ARTICLE

A Market in Litigation Risk

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Why do people hate litigation? Corporate America, in particular, complains that litigation is too expensive, time consuming, and unpredictable. But these are not distinguishing features of litigation. When a company launches a new product or enters into a new business line, it may face a process that is just as expensive, time consuming, and risky as litigation. The company will invest time and money in product development and market research and will bear the risk that the product ultimately will fail and its efforts will result in a loss.

What makes litigation seem so daunting, and distinguishes litigation risk from most other risks, is that litigants lack a mechanism to dispose of litigation risk. Virtually any other risk that a business faces can be spread or eliminated via the market. If a new business line is too costly or risky for a company to pursue on its own, it can find a larger partner and undertake a joint venture, or it can raise capital for the project through public or private markets, in the form of debt or equity. Moreover, companies not only spread business risks through the capital markets, but also dispose of some risks that they simply do not want to bear at all. An airline that does not want its annual profits to turn on fluctuations in oil prices can use hedge contracts to offload that risk to someone else. So too can a farmer offload risk through the futures markets and insurance policies and make sure that his annual income does not turn on fluctuations in crop prices or on a catastrophic fire. When it comes to litigation risk, however, a company that is sued generally is stuck with the risk. Insurance companies do not sell after-the-event insurance policies for lawsuits that already have been filed and there isn't a market in which litigants can trade away litigation risk. Neither the legal profession, the insurance industry, nor the capital markets has yet found a way to relieve litigants of risk.

This Article highlights the costs of this failure of risk management and seeks to develop a mechanism to relieve litigants of litigation risk. Moreover, in developing a new market for legal risk, the Article sketches out a new role for lawyers as market participants. Instead of working for clients with legal problems, some lawyers might work for investment funds, investment banks, or insurers that invest in, and profit from, legal risk. Indeed, upon departing from their traditional role as agents for risk-bearing clients, lawyers might even use their skills to trade in legal risk for their own account—as principals, rather than agents. Lawyers can benefit litigants and society not only by serving clients, but also by making markets in legal risk.

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INTRODUCTION

If, as Oliver Wendell Holmes observed, the "law" is "nothing more" than "prophesies of what the courts will do in fact,"[1] then the practice of law is essentially a predictive enterprise. The lawyer's job is to examine the facts of his client's situation and the relevant legal materials and to predict how a court will apply the law to the facts. When law schools educate students "to think like lawyers," they are in important respects teaching their students to think like judges and anticipate judicial decisions. And, given this emphasis on predicting judicial decisions, it is no surprise that the bench, the bar, and the academy place a great premium on rendering judicial decisions more predictable and accessible to lawyers and their clients.

But no matter how much judges may strive for clarity and predictability, law practice will always be laden with uncertainty. It is a lawyer's responsibility not only to internalize the judicial perspective and predict judicial reactions, but also to manage legal risk when the law is unclear and judicial rulings are difficult to predict. The transactional lawyer rarely says "yes" or "no" to a transaction and more often helps clients structure conduct so as to manage legal risks in the face of uncertainty.[2] The litigator likewise tends less often to give black or white answers—about winning or losing a lawsuit—and more often to advise clients on how to handle litigation, when to settle, and for how much.[3] Lawyers are risk managers whose specialized training gives them a unique understanding of a particular category of risk.

Indeed, in important respects law practice is simply another branch of risk management. The very same clients who rely on lawyers to manage legal risk often rely on other experts to manage a variety of other risks. One expert may evaluate the risk of natural disasters, such as hurricanes or earthquakes. Another expert may focus on market risks, perhaps looking at broad threats to the global economy or perhaps specializing in narrower risks affecting particular industry sectors (for example, home building or computer software) or particular commodities (for example, oil or corn). Although the process of predicting the reactions of courts, markets, and natural forces may differ dramatically, there is also a strong similarity among these various endeavors. Professionals in each field may rely on different tools and different skill sets

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1 O.W. Holmes, *The Path of the Law*, 10 Harv L Rev 457, 461 (1897).

2 See Jonathan T. Molot, *How Changes in the Legal Profession Reflect Changes in Civil Procedure*, 84 Va L Rev 955, 969 (1998).

3 See William B. Rubenstein, *A Transactional Model of Adjudication*, 89 Georgetown L J 371, 372 (2001); Molot, 84 Va L Rev at 971 (cited in note 2). See also Robert J. Rhee, *Tort Arbitrage*, 60 Fla L Rev 125, 140 (2008) ("[T]he dispute resolution process is an exercise in risk management wherein risk and return are traded.").

to make predictions and weigh odds, but they all are in a fundamental sense engaged in managing risk in the face of uncertainty.[4]

There remains, however, an important difference between litigation-risk management and risk management in these other fields—a difference which reflects a serious shortcoming of law practice today. Unlike lawyers, professionals in these other fields not only advise on the nature and extent of risk, but also can relieve risk bearers of risk—enabling them to hedge or offload it through market transactions. An airline concerned that its annual profits may turn on fluctuations in oil prices will hire an expert not only to evaluate the risk of a spike in oil prices but also to employ hedge contracts or trade in the futures markets to dispose of that risk. Indeed, corporate risk managers routinely take advantage of a variety of hedge contracts and insurance policies to protect against all sorts of market risks and natural and manmade disasters. Nor are these risk-transfer mechanisms available only to large corporations. The family farmer may be as well equipped as the multinational corporation to offload risk via the futures markets and to make sure that his annual income does not turn on fluctuations in crop prices. And individual homeowners carry property and liability insurance just like big corporations. The insurance business, the futures markets, and a burgeoning risk-management industry with an ever-expanding array of hedge offerings can relieve risk bearers of potentially devastating risks and pool those risks over broader groups of capital providers better able to bear them. As a result, risk managers in various fields are well equipped not only to advise on risks but also to dispose of them.

Risk-transfer mechanisms have developed in these other fields in large part because experts in these fields have not confined themselves to the singular role of advising risk-bearing clients. To be sure, some risk managers perform a function analogous to that of lawyers—helping clients to structure conduct so as to minimize risk. But this is not the only way that a risk expert can put his skills to work. Instead of advising the airline or farmer worried about commodity prices or storm damage, an expert may advise an investment bank, hedge fund, or insurance company that is contemplating relieving the airline or farmer of risk. This latter group of risk experts looks at risk as a profit opportunity rather than an evil to be avoided. Moreover, upon viewing risk as a profit opportunity, many of these risk experts begin to trade in risk as principals, rather than as agents. Many, if not most, are

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4 See Joseph Grundfest and Peter Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 Stan L Rev 1267, 1269 (2006) ("Lawsuits and investment projects have much in common.").

compensated based on their performance—that is the way investment banks pay their traders and hedge fund investors pay hedge fund managers—and some amass sufficient capital to trade in risk for their own accounts, rather than those of employers or investors.

When it comes to legal risks, in contrast, the risk-transfer mechanisms available to risk bearers are not nearly as well developed, in large part because lawyers cling to their traditional role as agents for risk-bearing clients. Although the legal profession has come to recognize just how important risk management is to law practice, and lawyers have taken increasingly sophisticated approaches to managing risk for their clients,[5] the legal profession has not yet taken the important step that other risk managers have taken toward viewing risk not only as an evil that a particular client may wish to avoid but also as a profit opportunity that some other market participant may wish to embrace. With few exceptions,[6] lawyers confine themselves to *advising* their clients on legal risks—on how best to handle a contract dispute, a regulatory challenge, or a lawsuit—and do not offer clients a way to hedge against legal risk while the relevant problems are still pending.[7] It may be that lawyers do not think they can price litigation risk accurately and for this reason are unable to set a purchase price for a litigation-risk transfer. It may be that lawyers lack the capital to absorb the downside risk of a catastrophic litigation loss and have not been able to find third-party capital providers willing to accept this sort of risk. Or it may be that even if lawyers could price the risk and find capital providers to absorb it (as I argue is feasible in this Article), the lawyer's professional role nonetheless inhibits lawyers from using their skills as market participants in their own right, or as brokers for profit-seeking capital providers, rather than simply as agents for risk-bearing clients. Whatever the reason, though, the legal profession has largely failed to

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5 For a discussion of changing attitudes toward legal risk management a generation ago, see Detlev F. Vagts, *Legal Opinions in Quantitative Terms: The Lawyer As Haruspex or Bookie?*, 34 Bus Lawyer 421, 421–29 (1979). For a discussion of just how unsophisticated the financial modeling of litigation remains when compared to the modeling of other business decisions, see Grundfest and Huang, 58 Stan L Rev at 1271 (cited in note 4).

6 See notes 30–31 and accompanying text.

7 I do not weigh in on the question of how lawyers can best manage risk by reaching a cost-effective resolution with the opposing party. For a discussion of those issues, see Ronald J. Gilson and Robert H. Mnookin, *Disputing through Agents: Cooperation and Conflict between Lawyers in Litigation*, 94 Colum L Rev 509, 512 (1994) (arguing that by applying their skills, lawyers "can play an extraordinarily constructive role in disputes—as peacemakers who facilitate efficient and fair resolution of conflict when their clients do not do so for themselves"); Rubenstein, 89 Georgetown L J at 372 (cited in note 3) (discussing how modern litigation efforts require lawyers to broker deals, not conduct traditional courtroom work). Instead, I focus on how lawyers might change their self-conception so as to find ways to dispose of litigation risk while disputes remain pending.

create markets that could relieve risk bearers of legal risk. And, as a result, the risk-transfer mechanisms available for legal risks fall well short of those available in other fields.

