEO, Triple-I

Personal/Consumer Litigation

Before funding is provided to the client, the investor may ask the attorney questions to ascertain the lawsuit’s legal strength and potential value. Funders then estimate how much they think a case settlement could be worth and offer cash based on a percentage of that estimate. In return, they claim a monetary stake in the final payment. The disbursement is referred to as a non-recourse loan because recipients do not have to pay back the money if the case is dismissed or lost. If the recipient wins or settles their lawsuit, the funder receives the dispersed amount plus interest.

When the recipient of the funding is an individual (versus, for example, a corporation), they typically use this money for living or medical expenses during litigation. In some

instances, clients may use it to hire legal experts or, more rarely, to cover legal fees if local laws permit. While attorneys usually don’t receive this money from clients to cover their professional labor, they might in states where it would be legal to do so. Regardless, in order for the money to be disbursed to the client, the attorney must agree to directly remit the proceeds to the funder from the client’s share upon settlement.

Commercial Litigation

Analysts estimate commercial litigation receives the majority of TPLF, and funded parties in the U.S. are typically corporations, including large, financially secure organizations, smaller businesses, and law firms. In exchange for a percent of the payout, the disbursement goes directly to:

- The plaintiff (or sometimes a corporate defendant) to cover legal costs such as expert witnesses and attorney fees, OR
- The legal firms, in which case they may use it to cover the costs of a single case or a portfolio of cases, depending on the agreement with the funder.

As with consumer litigation, disbursements are almost always non-recourse—there is no recovery if the case is lost. Therefore, stipulations in the funding agreement may typically include a hefty portion of the contingency fee or settlement and potentially other obligations. This is the reward funders expect for taking on the risk. The amount also reflects high barriers to entry (cost of legal evaluation expertise, capital requirements, etc.) and high loss potential.

The higher the settlement or verdict, the higher the returns or profit on the original invested capital. Funders may receive no returns or lose all of their invested capital if the case is lost or remains unsettled. Lower-than-expected winnings or settlements can still translate into a loss for the funder if their share amounts to less than their invested capital. Commercial third-party litigation financiers may command as much as half of a law firm’s contingency fee in exchange for taking on this risk to cover the costs for attorney labor and other case-related fees.



Funders do not take a leap of faith. They spend as much as six figures (sometimes more) to analyze the cases and legal portfolios they fund, employing tools similar to those used in a hedge fund and venture capital investing, such as artificial intelligence (AI) and expert consultants. Rather than targeting a single case, funders may cultivate a portfolio-level relationship with a law firm or corporation to spread the risk of loss over several cases and optimize profits. In such arrangements, law firms can make funding deals to cover a combination of working capital, claim monetization fees, and costs.

When funding is involved in commercial litigation, the legal firms typically get paid no matter how the case is resolved, even while their client or the TPLF may not see a penny. However, funders typically require law firms to agree to cap their billing rate for the case to mitigate the risk of capital loss. If the case is won, attorneys may give up a portion of their part of the settlement (as much as half) in exchange for the financing. This fee arrangement can be with the funder or the commercial client.

Commercial litigation cases reportedly attract the bulk of the industry funding. Funders channel their money to a variety of litigation areas:

- ↳ Intellectual Property/Patent infringement
- ↳ Whistleblower
- ↳ Arbitration
- ↳ Business torts and contract breaches
- ↳ Personal injury
- ↳ Class action

Why should insurers and policyholders be concerned about TPLF?

The bulk of the concerns with third-party litigation funding stem from the opaque nature of the industry's practices, particularly the lack of disclosure as to whether outside funding is involved in a given case. Few U.S. states or territories require attorneys or their clients to disclose TPLF agreements to the opposing side. While disclosure of funding agreements may be [mandated occasionally in certain jurisdictions](#) or cases, the overall lack of transparency in TPLF arrangements impedes fair play, causing difficulties for:

- the opposing parties to manage legal risks and associated costs;
- quantifying the impact on funded verdicts and social inflation.

These hurdles, in turn, impede insurers' long-run risk-mitigation tactics and, thereby, ultimately impact coverage affordability.

Third-party litigation funding has the potential to draw out litigation and costs.

