Litigation Funding and the Problem of Agency Cost in Representative Actions

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I. 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.”

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.”

We further know from centuries of inherited English tradition that litigation is an evil to be avoided. The multiple offenses of barratry, maintenance, and champerty were all ways at rooting out the peril of “officious intermeddling in a suit that no way belongs to one, by maintaining or assisting either party with money or otherwise to prosecute or defend it.”

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

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1 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 essay should be attributed to any of these fine individuals.


3 Id. at 741 n. 34.

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 inter meddling. 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 – all have let the venture capitalists, the investment banks, and the hedge funds into the litigation process. Alone, the US seems to have claimed a righteous path to maintain barriers, even criminal barriers, against the commercial financing of people having a good legal row.

And now it seems we too are succumbing to the view that litigation is a commercial venture and that legal disputes may properly be commodified. 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 Essay will try to do so primarily by examining one of the well springs for the burgeoning of litigation finance: the role of funders assuming some of the risks and benefits of representative litigation. The best comparison is between Australia, where litigation funding took off as a way of financing class actions, and the U.S., where the relation of funding to class claims remains uncertain. While that is the basic structure of this Essay, it is first necessary to examine briefly 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. What litigation funding represents is an attempt to raise money by way of equity rather than debt. If we view the prosecution or defense of a lawsuit as an economic decision to pursue an aim in either the obtaining or avoiding of 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

5 ABA Model Code of Responsibility, as amended through 1980, EC 1-3.
dispute. 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. The prohibitions encompassed in the barratry/champerty/maintenance troika basically restrict the ability to raise money for legal ventures through equity financing. 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.

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. 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 integrated advice to clients. 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. In turn, this means that the cost of finance is high because unlike normal business ventures, loans cannot be securitized against 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 the case happens to lose.

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 non-lawyers acquiring a stake in the returns of legal practice, the best (and oftentimes only) source of such financing is other lawyers. And, as basic economics teaches, when the supply to a market demand is artificially constricted in this way, prices will be high. Allowing lawyers to raise money for case prosecution through equity rather than debt should serve to rationalize the economics of legal practice, promote competition, and perhaps even bring down the costs of some forms of legal representation.

But it would be a mistake to assume that demand for litigation funding in the US is driven primarily by the plaintiffs’ bar. Rather, the primary initial

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6 This is the basic economic model of litigation formalized in Richard Posner, An Economic Theory of Law ___ (8th ed.). For an extended discussion of the early models and the impact of strategic behavior and behavioral economics, see my chapter on Why Litigate? in Samuel Issacharoff, Civil Procedure ___ (3d ed. 2012).
demand appears to come from institutional actors unfamiliar with the role of being claimants in the legal system and being 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 US. As a general matter, the firm is likely to be alarmed that its litigation costs in the US are already higher than in any corresponding market – for reasons that I previously addressed when last invited to the Clifford Symposium. Such a firm will neither have the experience nor the confidence to assess the wisdom of investing in further returns to litigating in the US. 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 mimicking human society while posing mortal threats to the honest ability of Micky Mouse to snatch another 75-year monopoly from millions of would-be Mouseketeers.7

Unfortunately, our large hypothetical foreign enterprise cannot sell off pieces of itself for this purpose and it is unlikely to create a new subsidiary just 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, this would make the legal claim into something of realizable value. This is precisely the role that litigation funders are playing already. They assume the risk and costs of a litigation venture, for a structured return that looks very much in sum and substance like a contingency fee.

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.8 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.

The more difficult question is whether such funding arrangements can be harnessed to address the serious agency costs associated with representative

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7 Eldred.
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 all come from class counsel and a robust line of cases, most notably *Amchem* and *Ortiz*, yield a strong series of concerns about the possible mismatch of incentives between lawyers and the mass of passive and nonparticipating class members.

To get at this question, I will compare the context in which litigation funding emerged in Australian class actions to the role that could be played in the U.S. I leave to the side the discussion of how far the prohibitions on various forms of third-party financing have broken down in the U.S. – that work has been ably undertaken by others, most notably Jonathan Molot9 and Anthony Sebok.10 Rather, I will assume for purposes of this Essay that the barriers will continue to fall and that the remaining questions concern the role that litigation funding is likely to play in the U.S.

II. THE VIEW FROM DOWN UNDER.

Markets reward entrepreneurial initiative. Starting from that basic intuition, new economic enterprises must find a market niche to fill. In classic “follow the money” fashion, the question is 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 and the prohibition on contingency fees. The use of private funders corresponds to these two debilitating factors in the development of mass-style litigation in Australia.

First, the loser-pays costs 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. But the premise of the class action immediately runs into tension with the idea of 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. Richard Posner once wrote in explanation of the economic premises of a class action that, “only a lunatic or a fanatic sues for $30.” It would take a particularly fanatical lunatic to do so and assume the risk of millions in adverse costs judgment to boot.