This absence of a well-developed risk-transfer mechanism for litigation risk in particular may help explain why litigation risk is so daunting for American businesses and why lawyers and litigation are so unpopular. To get a sense of the costs associated with this shortcoming of legal risk management, consider the plight of a company that finds itself defending a relatively large lawsuit—not the sort of run-of-the-mill, low-stakes lawsuit that the company's lawyers routinely handle without involving senior management, but rather a high-stakes suit that could substantially affect the company's financial condition. The company may ask its lawyers at the outset how much the lawsuit will cost (in legal fees and payments to the plaintiff), but the lawyers will only be able to make predictions, and very likely there will be more than one trajectory that the lawsuit may follow. At best, the defendant might hope for a quick, inexpensive disposition in the form of a reasonable settlement or perhaps even a victory in motion practice. At worst, the company might have to suffer through protracted, expensive litigation and face the possibility of a devastating judgment. For as long as a lawsuit is pending, then, the defendant remains exposed to a broad range of potential liability that it does not consider to be part of its core business and that it does not want to affect its financial condition.[8] Indeed, how much the company ultimately will pay for the lawsuit will depend only in part on the company's pre-lawsuit conduct and the merits of the lawsuit. The resulting settlement or judgment will also depend upon the performance of its own lawyers and those of the plaintiff, on the views of the presiding judge and/or jury, and on a host of procedural rulings that may be only tangentially related to the merits. Some of these factors—such as the judge, the jury, and opposing counsel—are completely beyond the party's control. Other factors may be within its control—for example, hiring a good general counsel and an effective, yet cost-conscious, law firm may reduce total litigation payouts—but even those factors are not within the company's core business mission. The company will want its profits to turn on the quality of its products or services, the effectiveness of its marketing, and the care with which it manages its operating costs. It simply will not want its bottom line to depend upon how well it handles litigation. The risk of pay-

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8 See Geoffrey Miller, *On the Costs of Civil Justice*, 80 Tex L Rev 2115, 2115 (2002) ("In most cases, the plaintiff can sell *res judicata* only to the defendant, and the defendant can buy it only from the plaintiff.").

ing more or less for a given lawsuit is not the sort of core business risk that the company is ideally suited to bear.[9]

That a company's financial condition may depend upon the outcome of a pending lawsuit can be of concern not just to the company's management and owners but also to third parties whose perception of the company may be vitally important to its success. When the company decides to borrow money to finance its operations—either in a private placement or through a public bond offering—its ability to do so and its cost of financing will depend upon how these third parties view its future earnings and cash flow. When a company seeks an equity investment or is the potential subject of a private sale or public offering, the due diligence into the company's future prospects will be even more intense. To the extent that future earnings will depend upon the company's core business abilities—factors like production prowess, marketing skill, cost control, and management experience—potential lenders or investors are reasonably well equipped to assess the company's future earnings. That is, after all, what public and private capital markets are all about—bringing capital to productive enterprises based on predictions about how that capital is best employed. But when a company's future prospects depend upon high-stakes litigation, potential lenders and equity investors are even less likely than the company's own management to be able to assess the relevant risks. In some instances, potential investors or lenders may consider large, pending litigation a deal breaker. If the suit is potentially big enough relative to the size of the company, the investor or lender may simply be unable or unwilling to spend the time to become comfortable enough with the risk. Or, if the capital supplier is willing to proceed despite the risk, it will likely do so on much less favorable terms for the company—compensating itself for the risk by reducing its valuation of the company (in the case of an equity investment) or increasing the interest rate it will charge (in the case of debt). The true costs of high-stakes litigation to a corporate defendant can thus far exceed the time and money it actually devotes to the litigation process.

To understand just how much failures in legal risk management can cost American businesses, it may help to distinguish among different kinds of litigation costs, just as Guido Calabresi distinguished among dif-

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9 See J.B. Heaton, *The Risk Finance of Class Action Settlement Pressure*, 4 J Risk Fin 75, 80 (Spring 2003) (explaining that while companies are better situated to bear the financial risk of litigation than typical defendants, they "simply do not have the specialized and case-specific knowledge necessary to price the risk"). See also *In re Rhone-Poulenc Rorer Inc*, 51 F3d 1293, 1298 (7th Cir 1995) (discussing how the defendant, a large corporation, might be pressured to settle rather than contest plaintiffs' claims given the dramatic uncertainty with respect to the value of the final judgment); Rhee, 60 Fla L Rev at 150–54 (cited in note 3) (discussing settlement pressures in tort litigation and suggesting a "direct connection between the theory of valuation and the underlying structure of accident law").

ferent kinds of substantive accident costs.[10] In his work on substantive accident law, Calabresi distinguished among the primary, secondary, and tertiary costs of accidents, and these terms may be inverted to help us understand the importance of good litigation-risk management.

Calabresi considered primary accident costs to be the actual costs of accidents and preventative measures.[11] When someone is injured at a railroad crossing or a railroad spends money putting up crossing signals to avoid such accidents, these are primary accident costs. Substantive accident law is supposed to be structured so as to promote efficient deterrence and minimize these primary accident costs. Secondary accident costs, according to Calabresi, are the costs associated with bearing primary costs.[12] If an accident victim at a railroad crossing misses weeks of work and pays catastrophic medical expenses but receives no compensation for his injuries, such an accident can be devastating for him and his family. If, however, the costs of railroad accidents are spread over those who benefit from railroad service—railroad owners, freight customers, and passengers—the costs are more easily borne. It is much harder for a single victim to bear a million-dollar loss than for a million people to contribute one dollar each.[13] Finally, the tertiary costs of accidents, according to Calabresi, are the transaction costs associated with assigning responsibility for accidents.[14] When the railroad victim sues the railroad for compensation, both sides bear litigation expenses, and society as a whole bears the burdens of operating the presiding court system.

For a scholar interested in litigation-risk management, rather than substantive law, these three sets of costs can be inverted to illustrate just how burdensome nontransferable litigation risk can be for our economy. The costs of adjudication that Calabresi relegates to tertiary status are the "primary costs" of dispute resolution. In comparing civil litigation, administrative adjudication, and private ordering mechanisms, scholars of procedure study which is the cheapest dispute resolution mechanism. They ask which system will cost the parties and the government the least time and money in absolute terms. They also advocate procedural reforms within each system that are designed to reduce those primary litigation costs.[15] This Article, in contrast, does not address primary

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10 See generally Guido Calabresi, *The Costs of Accidents* (Yale 1970).

11 See id at 26.

12 See id at 27–28.

13 See id at 39–67.

14 See Calabresi, *The Costs of Accidents* at 28, 251 (cited in note 10).

15 See, for example, Stephen B. Burbank and Linda J. Silberman, *Civil Procedure Reform in Comparative Context: The United States of America*, 45 Am J Comp L 675, 676 (1997) ("Litigation reform efforts in the United States have sounded a consistent theme of the need to reduce expense and delay.").

litigation costs. It focuses instead on the secondary and tertiary costs that arise when litigants lack an effective mechanism to dispose of litigation risk.

The secondary costs of litigation are the costs associated with the concentration of primary costs upon entities that are ill suited to bear them. Just as accident costs are more easily borne when they are spread over a larger pool, so too can litigation risk be more easily borne when it is spread over a broader group. A defendant facing a lawsuit that is large enough to affect its financial condition simply is not well equipped to bear that risk on its own. As noted above, the defendant may get off easily with a quick, efficient settlement, or it may bear the brunt of protracted litigation and a devastating judgment that could negatively affect its financial condition. If the risk could be transferred and then spread over a larger pool of similarly situated defendants, this would reduce the "secondary" costs of litigation, just as loss-spreading reduces the secondary costs of accidents under Calabresi's framework. Even if we did nothing to reduce the time and money spent on the litigation process, we could ease the burdens on corporate defendants by spreading litigation risk over a larger pool of risk bearers.[16]

Moreover, in some instances, litigation's largest expense may stem from the "tertiary" effects that pending litigation may have on litigant conduct. A $50 million lawsuit against a company can easily prevent that company from raising $250 million or even $500 million in debt or equity to finance new, productive business activities. At the very least, the uncertainty surrounding a significant potential liability may increase a company's cost of capital by depressing its stock price or increasing the interest rate it must pay on its debt. Where litigation risk interferes with an equity investment, a debt refinancing, or a merger or acquisition, the tertiary costs of litigation can dwarf the primary

16 Some would say that it is inefficient for public companies to buy any sort of insurance, as their investors can hold a diverse portfolio of stocks and in this manner spread the risk of a catastrophic event befalling any one company. For a discussion of why companies nonetheless insure, see generally Louis De Alessi, *Why Corporations Insure*, 25 Econ Inq 429 (1987). See also Rhee, 60 Fla L Rev at 153 (cited in note 3) (discussing reasons for insurance in the context of risk management in litigation); Robert Cooter, *Towards a Market in Unmatured Tort Claims*, 75 Va L Rev 383, 394 (1989). It is beyond the scope of this Article to make a broader argument on why companies are willing to pay premiums for insurance policies or hedge contracts of any sort. Proceeding from the reality that companies do hedge or insure against all sorts of risks, this Article asks whether lawyers might create a market mechanism for the transfer of legal risk that is of the sort widely available today for a variety of other risks. It may be worth noting, however, one argument in favor of insuring legal risks in particular: namely, that litigation risk is a specialized risk that a specialized legal insurer might be better suited to price and manage than the companies that currently must bear it. If companies are forced to bear litigation risk themselves, markets may misprice it (artificially depressing a company's share price, for example), and corporate managers may mismanage it (for example, by allowing risk aversion to lead them to pay more to settle a suit than it is worth so as to resolve the matter and put it behind them).

costs. In those instances, a system of risk pooling would do more to reduce the costs of litigation than radical procedural reform ever could hope to achieve.

The goal of this Article is to develop a risk-transfer and risk-pooling mechanism that could reduce the secondary and tertiary costs of litigation. Under the system I have in mind, the hypothetical defendant described above would not have to retain litigation risk for the duration of a lawsuit. Instead, it could choose to pay the "expected value" of its lawsuit plus a premium to protect against a higher-than-expected loss. After making such a payment, the litigant would still retain at least some of the risk, so as to align incentives and ensure its cooperation going forward. But the risk of protracted, expensive litigation and of a devastating judgment would no longer be concentrated with the single defendant. Instead, the risk and expense would be spread over a larger pool of lawsuits. By pooling litigation risk, such a mechanism could reduce the secondary costs of litigation. Moreover, by relieving defendants of litigation risk, it would remove an obstacle to productive economic activity and thereby reduce the tertiary costs of litigation as well.

Although this Article focuses on litigation risk borne by corporate defendants, it is part of a larger project that will examine a variety of ways that legal risk management might be improved and lawyers might move beyond simply advising on legal risks and begin actually relieving clients of risk. The larger project will examine plaintiffs as well as defendants and would consider legal risk-transfer mechanisms in transactional settings where no litigation is pending.[17] The goal is not only to integrate risk management into models of lawyering[18]—building upon Holmes's observation regarding the centrality of prediction to the practice of law—but also to sketch out an alternative model of

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17 See, for example, Jonathan T. Molot, *A Market in Litigation Claims: A Market Alternative to Judicial Settlement Efforts* *28–30 (unpublished manuscript, 2008). For an example of how plaintiffs' claims might not only be transferred, but securitized and traded on an exchange, see Benjamin C. Esty, *The Information Content of Litigation Participation Securities: The Case of CalFed Bancorp*, 60 J Fin Econ 371, 394 (1999). For market-based proposals under which plaintiffs' attorneys and/or third-party capital providers would bid for class action lawsuits in an auction setting, see Jonathan R. Macey and Geoffrey P. Miller, *A Market Approach to Tort Reform via Rule 23*, 80 Cornell L Rev 909, 913–15 (1995) (suggesting that one of the benefits of such a system would be to better align the interests of plaintiffs' attorneys with the interests of the class members); Jonathan R. Macey and 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).