When each side of a lawsuit has a sense of what it might take to resolve the situation, the attorneys can more easily find a way to do it as quickly and as cost-effectively as possible. This objective is why information about insurance coverage is often known on both sides of the table. However, attorneys and their clients typically refuse to share whether an outside investor has a financial interest in the lawsuit's outcome unless they are compelled by the court.

Third-party funding essentially erodes the incentive, formerly protected by the contingency fee mechanism, to litigate as efficiently as possible. In commercial litigation, the billing agreement structure attorneys have with funders decreases the impetus to minimize litigation time and costs. To get paid regardless of the outcome, law firms cap their rates and forgo a portion of any potential settlement. It can sometimes be more profitable for firms to keep litigating, occasionally employing more novel and expensive tactics.



Some law firms, despite their decreased contingency risk with TPLF deals, may even pass some of the funding cost onto clients by charging a higher contingency fee (e.g., 40% instead of 30%). Lack of transparency about the involvement of external funders can contribute to inefficiencies, decreased fairness, and loss of value for the plaintiff. It also can enable other concerns surrounding TPLF involvement to emerge unchecked, too.

Third-party litigation funding increases the threat of moral hazard.

It is logical to suspect that sharing a piece of the settlement pie with another party can incentivize wanting a bigger pie, perhaps even beyond what would've otherwise been necessary to feel justice has been served. A plaintiff who received personal litigation funding may turn down a reasonable settlement when the funder's portion, in comparison with the offer amount, becomes uncomfortably large due to the steep interest rates.

The funder's portion of a settlement in commercial litigation funding is usually based upon a set percentage. Any stakeholders (attorneys or clients) who agreed to share any percentage of their part with the funder may hesitate to resolve the case as quickly or as economically as they would have otherwise. This moral hazard risk is baked into the way TPLF works and is nearly impossible to mitigate, again, partly due to a lack of transparency.

David vs Goliath is no longer the primary dynamic in third-party litigation funding.

Some proponents of TPLF argue that litigation financing helps underfunded plaintiffs pursue justice. Litigation financing has existed for decades in various forms. Advocacy organizations, such as NAACP and the ACLU, have been financing lawsuits as third parties, for example, following legal rules and ethical codes for disclosure of involvement. Today TPLF, despite transforming into a booming for-profit industry, is still being touted as a way to even the playing field for plaintiffs who lack resources to pay for expert witness fees or individuals to cover medical and living costs in personal injury claims.

To a limited extent that can hold true. However, TPLF is regularly used to fund large class action suits, corporate

litigation, and law firms of all sizes. Any recipient, no matter how wealthy, can use TPLF to avoid using their own money to front the legal costs of their case. The multi-billion-dollar TPLF industry of today is mostly not composed of advocates providing money to support their cause (although they can if desired), but rather profit-seeking investors who simply want to stake a financial claim in a lawsuit that should be none of their concern.

Financing practices of third-party litigation funding have evolved beyond the justice mandate, becoming a cash fountain within the alternative investment space where there is less regulation and more speculative investors. This expansion of investor types over recent decades has made the TPLF less about supporting the right to seek justice and more about enabling speculative profit-seeking for investors pursuing returns substantially higher than the stock market.

“Third-party litigation funding agreements are rarely disclosed to the court or the litigants, and as such transparency is essential if the judicial process is to proceed in an orderly and cost-effective manner.”

-Sean Kevelighan, CEO, Triple-I

Third-party involvement in legal cases can put fairness and ethics at risk.

Secrecy around TPLF involvement can hide ethical red flags, including concerns about litigation tactics and case quality or fairness. That is why governments established laws as far back as the Middle Ages to address champerty, a legal concept based on prohibiting a third party from assisting a claimant in exchange for a financial interest in the outcome of a dispute.

In theory, freeing legal firms from the financial risks of contingency can allow them to pursue more quality cases. Third-party funders, however, typically assess cases for the probabilities of winning and the expected settlement size, employing all the expertise they can afford. The legal experts that funders use can have more area specialization than the case's attorney of record. These experts sign non-disclosure agreements, and attorney-client privilege applies to the results of their analysis.



