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VENTURE CAPITALISM FOR LAWSUITS? Why It Doesn't Exist, And What Alternatives For Financing Exist Instead

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This article is Part One of a two-part series by Professor Sebok on venture capitalism for lawsuits. Part Two will appear on this site on February 26, as one of Professor Sebok's biweekly columns. — Ed.

It is common knowledge that investors think about litigation when buying a stock. For example, on the most superficial level, one of the most important considerations in the minds of small investors who bought Microsoft last year was whether it will win its appeal of Judge Jackson's antitrust ruling. Similarly, savvy investors need to know whether biotech firms will be able to retain control of lucrative patents. This is why securities law requires full and accurate disclosure of all liability risks in prospectuses.

So if the stock market allows you to indirectly "invest" in litigation, why aren't there direct investment vehicles? Why isn't there something similar to Real Estate Investment Trusts (REITS) for lawsuits? If Fidelity can buy and sell pieces of office buildings in Houston, why can't it buy and sell lawsuits in the Harris County courthouse, and sell you a share of its portfolio?

This question is very complex, and, I believe, will become more important as civil litigation—especially in the area of mass torts–becomes more sophisticated on the plaintiff side.

Why We Don't Currently Trade Shares in Tort Suits, and What We Do Instead

Right now there are at least three reasons why shares in tort suits are not traded in secondary markets in the way that shares in oil companies are. First, it is not obvious that it would be economically viable to create a secondary market in lawsuits. Second, many states have laws that make it illegal to sell an interest in a lawsuit, and unethical for a lawyer to fund his or her clients' lawsuits. Finally, from a sociological and psychological point of view, we may not want to separate victims from their lawsuits to the point where the main reason for litigation is profit, not personal vindication.

Already, in a number of states, companies have formed that will forward money to plaintiffs who are defending on appeal verdicts they won at trial. Judgement Purchase Corp. of San Francisco, for example, is a venture capital firm, plain and simple. It is not a law firm. It does not give advice or offer any legal services. All it does is provide "seed" money in cases where a plaintiff has been awarded a verdict that the defendant is trying to overturn.

On a smaller scale, The Lions Group in New Jersey does the same thing as JPC. The Lions Group "lends" money to individuals who would like to maintain their lawsuits but need money immediately. Their typical client would be an auto accident victim who needs cash to pay for medical expenses and cannot wait years to receive a jury verdict or a deferred settlement.

Like JPC, the Lions Group takes all the risk: if the defendant's insurer refuses to settle and the plaintiff loses her case, they lose all the money they advanced to their client. On the other hand, if the client gets a victory or a hefty settlement, they can claim upwards of 150% - 200% of their original investment. Another company, called Expertfunding.com, also helps strengthen plaintiffs' resolve before trials. They will supply a client with the expert witnesses that could make the difference between success and failure in complex civil litigation.

The Market for Litigation

Clearly there is a market, of sorts, in litigation. The sort of arrangements invented by JPC and Expertfunding.com were unheard of twenty years ago. They are not fundamentally different from the realities faced by individual lawyers and individual litigants in the American contingency fee system. What makes them different is the scale and efficiency that they bring to bear to these cases.

Usually a single case is an all-or-nothing bet for the individual plaintiff. By selling his or her interest, the plaintiff spreads the risk, in effect, among many other plaintiffs. Similarly, for many solo practitioners, a single lawsuit is conducted in an information vacuum. Unlike big defendants' firms, solo practitioners do not have the money or experience to evaluate or price their clients' cases. But once the client sells a share of her interest to a venture capital firm, the lawyer enjoys the benefit of the firm's expertise and collective experience. To the extent that these litigation venture capital firms spread risk and share information, all they do is level the playing field between plaintiffs' lawyers and corporate defense lawyers.

Ethics Rules that Prevent Sophisticated Litigation Venture Capital Firms

Still, the kinds of investments described above are pretty simple compared to those typical of the sophisticated worlds of investment banking and real estate. Why has it taken so long for venture capitalism in litigation to achieve even the roughest sort of organization? One reason is that the law has been very hostile to lawyers' — and by extension, investors' — promoting litigation.

Most states, through their rules of professional ethics, prohibit what is called "maintenance": a lawyer may not advance litigation expenses to a client contingent on the outcome of a suit. So lawyers—those who would be closest to and best able to evaluate plaintiffs' suits—have been technically barred from "investing" in their clients' lawsuits.

The rule against maintenance is quite quaint once one thinks about the real world of mass-torts litigation. The Castano Group, for example, asked 100 lawyers to contribute $1 million each to fund research and litigation costs against the tobacco industry. And lawyers risk their own money all the time in contingency fee litigation. When a lawyer accepts a contingency fee case, she accepts the risk that if her client loses, she will never be paid.

Some might say that the rule against maintenance is unnecessary in the Twenty-First Century. In any event, many other institutions have come forward to do what the client's lawyer may not do. As long as the person giving the check to the plaintiff is not the plaintiff's own lawyer, that person is not constrained by the rule of professional ethics.

If that person (or entity) is a retired lawyer, a bank, or an investment firm, he (or it) may lend money and perhaps even purchase an interest in the plaintiff's case. That is, they may do all these things as long as they do not violate the laws against "champerty" — another quaint concept that has begun to bend under the pressure of the marketplace.

There was a time when any sort of contract regarding the sale of an interest in the outcome of a lawsuit was thought to be "champertous," and therefore illegal. Things have changed in two ways. First, the definition of champerty has been narrowed, so that the concept prohibits less than it once did. Second, a few states, such as Massachusetts and New Jersey, have simply done away with the very concept altogether — paving the way for a new future in which there can be a true market in lawsuits. Why this has happened and whether it is a good thing will be explored in my next article.