18 Consider David B. Wilkins and G. Mitu Gulati, *What Law Students Think They Know about Law Firms*, 69 U Cin L Rev 1213, 1213 (2001) ("Although the majority of legal scholarship continues to focus on law, a number of academics have begun to investigate the norms, institutions, and practices of lawyers."); David B. Wilkins, *The Professional Responsibility of Professional Schools to Teach about the Profession*, 49 J Legal Educ 76, 76 (1999) (lamenting "the law school's systematic and pervasive failure to study and to teach about the profession").

lawyering that does not hinge upon client service. There is a small group of lawyers today who go to work as traders for hedge funds and investment banks, rather than law firms, and who view legal risk as a profit opportunity, rather than an evil to be avoided.[19] But the legal profession generally views these professionals as lapsed lawyers—as part of the large cadre of people trained as lawyers who do not practice law but instead go into business. I suggest, however, that client service need not be the defining feature of lawyering. A lawyer may use the same skills and engage in the same predictive enterprise whether he is advising a client appearing before a judge, advising a hedge fund buying stock in that company, or making an investment in the company for his own account. Moreover, a lawyer who uses his legal skills to transfer legal risk from risk-averse litigants to profit-seeking investors or insurers may serve the litigants (and society) just as effectively as those lawyers who perform the traditional professional function of advising clients. The legal profession should embrace lawyers who choose to work as principals or brokers in a market for legal risk just as much as it embraces lawyers who cling to their traditional role as agents for clients.

I have chosen to focus on the litigation risk borne by defendants in this first phase of the project in large part because corporate defendants are the most vocal critics of our system of litigation and our legal system more broadly. I suggest that the burdens these defendants bear cannot be blamed entirely on the litigation process itself (or on the plaintiffs or judges whom corporate defendants often blame). Rather, the problems of civil litigation today stem at least in part from a market failure. If defendants could pin down litigation risk and dispose of it early on in a suit, they might not complain so bitterly about expensive, high-stakes litigation. Even if we did nothing to reduce the primary costs of litigation, we might make a significant dent in the problem by reducing the secondary and tertiary costs through litigation-risk transfers.

Before proceeding with my project, two caveats are in order. First, I do not want to overstate my ambitions. The risk-transfer mechanism I describe in this Article would likely work for only a small subset of cases, primarily those in which pending litigation is very large and threatens to interfere with business transactions (most often private-equity deals, or public mergers or acquisitions). The secondary and tertiary costs of litigation are at their highest where lawsuits disrupt deals, and it is in this narrow context that a risk-transfer mechanism would be of tremendous value—indeed, more valuable than conventional procedural reform designed to reduce primary litigation costs. Outside this context, however, transaction costs and adverse-selection problems

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19 See Part III.D.2.

are likely to loom too large for my proposed risk-transfer mechanism to be of widespread use.[20] Indeed, where a corporate defendant faces a routine, low-dollar lawsuit, it will likely be far better off retaining the expense and risk of the lawsuit for itself and disposing of that risk via a settlement with the plaintiff rather than a transaction with a third party. This Article may best be read as a business model for litigation risk managers in one discrete area, rather than as a proposal to reduce litigation costs across the board for run-of-the-mill litigation. The hope is that this model may do some good in its sphere and highlight the need for further exploration of legal risk markets in other spheres.

Second, I do not want to overstate the novelty of what I am doing. Although I have said that legal risk managers generally confine themselves to advising on legal risk and do not actually relieve clients of that risk, there are two important, albeit limited, exceptions to this rule. Rather than invent an entirely new model of risk transfers, I borrow from and build upon two existing models. The first model is the contingent fee arrangement. When a plaintiff's lawyer accepts a case on a contingent fee basis, he absorbs from his client the risk that the recovery will not be enough to cover litigation expenses. Contingent fee arrangements do not ordinarily work for defendants, however, as defendants need protection not only from legal fees and litigation expenses but also from judgments or settlements. For a variety of reasons I explore below, lawyers to date have not been able to relieve defendants of the downside risk of a large adverse judgment.

The other model I build upon is conventional liability insurance offered by most major insurance carriers. In contrast to the contingent fee arrangement, the general liability insurance policy *is* available to defendants, but it is available only for *specified* categories of litigation-triggering events and is available only *before* something has gone wrong and a lawsuit has been filed. Companies face all sorts of lawsuits that either clearly are not covered by liability insurance—indeed, most contract disputes are uninsurable—or else are subject to coverage disputes or policy limits that render the availability and extent of insurance coverage a major source of uncertainty.[21] Even where there is some insurance coverage potentially available, a company will often face uncertainty not only over how much it will have to pay the plaintiff but also over how much, if any, it will be able to collect from insurance. For as long as a suit is outstanding, a defendant will thus be stuck with the risk of a loss that will not be covered, in whole or in part, by insurance. The

20 See Part I.A.2.

21 Many litigation-triggering events are not covered by conventional liability insurance policies, which exclude "business risks" and conventional commercial contract disputes. See notes 25–27 and accompanying text.

insurance industry today generally does not offer after-the-event litigation coverage to defendants who lack conventional insurance or have some coverage but are unsure about whether it will suffice. Insurers are willing to insure against many liability-triggering events, but they do not insure litigation risk for events that have already occurred.

The risk-transfer mechanism I seek to develop in this Article is in some sense a hybrid between the contingent fee arrangement and the liability insurance policy. I am proposing a regime under which lawyers would team up with capital providers to price and absorb litigation risk from corporate defendants after a litigation-triggering event has occurred and a lawsuit has been filed.

The Article is organized as follows. Part I suggests that although there is not currently a market for litigation risk, and several major obstacles stand in the way of creating such a market, a market in litigation risk is indeed feasible. The discussion provides a roadmap for lawyers willing to stray from their traditional model of client service and to function as market participants, rather than just advocates or advisors. Part II then argues that some (but by no means all) lawyers *should* pursue such a course; it defends litigation-risk transfers on normative grounds and explores the effects that a litigation risk market might have on litigation dynamics, on primary conduct, and on the market for legal services. Finally, Part III addresses specifically what the bar, the bench, and other government officials can do to foster the development of a market in litigation risk, exploring several legal and policy reforms that may bear upon the feasibility and utility of litigation-risk transfers. Essentially, Part I asks whether we can transfer litigation risk, Part II asks whether we should transfer litigation risk, and Part III asks what we can do to facilitate litigation-risk transfers.

I. IS A MARKET IN LITIGATION RISK FEASIBLE?

If lawyers were to try to relieve defendants of some of the litigation risk that they currently must bear on their own, the most obvious model to follow and build upon is the contingent fee model employed by plaintiffs' lawyers. Plaintiffs' attorneys routinely absorb some risk from their clients and make it their business to build a diverse pool of litigation risk from a diverse pool of clients. Such arrangements make a great deal of sense because they transfer risk from the one-time litigant to an entity better able to bear it. Litigation risk simply is not as daunting for a law firm that has a diverse pool of cases and views litigation as its core business.

But if litigation risk is successfully shared by contingent fee lawyers on the plaintiffs' side, there are three significant differences between conventional contingent fee arrangements and the defense-side risk transfers that are the subject of this Article. First, plaintiffs' lawyers and their clients can easily price contingent fee arrangements using a standard formula that sets "zero" as the benchmark for success and gives lawyers a percentage (typically one-third) of any recovery that exceeds zero. In order to absorb litigation risk from defendants, in contrast, lawyers would need to agree with their clients in advance on a lawsuit's value.[22] Does a client want to purchase protection against a judgment exceeding $5 million, $50 million, or $100 million? Do its lawyers share the client's view of the expected value of the suit and the downside risks? Agreeing on a price at the outset—based on the client's and the lawyer's predictions about litigation—represents a major obstacle to risk pooling on the defense side.

Second, and potentially just as significant, the downside risk that litigation defendants would like to offload is one that lawyers alone generally are unable to bear. The risks and costs that contingent fee lawyers absorb from plaintiffs are simply the out-of-pocket expenses and opportunity costs associated with the litigation process. When a settlement or judgment falls short of client expectations, the contingent-fee plaintiffs' lawyer may earn less than he had hoped, but he will not have to compensate the plaintiff for the shortfall. Litigation defendants, however, need protection not only against litigation costs but also against a much bigger risk—the downside risk of a costly adverse judgment. Lawyers typically lack the capital to absorb this risk on their own and therefore would need to find a source of capital before they could relieve their clients of the risk of a large adverse judgment. To transfer the downside risk of an adverse judgment, we would need to find a third-party capital provider to back lawyers and supply the necessary risk capital.[23]

Third, even if one could price litigation risk accurately and find capital providers willing to assume the risk, there is the remaining question of litigation control. When plaintiffs and lawyers agree to a contingent fee arrangement on the plaintiffs' side, the two entities who share litigation risk—lawyers and clients—work together to make decisions about litigation strategy. Although the plaintiff ultimately calls the shots, the lawyer has a great deal of influence over the strategy. Once we introduce a third-party capital provider to absorb downside risk from defendants, the question arises as to who will control litigation. Who gets to decide whether to be aggressive or conciliatory, whether to make a settlement offer, and if so, for how much? These questions are not in-

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22 See Miller, 80 Tex L Rev at 2116 (cited in note 8) ("[T]he value of the claim to be sold is often very difficult to appraise. Litigation claims are unique, not fungible, and often involve important elements of value known only to one party at the outset of the transaction.").

23 For a discussion of the effects on the plaintiffs' side of substituting a third-party capital provider for a contingent-fee plaintiffs' attorney, see Samuel R. Gross, *We Could Pass a Law . . . What Might Happen If Contingent Fees Were Banned*, 47 DePaul L Rev 321, 325–30 (1998).

surmountable—and they routinely arise where defendants and insurance companies share an interest in litigation—but they nonetheless need to be addressed.

These three obstacles to the free exchange of litigation risk on the defense side can also interfere with the free exchange of litigation claims on the plaintiffs' side. Indeed, where plaintiffs want not only to offload the costs of litigation via a contingent fee arrangement but also to sell portions of their claims for cash, the same three sets of problems are likely to get in the way: (1) claims will need to be priced accurately, (2) third-party capital may be required to buy the claims, and (3) questions of litigation control will arise. The problems that surround plaintiff-side and defense-side risk transfers are sufficiently distinct, however, that I confine my discussion here to defense-side risk transfers and reserve plaintiff-side risk transfers for a separate article that will explore the feasibility and desirability of a robust market in plaintiffs' claims.[24] That being said, my treatment below of the obstacles to a defense-side risk-transfer market may nonetheless bear upon the feasibility of other sorts of legal risk transfers as well.

A. Pricing Litigation Risk

The challenge posed by pricing litigation risk represents a significant obstacle to developing a risk-transfer mechanism on the defense side.[25] If pricing were not an obstacle, I expect that insurance companies would routinely offer litigation risk insurance, just as they insure against other sorts of risk. Upon being sued for something that a company did not insure against in advance (perhaps because it was uninsurable or unforeseeable), the company would simply buy litigation insurance at that moment. It would not be insuring against the accident or business dispute that had triggered the lawsuit, for that event would already have occurred. Rather, the company would buy an "after-the-event" insurance policy that would protect it against a higher-than-expected judgment.[26] There would be a deductible for the ex-

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24 See Molot, *A Market in Litigation Claims* at *9 (cited in note 17).