Nonetheless, the external reviewers are not engaged to raise any concerns about the fairness or ethics of a lawsuit—factors that can and should determine whether an attorney should bring a case to court in the first place. And regardless of the privacy precautions that the industry claims to take, the lack of transparency around the existence of a funding agreement impedes the court’s ability to make certain ethical lines aren’t crossed, during the review, the structuring of the investment vehicles, or the solicitation of investors into the fund for the case.

Despite reaping benefits, attorneys have concerns about third-party litigation funding.

Over half of surveyed attorneys have concerns about TPLF and only 34% say they are against disclosure

A [September 2021 survey by Bloomberg Law](#) involving litigation funders and attorneys revealed that over half of responding attorneys had concerns about the ethical implications of using litigation finance while only 14% of funders reported hearing that concern from potential clients. Data from this survey also revealed that nearly 80% of funders believe disclosure should not be mandatory compared to only 34% of attorneys. Yet, 69% of

these attorneys say they are more likely to seek funding now than five years ago.

The American Bar Association has not come out against TPLF but it has set out a list of [best practice recommendations](#), which includes limiting funder access to only public files and not privileged information. Interestingly, in a separate [paper for the American Bar Association](#), Christopher P. Bogart, chief executive officer of Burford Capital (a leading global third-party litigation funder) advised that:

“the lawyer should seek to understand where the financier’s money comes from—for example, whether it is a publicly-traded company with its own permanent capital base or whether the funds will need to be raised and additional approvals sought from a fourth party.”

Bogart’s caveat appears to be common-sense best practice, but it highlights a significant concern and potential conflict of interest: attorneys, despite being the ultimate main beneficiary of TPLF, are not subject to oversight or transparency in their vetting or use of commercial funders.

What is the financial impact of third-party litigation funding?

The nature of this business—complexity, lack of transparency, market players, etc.—can make scope and impact analysis a challenge. For instance, while the largest funders, such as Burford Capital, L.P, are publicly traded, most third-party litigation funders are private investment funds.

Westfleet Advisors puts the number of [litigation funders active](#) in the U.S. commercial litigation finance market in 2021 at 47, up from 41 in 2019. The 2020 version of the report stated their data came from entities operating mainly as funders and therefore did not account for direct investment from family offices and similar investors. This caveat was not found in the 2021 version but given the increase by only one funder from 2020, we presume this stipulation may still apply.

The 47 funders had combined assets under management (AUM) of \$12.4 billion, up \$3 billion—nearly a 32% increase – from 2019. The average dollar value for transactions was

\$6.5 million (versus \$7.8 million in 2020) with single matter deals averaging \$3.5 million and portfolio transactions averaging \$8.5 million.” Data from 2021 reveals a nearly even distribution between lawyer-directed deals (52%, down from 65% in 2020) and client-directed deals (48%).

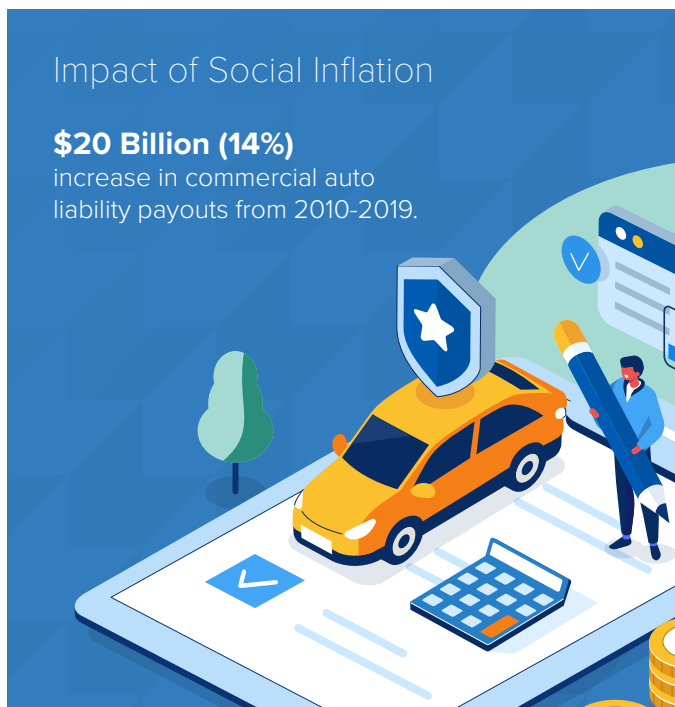
The amount of commercial litigation funding captured by large law firms further dispels the David versus Goliath narrative as 41% of total commitments in 2021 across the funders were allocated to “big law”, firms ranked in the AmLaw 200 according to gross revenue. Among all 2021 portfolio commitments, 53% were earmarked for big firms. That amount was a seismic increase (up 488%) from 2020, mainly due to a small number of \$50 million plus deals. Only 34% of TPLF deals with large law firms were designated for client-directed, single-matter deals, indicating TPLF may play more of a role in keeping law firms profitable across their case load than in empowering individuals to fight for justice.