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. Under Australian law, contingency fees are not allowed as such. A lawyer for a prevailing client may get an “uplift” to reflect the risk of non-recovery from her own client in case of a loss. But that uplift is charged to the opposing party and a 25 percent uplift is the maximum allowed in no-win, no-fee conditional representation. A large case may justify fees for a great deal of work, but those fees can never exceed 125 percent of the imputed hourly billing (what in the U.S. would be termed a lodestar). 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 near certain to prevail, even apart from the difficulty created by the loser pay 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 consequences – in effect, a form of litigation insurance. Second, and most significantly, the funders operate under a completely different risk calculus as 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 by contract agree to a recovery of a percentage of the litigation proceeds, in effect a

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11 There appears to be some uncertainty in Australia about whether this is already a practice utilized by claimants’ law firms to induce class representatives to come forward. It appears to be possible under Australian law for law firms to do so. Moreover, 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.
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 troika of barratry/champerty/maintenance, but those have now been jettisoned under Australian law. One interesting point of note: the going rate in these funding contracts (seemingly across the board) is 40 percent, curiously identical to the percentage to which American contingency fees have gravitated. The one difference is that in the U.S., court supervision of class actions has brought down that percentage in large cases. In Australia, by contrast, this is treated as purely a matter of private contract.

Funders, however, faced an obstacle not presented in the American class action context, or even under Australian class action rules. The certification of a class 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. 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 owing for the services to which she was a passive beneficiary. 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 their concern that in any class action, the returns to the class be realized by their backer. In the U.S. 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. This cannot be done in Australia because the 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 cases 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

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12 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.

13 Charles Silver, A Restitutionary Theory of Attorneys’ Fees, Cornell.
terms of how they want to prosecute the claims. In a securities 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 risk of no compensation in the case.

What the liberalization of class definition could not remedy is the moral hazard problem associated with investing the privately held legal claims. Funders find themselves in an information deficit with regard to the claims of the individuals who have every incentive to withhold adverse information prior to the funding commitment. This is a variant of the problem faced in the U.S. 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.

To some extent the funders are in a better position to assess cases than lawyers accepting a referral in the U.S. First, since the funders will be financing the litigation, including 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 pleading rules than the U.S., so a claim on file will have more information and more of a developed fact record than has been necessary in the U.S.

This informational protection against moral hazards only works for certain kinds of legal claims. Funders are reasonably well able to assess the liability prospects at the front end of the litigation. However, they are poorly positioned in assessing the bona fides of individual injuries (i.e., the damages side of the equation) which is critical since the funders are recovering as a percentage of the quantum assessed as damages or recovered through settlement. It would stand to reason, therefore, 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 an addition of individual damages claims. It is therefore not surprising that the funders have gravitated to the economic harm cases (primarily, if not exclusively, securities cases) in which the harm is defined market-
There are no reported instances of any mass physical harm cases in Australia having been underwritten by funders so far.

The market for litigation funding is relatively new and immature. There are only five or six firms that are capitalized to handle these investments, although there do appear to be some new entrants exploring the market. As a result, the funders can afford to be highly selective in the cases they take up which explains the stunningly high success rate in financed cases to date. 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 with the plaintiffs’ counsel are being paid on an hourly basis by the funder and that their contingency risk in the case is removed. 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 relinquish any entrepreneurial risk in the case. The attorneys are cost indifferent as to winning or losing and the funders are the real party at risk. Because the funders are paying hourly costs, 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 rights of participation in reviewing and approving litigation decisions. The simple and well recognized principle is that, he who pays the piper picks the tune. Funders try to limit their out-of-pocket costs by having in-house attorneys of the funders do the legal work themselves, by trying to discourage areas of legal work that they believe will be unfruitful, and even by entering into settlement negotiations with the 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.

The result is a curious recreation 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 removes even the limited contingency incentives of class counsel, as would be normal in the U.S. In its place, the financial intermediary becomes the party at risk and the party with complicated incentives to limit litigation outlays while trying to achieve a favorable litigation result.
III. LAWYER-DRIVEN CLASS ACTIONS IN THE U.S.

The Australian experience forces a reexamination of 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. 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 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. Key to the success of funders in Australia was the regulatorily-enforced absence of competition from lawyers who could not leverage their investments sufficiently to assume the indemnification of class representatives or underwrite the high cost of mass litigation.

That risk-return void is not present in U.S. class representation. Lawyers are well accustomed to pricing contingency risk and readily enter into representations of mind-numbing expense and complexity. Class representation may not be a game for the faint of heart or the light of wallet. Nonetheless, the battles for control of mass cases in front of the JPML 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.