25 In the companion paper on plaintiff-side risk transfers, I highlight the shortcomings of contingent fee arrangements and the need for a more robust market in litigation claims that would enable plaintiffs to monetize portions of their claims and offload the risk of collecting nothing. See id at *24–25.

26 In England, plaintiffs and defendants alike can buy "after-the-event" litigation insurance to cover their opponents' legal fees in case they should lose and be subject to fee shifting. See, for example, David Wilkinson and Adam Blanchard, *Mass Tort Treatment of Pharmaceutical Product Liability Cases in England*, 73 Defense Counsel J 264, 273–74 (2006). See also Gross, 47 DePaul L Rev at 330–35 (cited in note 23); Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 Chi-Kent L Rev 625, 631–32 (1995) (suggesting that British rules against champerty—allowing third parties to insure a plaintiff for the cost of

pected judgment or settlement, and an insurance claim only where the judgment or settlement exceeded that amount.

Insurance companies do not typically offer this sort of "after-the-event" litigation insurance because they do not believe they can price it accurately. An insurance company—or any other capital provider—seeking to price litigation risk would encounter three related problems. First, there is the basic question of whether litigation risk is susceptible to accurate pricing or whether litigation is just too unpredictable to price. Second, even if one could price litigation risk given complete information, there are a host of information asymmetries and adverse-selection problems that arise because those seeking to dispose of litigation risk often know more about that risk than those who would assume the risk. Third, there are work product and privilege issues that must be addressed if information is to be shared with a third party seeking to price and assume litigation risk from a defendant.

1. Pricing heterogeneous risk.

To begin to understand these pricing problems, it may help to unpack the reaction of an anonymous CEO of a major US insurance company when I asked him why his company does not offer litigation insurance. He said: "Isn't that like selling fire insurance to someone whose house is already burning?" There are several objections built into this simple statement, and to understand his objection one must dig a little deeper. Although on its face the CEO's objection might seem to hinge on the fact that some litigation-triggering event already has occurred, this in and of itself is not the problem. Consider, for example, a hypothetical uninsured homeowner waiting for the fire department to arrive as he stands outside on the street watching a fire spreading from his kitchen to adjacent rooms. Imagine further that an insurance agent arrives on the scene just before the fire department and says: "Do you think the fire department will be able to confine the fire, or do you think you are going to lose the entire house?" The homeowner presumably would be willing to pay a hefty premium at that point for coverage—even if there was a significant deductible equal to the value of those rooms that already were burning. He would essentially be buying insurance against the fire spreading—a risk distinct from the risk that a fire will start in the first place.

Litigation insurance resembles this sort of "fire-spreading" insurance insofar as some bad event—whether an accident or a business dispute—already has occurred, and the question is just how bad the

the defendant's legal fees—increases the market power of contingent-fee plaintiffs' lawyers, and often leads to higher fees).

damage is going to be. How much will the ensuing litigation cost, both in legal fees and in payments to the plaintiff?

The problem for insurers is not that the loss-triggering event already has occurred—for litigation risk can be segregated as an independent risk—but rather that once an event has occurred, the remaining litigation risk is highly individualized. In predicting whether a particular fire will spread from the kitchen to the entire house, one would want to know a lot about the specifics of the case: for example, the layout of the house relative to where the fire began, whether the internal doors were left open or shut, the wind direction and relative humidity, and whether the fire department happens to be fully staffed at the moment or is occupied with another fire. This stands in contrast to the question of how much fire damage is likely to occur in a year among a large group of similarly situated homeowners whose houses are not yet burning. These homeowners may have some distinguishing features that insurers care about—for example, are they smokers, do they have smoke detectors, how far do they live from the nearest fire station, and how expensive are their homes? But there are not nearly as many case-specific variables to distinguish one policyholder from another. Fire-spreading insurance differs from fire insurance insofar as one risk is heterogeneous and the other is homogenous.

The same is true of the distinction between litigation insurance and insurance for litigation-triggering events. The ex ante question of whether some fortuitous event will happen that will lead a company to be sued and to pay litigation expenses and damages may not be quite as undifferentiated as the question of whether a house is likely to burn, but liability insurance can be priced by lumping policyholders in large groups based on business types and sizes (factors that will make litigation-triggering accidents more or less likely). In contrast, once a litigation-triggering event has occurred, the risk of a high or low judgment or settlement is a highly individualized risk that can turn on a variety of case-specific variables, including not only the facts of the case and governing law but also the quality of the respective attorneys and even the identity of the judge. With due diligence (or discovery), one could learn a great deal about a lawsuit's distinguishing features and its likely course. Indeed, a lawyer called upon to value a suit—perhaps when he is preparing for settlement negotiations but potentially even at the outset when he is contemplating representing the plaintiff for a contingent fee—will have a wealth of information to inform his judgment. A thorough lawyer would look at the relevant documents, interview the relevant witnesses (or review depositions if they have been taken), research the relevant law, and inquire into the reputations of the opposing party and its attorneys and of the jurisdiction and presiding judge.

For an insurance actuary, the unique characteristics of individual lawsuits make litigation risk seem almost uninsurable. Insurance actuaries are trained to price risks for large groups of similarly situated policyholders. Indeed, actuaries calculate insurance premiums by fitting each policyholder into a large, homogenous group and examining the historical performance of the group as a whole. The fewer distinguishing features, the better, as this enables actuaries to use broad statistical evidence to price policyholder risks. The fact that a lawsuit is unique places it largely beyond actuarial science.

But if insurance actuaries are poorly suited to price litigation risk, this does not mean that the risk is inherently uninsurable. The wealth of distinguishing information that renders litigation risk ill suited for actuarial science is precisely what makes it well suited for lawyers.[27] Lawyers like to know as much as possible about a suit when evaluating its risks. Indeed, first-year law students learn early on that our legal system is designed to base judgments on individualized information rather than the sorts of statistics that actuaries rely upon.[28] The "blue bus" hypothetical taught in many first-year civil procedure classes highlights this difference between actuarial and legal judgment. In the hypothetical, a pedestrian struck by a bus knows only that the bus was blue and sues the bus company that owns 80 percent of the blue buses whose routes pass by where the pedestrian was injured. Although it is more likely than not that the defendant company is responsible, the case nonetheless is dismissed because our legal system is unwilling to assign responsibility to a bus company that may well be innocent based on undifferentiated statistical evidence alone. In contrast to actuarial science, a legal education trains lawyers to base their judgments on case-specific features rather than statistical pooling.[29]

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27 Of course, conventional liability insurance covers the risk *both* of a litigation-triggering event *and* of a range of potential judgments or settlements, just as fire insurance covers the risk *both* of a fire starting *and* of the fire doing more or less damage. When an insurer writes liability insurance policies or fire insurance policies, it knows that among those few policyholders who end up suffering fires or accidents covered by their policies, it will pay small claims to those who suffer small losses and large claims to those who suffer large losses. But actuaries pricing these policies in the first instance can lump policyholders into large homogenous categories and need not consider the array of distinguishing features that a lawyer would consider in pricing a lawsuit *after* a litigation-triggering event has occurred.

28 See, for example, Jack H. Friedenthal, et al, *Civil Procedure: Cases and Materials* 966–70 (9th ed 2005) (discussing *Denman v Spain*, 135 So2d 195 (Miss 1961), in which the court held that verdicts could not be based on "possibilities").

29 See Charles Nesson, *The Evidence or the Event: On Judicial Proof and the Acceptability of Verdicts*, 98 Harv L Rev 1357, 1379 & n 70, 1380 (1985) (noting that probabilistic evidence is insufficient to support a verdict); Lawrence Tribe, *Trial by Mathematics: Precision and Ritual in the Legal Process*, 84 Harv L Rev 1329, 1340–43, 1349 (1971) (presenting various hypothetical situations involving statistical evidence and noting that none would be sufficient to support a verdict).

Given that lawyers are trained in a system that values individualized evidence over statistical data, lawyers are quite well equipped to do what actuaries cannot. Indeed, lawyers routinely price litigation risk—for themselves and their clients. Plaintiffs' lawyers do so every time they decide to accept a case on a contingent fee basis.[30] Although the lawyer and client need not agree in advance on the precise value of the lawsuit, the lawyer must typically decide whether one-third of the expected recovery is worth the time and effort he likely will devote to the case. More prominent, successful plaintiffs' lawyers take only more valuable cases, and they engage in serious due diligence before they decide to take a case. Moreover, lawyers for plaintiffs and defendants alike must price litigation risk every time a lawsuit is settled. The fact that the vast majority of suits settle suggests that lawsuits are indeed susceptible to pricing. If parties with diametrically opposed biases and incentives tend eventually to agree upon a price, there is no reason that a third party with access to the same information as the plaintiff and defendant could not price a lawsuit as well.[31]

One might object that even if a third party could price litigation as accurately as the plaintiff and defendant, nonetheless settlements are not necessarily accurate predictors of what a jury actually would do. Indeed, there is some evidence that when parties fail to settle, the jury verdict often falls well above or below the settlement range that the parties were contemplating.[32] But that is the whole idea of a settlement—it is to base settlement amounts not just on the most likely jury reaction but on the weighted probabilities of a wide range of possible outcomes, some of which may be remote but nonetheless quite costly.[33] Moreover, if our goal is to ensure that defendants pay reasonable amounts for their wrongdoing, it is far from clear that a jury verdict is the gold standard.

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30 See, for example, Richard A. Nagareda, *Aggregation and Its Discontents: Class Settlement Pressure, Class-wide Arbitration, and CAFA*, 106 Colum L Rev 1872, 1905–06 (2006).

31 Settlements do not require complete agreement on the value of the suit. So long as the plaintiff's and defendant's values do not differ by more than the combined legal fees to be saved by a settlement, there will be a range within which settlement is feasible. See generally George L. Priest and Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J Legal Stud 1 (1984); Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J Legal Stud 55 (1982) (performing a cost-benefit analysis of whether and when plaintiffs will bring suit under the American, British, plaintiff-favoring, and defendant-favoring systems of adjudication).

32 See Samuel Gross and Kent Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L Rev 1, 7 (1996) ("[J]ury verdicts are rarely compromises.... When a civil dispute ends in trial there is almost always a clear loser, and usually a clear winner as well.").

33 To take a simple example, if the plaintiff and defendant think there is roughly a 50 percent chance of a \$1 million verdict and a 50 percent chance of a defense verdict, the settlement range might be around \$500,000 (between \$450,000 and \$550,000 if each side expects \$50,000 in legal fees), and yet a jury verdict would likely come in well outside that settlement range (either at \$1 million or \$0).