Burford Capital, L.P., according to its website, has provided litigation financing to 94 of the 100 largest U.S. law firms and over 91% of the largest 100 global firms. The funding titan also reports that “corporate clients—from Fortune 500 companies to startups—account for 56% of the value of Burford’s total commitments.”

TPLF’s growing footprint in the litigation industry enables high returns for investors, which reportedly [skyrocketed as high as 52%](#) with some investments. To put this in perspective, S&P has averaged about 10% since its inception. If TPLF continues to outperform equities and several risky asset classes, it’s unlikely that investor demand for opportunities will subside soon.

A propensity to increase legal costs drives social inflation



Source: Triple-I and Casualty Actuarial Society analysis of National Association of Insurance Commissioner (NAIC) data. Social Inflation and Loss Development, Lynch, J. and Moore, D., February 2022

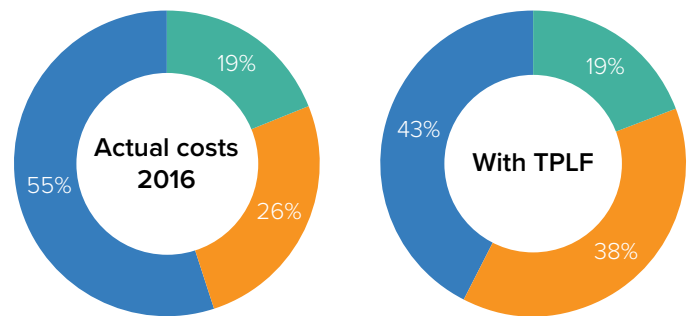
Since TPLF may come at almost any stage of the litigation, the lack of transparency makes it inherently impossible to nail down whether funding drives more cases to court or not. However, research indicates that TPLF, through

its potential to extend legal proceedings and thereby escalate costs, may be a significant driver of the upward trend in social inflation. The fallout may be especially notable in auto and casualty insurance.

In addition to potentially increasing costs for insurers and policyholders, TPLF also may have a financially counterproductive effect for plaintiffs. [Data modeling by Swiss Re](#) indicates that TPLF extracts a disproportionate amount of value from claimants. Up to 57% of torts involving this funding goes to the funders, the attorneys, and parties other than the plaintiff.

Distribution of Tort System Costs

- Plaintiffs’ compensation
- Plaintiffs’ legal costs (includes TPLF)
- Defendants’ legal costs



Source: Swiss Re, Institute for Legal Reform, Research Nester.

An Insurance Research Council [study](#), based on a sample analysis of 80,000 auto injury claims paid in 2017, shows that hiring an attorney for a claim may result in lower settlement amounts, require more time to resolve, and involve more (and potentially unnecessary) medical care.

[Research](#) conducted by the Milliman actuarial firm, “Trends in Attorney Representation: Texas Commercial Automobile Insurance,” indicate that relative costs of resolving claims from 2015 to 2019 were significantly higher for claims with attorney representation. Milliman’s findings also reveal that in 2019, the average total loss with attorney involvement was 17.1 times higher, while the average cost for adjudicating a claim was 52.8 times higher.

Protecting coverage affordability requires a push for transparency.

Insurers can mitigate general economic inflation using pricing models and loss reserves. While the effects of TPLF, like other components of social inflation, remain challenging for insurers to quantify, understanding the risks remains crucial. Disclosure of the involvement of TPLF in a legal claim can go a long way toward fairness, cost mitigation, and value for both sides of the litigation table.

Financial innovations tend to outpace legislation and regulation, but history tells us that reining in problematic practices can be good, in the long run, for all stakeholders in the system.

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