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15 See UAW v. Brock.
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 were shielded from competition from the bar. But this does not mean that there are no potential points of entry in the U.S. 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 helps create an entrenched bar. Under Rule 23(a)(4), courts are instructed to ascertain the adequacy of representation afforded absent class members. 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 assurances of fairness”16 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 perhaps as well some of the costs of representation. Perhaps – and perhaps not. It is simply not so clear that 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 writing17 and in my role in the American Law Institute’s project on aggregate litigation.18 The major class action cases of the past 15 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 that ability or the incentive to monitor the litigation activities of those who act on their behalf. Together this theme unifies the disparate technical questions presented in cases from

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16 Amchem.
18 See AMERICAN LAW INSTITUTE, PRINCIPLES OF THE LAW OF AGGREGATE LitIGATION (2010).
Amchem\textsuperscript{19} and Ortiz\textsuperscript{20} over a decade ago, to Wal-Mart\textsuperscript{21} and Smith v. Bayer\textsuperscript{22} more recently.\textsuperscript{23}

If we consider the question of representational fidelity to the interests of the absent class members as a matter of agency cost endemic to all principal-agent relations, the question is what strategies are available to reduce the potential for agency cost? Over the past 20 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. In the 1983 Third Circuit task force report on attorneys’ fees, chaired by my colleague Arthur Miller, there was a proposal 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 progress of the case. 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 monitoring the work of class counsel given the limited stake. 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 comes with the 1995 Private Securities Litigation Reform Act (“PSLRA”). Instead of selecting a class representative because of her typicality, however, 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 – generally a retirement fund or some other institutional player) as the intermediary between the class and class counsel. 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. 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. Instead of choosing a party distinctly at risk, as with the lead plaintiff under the PSLRA, CAFA sought to harness the structural independence of attorneys general as intermediaries. If the PSLRA

\begin{itemize}
\item Amchem Products, Inc. v. Windsor, 521 U.S. 591 (1997).
\item Ortiz v. Fibreboard Corp., 527 U.S. 815 (1999).
\item Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011).
\item 131 S. Ct. 2368 (2011).
\end{itemize}

\textsuperscript{23} For further discussion of the ability to bind the absent class to the litigation decisions of a class action, see Samuel Issacharoff, \textit{Assembling Class Actions}, ___ Wash. U. L. Rev. ___ (2013).
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\textsuperscript{24} has to be accompanied with notice to all the attorneys general of the state of residence of any class member. 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 the 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.\textsuperscript{25} In part, this impulse to compel greater judicial oversight of the interests of absent class members motivated the 2003 reforms of Rule 23 of the Federal Rules of Civil Procedure in requiring greater formal attention to the selection and compensation of class counsel.

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.\textsuperscript{26} 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 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 job and satisfying our wishes. In turn, we rely on a species of “super agents”\textsuperscript{27} 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.

\begin{thebibliography}{99}
\bibitem{24}Summary of CAFA jurisdictional threshold.
\bibitem{25}See Posner in Reynolds v. Beneficial; Chris Brummer, Note, ____. __ Colum. L. Rev. ___ (2005).
\bibitem{27}This is the term that Dan Ortiz and I applied to this problem of agents watching agents (presumably in turn watching further agents). Id. at ___.
\end{thebibliography}
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. 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 distribution of the litigation proceeds.

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. 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 constituent concerns of public officials. The gap between the two creates a new domain for agency costs, including the political objectives of attorneys generals that may be at significant remove from those of the class. 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.

Finally, for reasons well 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. Most class actions settle – 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 case law 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

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28 E.g., Hevesi.
29 See Third Circuit Task Force on Selection of Class Counsel (Jan. 2002), testimony of Keith Johnson, Chief Legal Counsel, State of Wisconsin Investment Board.
31 Maggie Lemos, Harv. L. Rev.
32 CITES.
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, 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:

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.33

Let me conclude this essay 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 U.S. is too small to accommodate the immediate demand that would be created, yielding a bonanza for funders and an unwarranted tax on legitimate class counsel.

But in the spirit of the exercise, I suggest that courts not certain about the propriety of a proposed class action, or concerned about the headless class problem, could seek to bring in funders as a way to get an incentivized

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33 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 to incentivize a maximum of monitoring.
monitor on the return to the class.\textsuperscript{34} By and large, courts are likely to be shocked or even horrified by the presence of funding entities acting behind courtroom lawyers and introducing the prospect of unaccountable decisionmaking 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. Some part of those requirements are guarantees of solvency in case of the harms, 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 Clausewitz’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. 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.

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,

\textsuperscript{34} 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. See also Miller & Macey on auctions.
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.

CONCLUSION

So far the debates over third-party funders have turned mostly on whether the practice should be allowed in the U.S. Some argue that it is just another source of excess litigation, others may worry about the further erosion of standards of professionalism. 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.

35 Beisner & Miller.
36 CITES