Whether defendants settle with plaintiffs directly, whether they proceed to trial, or whether they transfer liability to a third party who will bear the risk of a settlement or trial really should not make all that much of a difference. So long as the three risk-transfer mechanisms are based upon similar information, each should be an equally accurate measure of the defendant's responsibility to the plaintiff.[34]

One might further object that jury verdicts, settlements, and the risk-transfer mechanism I have in mind are idiosyncratic and do not reflect any truth about a suit's inherent value. But the prices that courts or parties assign to litigation risk are no more arbitrary than many of the market prices that we are perfectly comfortable accepting as accurate. What are the chances that a company like Boeing will default on its debt? That would depend upon market conditions, commodity prices, interest rates, the global economy, labor disputes, management performance, and a host of other factors. Yet, there is a market for credit-default swaps that places an exact price on that possibility each day. Moreover, equity markets may involve even more variables than debt markets and even greater uncertainty. The value that equity markets assign to the stock of Boeing or any other public company reflects the market's predictions regarding a variety of factors that will affect its future earnings (including, potentially, how it might fare in some large piece of litigation). Yet we are perfectly comfortable accepting market prices for equities as reasonably accurate. Provided there is sufficient information available to the markets, we trust the markets to make predictions that are just as difficult to make as predictions about the course of a lawsuit.

Some lawyers might believe that litigation risk is too difficult to price for a market in legal risk ever to be sensible. I suggest these lawyers have it exactly backward. It is the absence of a market that makes pricing difficult, not the other way around. Legal risk is no more difficult to price than the many other risks we rely on markets to price every day.

2. Overcoming information asymmetries and adverse-selection problems.

If litigation risk is at least susceptible to accurate pricing, the question arises as to whether counterparties to litigation-risk transfers can gain access to the information they need in order to value a suit

34 For a discussion of how imbalances in risk preferences may skew settlements away from the merits—and render settlements between plaintiffs and defendants *less* accurate than the sale of claims to third-party capital providers—see Molot, *A Market in Litigation Claims* at *6 (cited in note 17). Whereas a one-time, risk-averse plaintiff forced to sell to a repeat-player, risk-neutral defendant may be coerced into an unduly low settlement, a plaintiff free to shop her claim around and sell it in the open market will not be as easily coerced into a low settlement.

accurately and negotiate a fair risk transfer. In public and private capital markets we work hard to make sure that both parties to a transaction have equal access to information. To foster complete information sharing, our securities laws prohibit insiders from trading public securities based on nonpublic information, and contract law penalizes parties who withhold important information from counterparties in private transactions.[35] Can we similarly ensure that when litigation risk is priced, the defendant and its counterparty will have equal access to information about the case? The information asymmetry between a litigant and a potential risk bearer is likely to present a significant obstacle to the creation of a viable market in litigation risk.

If the defendant's own lawyer were the one to assume risk from the defendant—as is true in contingent fee arrangements on the plaintiffs' side—then it would not be at all difficult to overcome this information asymmetry.[36] After all, the defendant's lawyer would likely have access to pretty much everything the defendant has. But in all likelihood, the entity willing to assume downside risk from a litigant will not be the legal team that represents the defendant in the litigation.[37] This Article urges *some* lawyers to stray from the traditional role of client service, to embrace litigation risk as a profit opportunity, and to find capital to create a new market in litigation risk. But I do not suggest that this new role as market participant will ever become the dominant role for lawyers. The vast majority of lawyers will continue to represent clients, just as they always have. The goal of this Article is to suggest that if enough lawyers were to stray from their traditional role and create a market in litigation risk, this market would give conventional litigators yet another risk-management tool that they could utilize in serving clients. In advising clients on how to handle a lawsuit, one option the lawyer would provide is to try to offload the risk via the new market I envision.

To the extent that someone other than the defendant's own lawyer is assuming the risk—most likely a legal team funded by or working with a third-party capital provider[38]—then the defendant would need to turn

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35 See, for example, Alan R. Bromberg and Lewis D. Lowenfels, 1 *Bromberg and Lowenfels on Securities Fraud & Commodities Fraud* § 2.18 (West 2d ed 2008) (discussing Rule 10b-5, which prohibits insider trading); Joseph M. Perillo, 7 *Corbin on Contracts* § 28.20 (Matthew Bender rev ed 2002) (discussing the implications of nondisclosure on the enforceability of contracts).

36 I discuss below the conflicts of interest that would arise if the lawyers representing the defendant were to absorb risk from the client—and become the client's counterparty rather than simply its agent. See notes 75–77 and accompanying text.

37 For a discussion of the ethical problems lawyers would face, and might try to overcome, if they were to serve *both* as client representatives *and* market participants, see Molot, *A Market in Litigation Claims* at *39–40 (cited in note 17).

38 I discuss below the most promising possible structures. See notes 58–65 and accompanying text.

over a wealth of information to that counterparty, going to great lengths to reassure the potential risk bearer that its information is complete. Defendants would need to make witnesses available for interviews, documents available for inspection, and perhaps even lawyers' analysis available for review. The due diligence needed to price suits accurately would resemble an abbreviated version of the discovery process—perhaps more robust in some respects, as counterparties might be allowed access to some information that work product and privilege protections place beyond the reach of plaintiffs.[39]

Just as plaintiffs in discovery often suspect that defendants are not being completely open, there would always be the fear that the defendant knows something about the matter that the counterparty does not. In some respects, this problem is no greater in the litigation-risk transfer context than in conventional litigation. Indeed, a counterparty to a litigation-risk transfer may have a more powerful tool at its disposal when it fears that the defendant is not being honest. Whereas the plaintiff can only complain to the judge if it suspects that the defendant is withholding something, a potential counterparty to a litigation-risk transfer can simply walk away from the deal and leave the defendant to bear the risk.

There is one respect, however, in which the problem of information asymmetries is more acute in the pricing of litigation-risk transfers than in the negotiation of settlements with plaintiffs. The problem is one of adverse selection.

If we were to develop a litigation-risk transfer mechanism, it would be up to defendants to decide when to take advantage of it, just as it is up to potential insurance customers to decide whether to buy health, life, property, or liability insurance. Insurance companies prefer homogenous risks to heterogeneous risks not only because their actuaries are trained to price undifferentiated risk, as noted above, but also because adverse selection is less of a problem with undifferentiated risks. Where insurance policyholders are *truly* similarly situated, they do not know any better than the insurance company whether they are more or less likely than the average person to suffer a calamity. Where, however, the risk that a policyholder seeks to insure is highly differentiated, there is a much greater likelihood that the insured will know more than the insurer about the risk and will seek coverage precisely because he fears that the outcome is likely to be worse than an outside observer might expect. To return to the fire-spreading insurance example above, the homeowner standing on the street may know better than an insurance company that his humidifier

39 The effect of information sharing on privilege and work product is addressed below. See notes 109–10 and accompanying text.

had broken and his house has been very dry, that his walls and floors are covered with very flammable tapestries and rugs, and that he had left all the doors open in the house before running out to the street. Likewise, in litigation, a defendant in a lawsuit over a business dispute, a product defect, or an accident will know whether its general practice is to cut corners and reduce costs or to emphasize care and fair dealing even at great expense. The defendant who fears that a bad memorandum will surface is the one who will seek to buy litigation insurance, whereas the defendant who knows it has been scrupulous in its business practices has less to fear from litigation and is more likely to retain the litigation risk itself.

This adverse-selection problem may pose an obstacle to litigation-risk transfers in many cases, but it should not be insurmountable in every case. In the right category of cases, defendants and risk bearers can use several strategies to assuage adverse-selection problems and information asymmetries, and thereby render risk transfers feasible.

First, the most obvious way to assuage these problems is simply to make sure that due diligence is rigorous. The entity seeking to assume litigation risk from a defendant could not rely on the defendant's portrayal of a lawsuit but rather would have to dig in and examine all the relevant documents and witnesses itself. Second, the risk bearer would have to draft its contract with the defendant so as to penalize the defendant if it withholds information. If the risk bearer were to learn after assuming the risk that the defendant had withheld damning evidence during their negotiations, the risk bearer would be entitled to terminate the contract and perhaps retain some, or all, of the premium as a penalty.[40] Third, the risk bearer might be able to enlist the defendant's own lawyers in its quest for full disclosure. Although the lawyers who actually represent the defendant might cling to their traditional role of client service, there may be a way to structure their compensation so as to promote more complete information sharing. I explore in detail in Part I.C one such structure, under which the risk bearer would inform the defendant's own lawyers ex ante that it would like to keep them on as counsel even after the risk transfer has been completed, and to pay them a contingent fee–type performance bonus if they resolve the suit for less than the transfer price. Such an arrangement no doubt would create a conflict of interest for the attorneys during negotiations between their client and the potential risk bearer—a conflict I explore in depth below—but provided the conflict can be overcome (I argue below that it can), this arrangement would give the lawyers an incentive to ensure that the suit is priced accurately and that the de-

40 This solution is not ideal as it could yield additional litigation between the defendant and counterparty after the suit with the plaintiff is complete.

fendant's disclosure is complete.[41] The prospect of a contingent fee arrangement with the defendant's counterparty would give the lawyers a strong incentive to make sure that no damning information is withheld during negotiations.

The most promising way to address the adverse-selection problem, however, would be through careful case selection. There are essentially two reasons why defendants might seek to get rid of their litigation risk, and a potential risk bearer deciding whether to assume litigation risk would want to know: Is the defendant seeking to give me the risk because it thinks it can do better with me than it will with the plaintiff? Or is the defendant seeking to give me the risk because it has a valid business reason for trying to dispose of it and is willing to pay a premium to dispose of it now? Where there are valid business reasons for transferring litigation risk, particularly where the defendant needs to reassure a third party about a lawsuit's value, adverse selection becomes much less of a problem. Indeed, one could go a long way toward alleviating the adverse-selection problem simply by confining litigation-risk transfers to those cases where defendants can demonstrate valid business motivations—that is, to cases where the tertiary costs of dispute resolution are at their greatest. Consider, for example, a company that is in the process of being sold—say for around $200 million—and also is a defendant to a lawsuit claiming $20 million. A potential purchaser of the company might ask the seller to take $20 million off of the $200 million purchase price for the suit, or at least to leave that $20 million in escrow pending resolution of the suit. The seller, in contrast, may believe the suit is worth much less than that, perhaps as little as $5 million. In such a scenario, even if the company's owners themselves—the people who know most about the suit—would feel perfectly comfortable bearing the litigation risk, they may have to find a way to reassure the potential purchaser about its value and thereby remove an obstacle to the deal. The sellers might try to settle the case with the plaintiff at that moment, but it might not be an opportune moment to settle, as the deal cycle very often is much quicker than the litigation life cycle. If the company approaches the plaintiff with a $5 million or even $10 million settlement offer before discovery is complete, the plaintiff might surmise (incorrectly) that the defendant knows something damning about its case that the plaintiff has not yet discovered and that the case is worth the full $20 million it has claimed. Or, the plaintiff might surmise (correctly) that the defendant is desperate to settle for business reasons, and the plaintiff might therefore try to extract a larger settlement. Either way, the defendant may have a valid business reason for seeking

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41 See Parts I. C and III.D.1.

certainty and may not be able to get it from the plaintiff at a fair price in time to conclude the deal. In order to eliminate an obstacle to a $200 million deal, the company's owners might be willing to pay more than the $5 million they think the suit is worth—perhaps as much as $8 or $10 million if this will eliminate a $20 million risk and induce the buyers to proceed with the transaction. Given the choice of (1) losing out on a $200 million deal, (2) leaving a full $20 million behind in escrow for the duration of the lawsuit, or (3) paying a premium to a third-party litigation insurer, the seller may reasonably prefer to pay the premium.

By confining risk transfers to business contexts like this, we could go a long way toward addressing the problem of adverse selection. The defendant would be interested in a risk transfer not because *it* views the risk as so daunting, but rather because its potential business partner or investor, who knows little about the suit, is daunted by the risk. A third-party insurer willing to assume the risk could exploit the "bid-ask spread" between the seller and buyer over the value of the lawsuit and charge a substantial premium for assuming the risk and eliminating an obstacle to a larger deal.[42]

3. Managing costs and maintaining privilege.

Even if we could overcome adverse-selection problems and price litigation accurately based on an adequate exchange of information, there are costs associated with information exchanges that need to be addressed. The first cost is simply the transaction costs of third-party due diligence. Insurance companies may be reluctant to insure litigation risk not only because their actuaries do not like heterogeneous risks but also because pricing such risks is expensive and time consuming.[43] The due diligence required to price a large, complex lawsuit would involve hiring a team of experienced lawyers to examine the relevant documents, interview the relevant witnesses, research the relevant law, and look at any publicly available information on outcomes of comparable suits in comparable jurisdictions. This sort of due diligence is quite expensive—expensive enough to eat up a large chunk of whatever premium the defendant would pay for coverage. Litigation coverage would therefore make sense only for very large suits where the amount at stake is sufficient to justify the transaction costs associated

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42 In contrast, where there is no business deal pending—and the defendant does not need to satisfy a third party who is more concerned about the litigation than it is—there may be an insurmountable "bid-ask spread" between the defendant (who would want to dispose of the lawsuit at a low price) and a potential litigation insurer (who would only be willing to accept the liability at a comparatively high price).

43 Consider Michael Klausner, Geoffrey Miller, and Richard Painter, *Second Opinions in Litigation*, 84 Va L Rev 1411, 1418 (1998) (discussing costs of obtaining "second opinions" on litigation).

with due diligence.[44] Just as the adverse-selection problems discussed above might narrow the field of cases for which risk transfers are feasible, so too would due diligence costs narrow the field.[45] Given that larger suits are the ones with risks and expenses most troubling to defendants anyway, however, the restriction of coverage to large cases should not lead us to underestimate the value of risk transfers in this narrower category of cases.

A second information-related cost is the need to maintain the confidentiality of whatever is shared during due diligence. Although most of the materials turned over during due diligence would inevitably have to be shared with the plaintiff anyway, some of these materials might be protected from disclosure to the plaintiff by attorney-client privilege or work product doctrine. In order to price the suit accurately—and avoid the adverse-selection problems and information asymmetries noted above[46]—lawyers conducting due diligence would most likely want access to everything that the defendant has. Yet, the defendant would fear that if it turns over work product or attorney-client materials, it would risk undermining these protections and exposing the materials to discovery by the plaintiff.

This problem is not entirely unique to the litigation-risk transfers that are the subject of this Article. Every day, companies that are bought and sold also happen to be parties to litigation and the due diligence required for these corporate transactions inevitably requires examination of the relevant lawsuits. Typically, parties to corporate transactions claim "common interest privilege" to protect the information they share from being disclosed to anyone else.[47] To the extent that privilege can be maintained in these transactions, there is no reason it cannot be maintained for litigation-risk transfers.[48] Indeed, the legal due diligence would proceed just as it routinely does in private-equity and merger-and-acquisition transactions, albeit the entity doing the litiga-

44 See id at 1420 (noting that "[s]econd opinions will tend to be more attractive" when larger stakes are involved).

45 In fact, the few insurers who offer litigation buyout policies typically charge diligence fees up front to look at the risk. See, for example, American Insurance Group, Inc, *Litigation Buyout Insurance: Questions and Answers* 3, online at http://www.aig.com/aigweb/internet/en/files/Mkt_LBG_Questions%20and%20Answers_tcm20-73192.pdf (visited Jan 11, 2009).

46 See Part I.A.2.

47 See, for example, *Hewlett-Packard Co v Bausch & Lomb Inc*, 115 FRD 308, 312 (ND Cal 1987) (holding that attorney-client privilege was not waived when a party voluntarily disclosed its attorney's opinion letter to a nonparty with whom it was in the process of negotiating a transaction).

48 Although some courts have distinguished between "common business interests" and "common legal interests" and afforded protection only to the latter, when one entity purchases another and assumes its liabilities, this generally will create a common legal interest between the defendant and the potential purchaser assuming its liabilities. See id at 308. The same should be true when a company's liabilities are divided among a purchaser and a litigation-specific risk bearer.

tion-specific due diligence would focus on the litigation risk and not bother with the diligence relevant to the rest of the deal.[49] Moreover, the argument for maintaining privilege may be stronger for litigation-risk transfers than for traditional business transactions, as a potential risk bearer's willingness to absorb litigation risk may be analogized to a liability insurer's common legal interest with its insured.[50] Just as a conventional liability insurer and its insured can claim common interest privilege, so too might the litigation-risk bearer and the defendant. Although the system of litigation-risk transfers I envision would require participants to pay close attention to the implications for work product doctrine and attorney-client privilege—and to consider how a litigation-risk bearer's status as an "insurer" or "noninsurer" might bear upon these questions[51]—the problems should not be insurmountable.

B. Finding Capital to Cover Litigation Risk

Lawyers seeking to create a market in litigation risk would need not only to overcome the pricing obstacles described above but also to raise the capital necessary to absorb litigation risk. A lawyer may be willing to bet on his ability to dispose of a lawsuit for less than a negotiated strike price, but if the lawyer cannot assure the defendant that he has the money to pay a higher than expected judgment, then the lawyer will not be able to relieve the defendant of risk. This is a very different scenario from that faced by plaintiffs' lawyers, who need only absorb out-of-pocket litigation expenses and opportunity cost. As individual lawyers and even large law firms generally lack the working capital to pay adverse litigation judgments of the magnitude that their corporate clients fear, lawyers must look to third parties to supply risk capital and share downside risk. Lawyers may be the people best suited to price and manage litigation risk, but if lawyers cannot raise the necessary risk capital, they will never be able to make the transition from client advisors to market participants. In making this transition from client advisor to capital raiser, a lawyer must consider how an investment in litigation risk compares to the many other investment opportunities available to capital providers.

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49 A private-equity firm purchasing a company need not only evaluate pending or threatened lawsuits but also must value the target company's other assets and liabilities.

50 See *Kandel v Tocher*, 256 NYS2d 898, 899 (App Div 1965) (protecting privilege for liability insurer); *Ogden v Allstate Insurance Co*, 447 NYS2d 667, 668–69 (Sup Ct, Chenango County 1982) (distinguishing between "liability insurance" or "litigation insurance," where common interest privilege would apply, and "coverage other than liability insurance").

51 See *Ogden*, 447 NYS2d at 668–70 (discussing treatment of litigation-risk transfers under insurance law).

1. Attractiveness to capital providers.

Although insurance companies deciding how to deploy their capital are likely to view litigation risk insurance as less attractive than other forms of insurance, the reluctance of insurance companies to provide after-the-event litigation insurance should not mislead other capital providers into believing that litigation is somehow uninsurable. Insurers shy away from litigation risk because of the pricing problems addressed above, *not* because litigation risk is uninsurable. To the contrary, litigation risk can be pooled and managed just like other insurable risks. The defining feature of an insurable risk is the effect that diversification—or the law of large numbers—has upon it. Life and fire insurance work because although one cannot tell in advance which individual will die prematurely or which house will burn, when the pool is large enough one can count on the fact that people will die, on average, at the average age and houses will burn, on average, in predictable numbers. Although lawsuits have to be priced individually, the law of large numbers works in this context just as it does with other insurable risks. Each suit may have a different expected value, but a large enough pool of suits will come in at or near the collective expected value for the pool.

In order to show that diversification works with a pool of heterogeneous litigation risk, just as it does with the more homogenous risks that insurers tend to underwrite, I have modeled pools of hypothetical lawsuits accumulated over a period of several years. Although each individual suit in a pool may be highly risky in its own particular way—each with its own distinct range of potential outcomes—the performance of the pool as a whole tends to produce a relatively narrow band of results. Whereas an individual lawsuit may come in at the low or high end of a broad spectrum of possible outcomes for that suit, the pool as a whole will come in close to the pool's average expected result. Just as the average person in a large enough pool will die, on average, at a given age, so too will the litigation pool as a whole perform near the pool's average.

Indeed, when I used a computer model to examine how a diverse pool of forty lawsuits accumulated over five years would perform, I found that with five thousand runs of the pool as a whole, there were relatively few outliers, and the performance of the pool as a whole tended to cluster relatively close to the pool's mean. Figure 1 below suggests that a capital provider interested in profiting from litigation-risk transfers could expect to earn relatively stable returns so long as it built a large enough pool of suits.

FIGURE 1
IS LITIGATION INSURABLE?

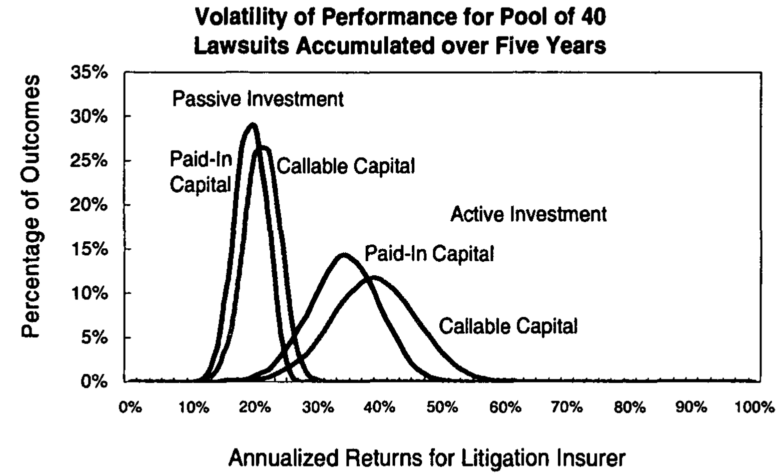


Figure 1 is not intended to predict the actual returns that a litigation insurer could expect to earn, as actual returns would depend upon a number of variables, the effects of some of which are reflected in the different curves above.[52] It suggests, for example, that returns would depend

52 Figure 1 is based on a Monte Carlo simulation with five thousand runs of forty lawsuits accumulated over five years. (The model assumes some ramp up, with four suits taken in the first year, six in the second year, eight in the third year, ten in the fourth year, and twelve in the fifth year.) The model uses a lognormal distribution of damages awards for each lawsuit—with a remote chance of a very large award and a much higher probability of a smaller award—as that reflects experience in many cases where plaintiffs use the remote possibility of a large damages award to induce defendants to settle. The actual shape of distributions for each suit depends upon three core variables: chances of liability, size of mean damages award, and range of awards surrounding that mean. To simplify the model, I allowed three potential values for each variable. Thus, each suit in the pool had a likelihood of liability of 25 percent, 50 percent, or 75 percent, even though in reality the chances of liability for a suit might range from 0 (in a frivolous suit) to 100 percent. The mean damages award for each suit was $20 million, $50 million, or $100 million, though in real life the mean might be anywhere. Finally, to represent the range of possible damages awards surrounding the mean—and to see whether the case is more predictable and has only a narrow range of possible outcomes, or less predictable and has a broader range of possible outcomes—there was a volatility (or standard deviation) assigned to each case ranging from multiples of 0.5, 1.0, or 1.5 times the mean.

Because a litigation insurer would not know in advance how many cases will be small, medium, or large, and whether those cases will be more or less risky in terms of the range of damages awards and the chances of liability, I allowed the computer to select the value for each of these three variables at random. Further variables assigned by the computer included likelihood of going to trial (10 percent, 30 percent, 50 percent), duration of litigation (one, two, or three years for settled cases versus two, three, or four years for tried cases), and premium levels (which were set at a 20 percent premium over the actuarially fair level).

on how an insurer is capitalized[53] and on how it invests premiums and capital while suits are pending—note the lower returns and lower volatility (or narrower band of outcomes) where the insurer employs a low-risk, passive investment strategy versus a higher-risk, more aggressive investment strategy.[54] Other contributing factors that are not reflected in Figure 1 are the size of the premium customers would be willing to pay for risk transfers,[55] the accuracy of an insurer's underwriting, and the effectiveness of its subsequent litigation management. I have modeled some of these other risks as well—to see what would happen, for example, if the risk bearer were to underprice suits, if it were able to accumulate a pool of only half as many suits, or if its investment of premiums and capital turned out to be half as profitable as expected.[56] The model reveals that these risks are manageable as well, as Figure 2 demonstrates.

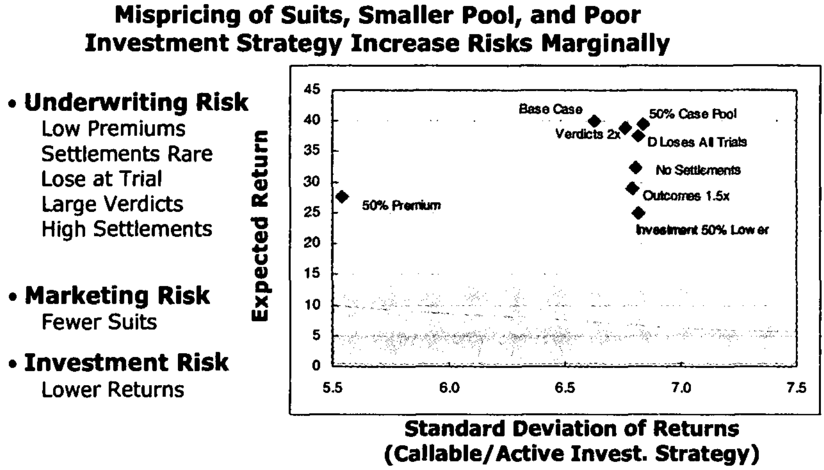
53 The model assumed a capitalization in line with that of many insurance companies (1.4 premium-to-surplus ratio), and permitted an insurer either to be fully capitalized in advance ("paid-in capital") or to allocate capital to this line of business as cases come in ("callable capital"). See, for example, Hanover Insurance Group, Inc, *Q1 2008 Earnings Results* slide 18, online at http://www.hanover.com/thg/investors/pdf/2008Q1.pdf (visited Jan 11, 2009).

54 The model permitted capital and premiums to be invested "passively" at a 5 percent fixed risk-free rate or "actively" at a floating rate that a more aggressive capital provider, like an investment fund, might employ. One can see from the shapes of the curves—the narrow band of outcomes for passive strategy and wider spread of outcomes for the active investment strategy—that investment risk may very well exceed litigation risk. (To approximate investment fund returns, the model used data from the actual investment performance of one investment fund manager whose performance has produced a mean rate of return in the 10 to 15 percent range and a volatility of about 5 to 6 percent.)

55 The model simply assumed a premium that was 20 percent in excess of what would be actuarially fair for the risk involved.

56 The risk reflected in the Figure 1 flows from the fact that an underwriter will know there is a range of possible outcomes for each case. This Figure 2 reflects the further risk that an underwriter may make mistakes when it evaluates a suit and fixes a premium. The various dots on the Figure indicate the average return and standard deviation from that mean that a risk bearer would expect if, instead of pricing things accurately (the "Base Case"), it charged too low a premium (50 Percent Premium), was unable to settle (No Settlements), was forced to pay more than expected in settlements or judgments (Outcomes 1.5x), or was to lose when it proceeded to trial (D Loses All Trials). The remaining dots reflect the risk of a case pool half as large as expected (50 Percent Case Pool) and of poor investment returns (Investment 50 Percent Lower).

FIGURE 2
ADDITIONAL RISKS



Again, the purpose of this modeling—and of the two figures included above—is not to project actual returns, but rather to illustrate that by building a diverse pool of lawsuits, a capital provider could narrow the range of possible outcomes and thereby hope to achieve reasonably steady returns on the pool as a whole, even if it made some serious mistakes in pricing lawsuits. If a capital provider were seeking to earn a profit by relieving defendants of litigation risk—whether a conventional insurer or a less conventional capital provider like an investment fund—that entity could rely on the law of large numbers to achieve relatively stable returns.[57]

2. Public versus private financing.

Given that litigation risk is insurable but insurance companies are reluctant to insure it,[58] the question remains as to where else lawyers

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57 An insurer likely would not want to take a case, however, where the threatened judgment might be large enough to drive the original defendant into insolvency. In such a case, the very provision of insurance—and substitution of a deep-pocketed target—would increase the likely settlement value. Consider Kathryn E. Spier and Alan O. Sykes, *Capital Structure, Priority Rules, and the Settlement of Civil Claims*, 18 Intl Rev L & Econ 187, 187 (1998) ("[T]he presence of debt may directly dilute the value of the tort claim, may narrow the bargaining range in negotiations, and may lead to a failure to settle.").

58 Insurance companies can insure litigation risk by relying on lawyers, rather than actuaries, as their underwriters, and they have done so in some instances. See, for example, Russ Banham, *Parrying the Litigation Threat*, CFO Mag (November 2000) (discussing the expansion of the pending-litigation insurance market). See also notes 28–30 and accompanying text. Anecdotal evidence reveals, however, that insurance capacity is available only in narrow categories of cases

should look for capital to insure litigation risk. When the insurance industry has been unwilling or unable to meet a demand for risk transfers in the past, we have relied sometimes on private markets and sometimes on government to fill the gap. In the aftermath of insurance losses following several major hurricanes in 2005, for instance, the insurance industry relied on other capital providers for reinsurance capacity to absorb catastrophe risk so that insurers could continue to offer homeowners protection against wind damage. Storm risk was passed on to investment funds and other investors via catastrophe bonds ("CAT Bonds"), which offer investors high returns in exchange for the risk of losing their investment if insurers suffer catastrophic losses.[59] Flood insurance, on the other hand, is something that many insurance companies have refused to offer in the Gulf Coast states and instead have left to government to supply. Because a single storm can result in the flooding of large groups of policyholders, the risks associated with flood insurance in some regions are simply too large and too correlated for the insurance industry to be willing to absorb. Given inadequate supply, Federal Emergency Management Agency has stepped in and provided most of the flood insurance held by homeowners in the Gulf Coast states.[60]

Both options are possible with litigation insurance as well. In theory, if Congress became convinced that it could make a dent in the litigation problem not only via the substantive and procedural changes advanced by business interests (for example, damages caps and class action reform) but also by making litigation risk insurable, then Congress might be willing to make federal resources available for such an endeavor. As a political matter, however, it is highly unrealistic to expect that Congress would pursue such a course any time soon. One of the driving forces behind the litigation reform movement today is the in-

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and only in relatively small amounts, in part because of the pricing problems identified above and in part because insurers' reinsurance arrangements do not cover these risks.

59 See, for example, Todd V. McMillan, *Securitization and the Catastrophe Bond: A Transactional Integration of Industries through a Capacity-enhancing Product of Risk Management*, 8 Conn Ins L J 131, 141 (2001) ("[A]n investor's return on investment depends on the occurrence or nonoccurrence of the event specified within the risk period covered by the catastrophe bond. . . . [S]hould a catastrophe occur within the risk period, the bondholders will indemnify the insurance company."); Robert J. Rhee, *Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance, and Government Action*, 37 Ariz St L J 435, 496–509 (2005) (discussing securitization of terrorism risk). See also Robert J. Rhee, *Catastrophic Risk and Governance after Hurricane Katrina: A Postscript to Terrorism Risk in a Post-9/11 Economy*, 38 Ariz St L J 581, 581–82 (2006).

60 See National Flood Insurance Act of 1968, Pub L No 90-448, 82 Stat 572, codified at 42 USC § 4001 et seq. It may be that the absence of private insurance for flood damage is the result of people deciding in some instances to (re)build in places where the risks are too large and it is not economically rational to do so (or at least where an actuarially fair insurance premium would be prohibitively expensive).

surance industry.[61] Insurance companies have vast sums of wealth tied up in litigation, and anything they can do to make it less costly could make them more profitable. Yet insurance companies see the problem not as a question of risk pooling or risk spreading—after all, they already hold diverse pools of litigation risk. Rather, they think the problem lies in the litigation process itself.[62] Without full-blown support from the insurance industry, any legislation designed to provide federal litigation insurance would be unlikely to make any progress.

Moreover, even if one could muster the political force needed to establish federal litigation insurance, there are practical reasons why public financing might not be as effective as private financing. As the discussion above explored, if we wish to price lawsuits accurately—and make sure that defendants neither get off too easily nor bear too much of a burden—it is vitally important that participants in litigation-risk transfers have proper incentives. Defendants will try to dispose of litigation risk at the lowest price possible, and it is important that whoever is absorbing this risk—whether a lawyer or another capital provider—has a profit motivation commensurate with that of the defendant. Although one could provide private attorneys with financial incentives to price suits accurately on behalf of a federal insurance program—and I explore attorney incentives and compensation in greater detail in the next Part—the ideal setting is one where the risk-assuming lawyers and their capital providers alike have profit motives as strong as those of the defendant with whom they are negotiating a deal. Risk transfers are more likely to be priced accurately when both sides of the transfer have profit incentives.

So if insurance companies are unwilling to insure litigation risk and the government is unlikely and ill equipped to insure litigation risk, what other sources of capital are available to perform this function? The most promising source is investment funds—funds that earn profits for institutional investors and wealthy individuals by investing in a variety of asset classes and taking on a wide range of risks. Multistrategy investment funds make an array of bets on publicly traded stocks, bonds, currencies, and commodities, and many have gotten into the business of making private investments in private companies as

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61 See, for example, James P. George, *Access to Justice, Costs, and Legal Aid*, 54 Am J Comp L 293, 306 (2006) (noting that the insurance industry paid for the Towers Perrin Report, an oft-cited study focusing on the costs incurred by insurance companies in annual tort claims, as part of the "tort reform battle").

62 Id ("Tort costs as a percentage of GDP has ... increased by .041 of a percentage point over 20 years, and the [Towers Perrin] Report predicts the increase will continue absent continued tort reform legislation.").

well.[63] Many multistrategy investment funds have an appetite for insurance-related investments like CAT Bonds. Insurers and reinsurers looking to pass along risk have found hedge funds a receptive audience.[64] This is true in part because the insurance industry also is willing to pass along a large enough portion of the premiums to make these risk transfers attractive to hedge funds. It is true also because insurance risks are uncorrelated with the other market risks to which these funds are exposed, and the funds are always looking to diversify their risk exposure. If they can earn the same rate of return by absorbing insurance risk that they earn by purchasing stocks or bonds, funds will likely do so, as the insurance risk will be uncorrelated with swings in the stock and bond markets.

Moreover, investment funds not only view insurance risk as an attractive profit source but also view litigation risk in this manner. Many multistrategy funds today already have so-called "litigation strategies" in place. When they believe that the market has overvalued or undervalued a prominent lawsuit, investment funds often buy or sell shares of the litigant's stock (or options on that stock). The intellectual property dispute over the Research in Motion, Ltd (RIM) wireless Blackberry device offers a good example of the role that litigation can play in stock market prices. In the days leading up to and immediately following a resolution—when a settlement ultimately was reached—the market prices of the relevant public company moved sharply.[65] Given that investment funds already are pursuing insurance and litigation strategies, these funds may very well be interested in providing the capital that lawyers need to make a market in litigation-risk transfers. The lawyer willing to stray from the traditional model of client service and become a market participant would be wise to look to hedge funds for the backing he will need to relieve defendants of litigation risk.

3. Obstacles faced by private, noninsurance capital providers.

Although investment funds offer a more promising source of private financing than insurance companies, lawyers seeking to raise capital from funds will confront problems that would not arise if they

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63 See, for example, Och-Ziff Capital Management Group LLC, *Form S-1* 94 (July 2, 2007), online at http://www.secinfo.com/d14D5a.u4G9w.htm (visited Jan 11, 2009).

64 See Josh Friedlander, *Hedgies Expand Reach in Reinsurance*, Investment Dealers' Dig 8, 9 (May 30, 2005) ("[CAT] bonds have proved to be a bridge connecting the massive world of insurance risk to the capital markets.").

65 See Robert G. Sterne and Robert F. Redmond, *Surviving the Rocket Docket*, The Daily Deal (Mar 13, 2006) ("RIM stock was depressed by the legal uncertainty as shown by the surge in Blackberry shares after the [federal court hearing] and in after-market trading."). See also *Shares Hit by Suit over E-mail Patents*, Chi Trib C2 (Nov 7, 2006) (noting that the stock for Palm Inc, the maker of the Treo smart phone, decreased by 7.6 percent following the news of a patent infringement lawsuit).

were backed by insurance companies instead. Insurance companies may not be as well equipped as other capital providers to bet on litigation risk, but their capital structure and regulatory approvals nonetheless render them much better equipped to absorb the downside risk of a large, adverse litigation judgment. The insurance business is set up to be highly leveraged, so that if any insurance company were to receive claims on all of its policies, it would go bankrupt many times over. Each policy carries with it a remote risk of a claim, and each policyholder thus pays a small premium to protect against a large loss. Policyholders are willing to give their money to insurance companies in the expectation that the money will be there to pay claims because regulators and ratings agencies make sure that insurers maintain appropriate reserves for expected losses. And insurance companies reap the benefits of being able to earn premiums on many more policies than they could ever cover, relying on their knowledge that only a fraction of them will ever result in claims. This translates into larger investment returns (or "float") on the premiums they hold for outstanding policies and more underwriting profit than an insurer would be able to earn if it had to have assets on hand sufficient to cover all outstanding policies. In other words, leverage enables insurance companies to write more policies and earn more money for a given amount of invested capital and thus to earn higher rates of return than would be possible without such leverage.

But if insurance customers are willing to trust that a rated insurance company's reserves are adequate to pay its claims—and that it need not have cash on hand to cover every single policyholder's potential claim—these customers are unlikely to place similar trust in just any capital provider. In some instances, an investment fund may be big enough and have a long enough track record that defendants would be willing to accept the fund's guarantee.[66] But in other instances, the defendant may want assurances that the money will be there to pay an adverse judgment. Just as the defendant could not simply accept a lawyer's word that he will be good for the money if the judgment comes in higher than expected, so too might it refuse to accept a hedge fund's guarantee. In the absence of a rating from a respected rating agency, the fund might either have to collateralize its obligation fully—say by putting the full exposure in cash in escrow—or have to find a highly creditworthy intermediary (such as a bank or insurance company) to guarantee its obligations.

If an investment fund could only do litigation deals if it were to collateralize its obligations fully, this would substantially reduce its prof-

66 But see note 69 (discussing changes brought on by a worldwide credit crisis).

itability. A fund that generally earns 15 percent per year on its investments would want to invest the premium received for a litigation-risk transfer alongside its own capital, hoping to earn 15 percent on the premium for the duration of the lawsuit. If the fund charged the defendant a $10 million premium to cover up to $50 million in losses, it would expect to invest both the $10 million premium and its $40 million at risk in these high-returning strategies. If the fund were required instead to post the entire $10 million premium and $40 million capital at risk as collateral until the lawsuit is concluded, it would earn much less—most likely, a risk-free rate of return of less than 5 percent. Instead of earning $7.5 million in investment returns on $50 million during the first year of the deal, it would earn less than $2.5 million. This difference in investment returns would in many instances make the difference between deciding to do a deal or not do it, and the viability of litigation deals for investment funds might therefore depend on the extent to which they will have to collateralize their obligations.

A more attractive alternative to full collateralization would be to find a creditworthy entity able to guarantee the fund's payment and yet not to require full cash collateralization in exchange for this guarantee. One entity that might perform this function is the investment bank that serves as the fund's "prime broker."[67] Major investment banks have credit ratings on par with those of major insurance companies, so litigation defendants should have no problem accepting the guarantee of a major investment bank[68]—at least during normal times.[69] Moreover, because investment banks routinely serve as prime brokers for investment funds—loaning money to investment funds so that they can use leverage to increase investment returns—these investment banks are in a good position to bear an investment fund's credit risk without requiring full collateralization. Given a prime broker's familiarity with a fund's investment strategies, it might not need to require that the hedge fund set aside $50 million in safe investments that earn only a risk-free

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67 An insurance company might be willing to "front" for a hedge fund if it could become comfortable with the fund's credit risk. Moreover, if the hedge fund were to set up its own regulated reinsurer—something many hedge funds have done—this might enable the fronting insurer to receive full reinsurance credit from regulators for risk passed on to the hedge fund.

68 The investment bank could either guarantee payment or else itself do the deal with the defendant and then, in turn, pass along the risk to the investment fund.

69 The credit crisis that began while this Article was in the editing stages has changed the landscape of the financial world, forcing Lehman Brothers into bankruptcy, bringing American International Group to the brink of bankruptcy, and casting doubt upon the creditworthiness of a wide array of institutions previously thought to be safe credit risks. With Bear Stearns's acquisition by J.P. Morgan and the decisions of Morgan Stanley and Goldman Sachs to become bank holding companies, the days of the stand-alone investment bank may now be over. All of the investment banks that serve as prime brokers for hedge funds may now be affiliated with traditional banks.

return. Rather, it could permit the fund to continue investing the \$50 million using the same strategies it employs for the rest of its assets.

This is not to say that obtaining credit from its prime broker would be costless for an investment fund. In addition to paying something for the credit guarantee, the fund would also use up some of its borrowing power to secure the guarantee. For a fund that is close to its credit limit, the attractiveness of a litigation deal will depend upon how the expected risk-adjusted rate of return for the litigation deal compares to the other uses to which it could put its borrowing power. Moreover, litigation-risk transfers would also use up valuable "side-pocket" capacity that hedge funds set aside for illiquid deals. Historically, the world of investment funds was divided into two categories—private-equity funds, which made *illiquid* investments in *private* companies, and hedge funds, which traded in *liquid* securities on *public* exchanges. It is hedge funds that employ a variety of different investment strategies, including the insurance and litigation strategies described above,[70] and so hedge funds are more likely than private-equity funds to try to profit from litigation risk. Many hedge funds have created side-pockets for illiquid investments, essentially modeling a portion of their investment strategies after private-equity funds and setting up mini-private-equity funds for illiquid investments within their larger hedge fund structure.[71] But most funds are restricted by their initial investor agreements to side-pocketing only a portion of their assets (30 percent is relatively common), and the rest of their assets must remain in liquid securities that can be sold on short notice so as to enable investors to redeem fund interests at regular intervals.[72] In deciding whether to do an illiquid litigation deal that may last several years, a hedge fund would therefore want to ensure not only that the expected return justifies the level of risk but also that the deal is more profitable than the other illiquid opportunities for which it could use its side-pocket capacity. To justify litigation deals, a hedge fund may want returns that are substantially higher than its average rate of return for the fund as a whole.

In short, the obstacles faced by hedge funds are not insurmountable, but the costs that hedge funds would bear for doing illiquid litigation deals are likely to place upward pressure on the premiums that would need to be charged to make the deals attractive. Hedge funds' requirement of high premiums would, together with the due diligence expenses and adverse-selection problems discussed above, further nar-

70 See text accompanying note 63.

71 Gwyneth Rees, *Bulging Pockets–The Increasing Use of Side Pockets in Alternative Investment Vehicles* 1 (Walkers May 2007), online at http://www.walkersglobal.com/pubdocs/Hedge%20funds%20and%20Bulging%20Side%20Pockets_G.Rees.pdf (visited Jan 11, 2009).

72 Id.

row the scope of cases in which risk transfers would make sense. Litigation-risk transfers are likely to be expensive enough that they will only work in a small subset of cases, albeit cases where the benefits to be reaped from risk transfers may be enormous. Risk transfers would likely make sense in those instances where litigation risk interferes with business transactions and where the tertiary costs of litigation are highest.

C. Alignment of Risk and Control

If the two major obstacles to litigation-risk transfers are pricing the risk and finding someone to take it, the third remaining obstacle concerns the question of who will control the suit once the financial risk has been transferred. Defendants could not retain complete control of litigation upon disposing of the financial risk, as they would not have proper incentives to protect the financial interests of their insurers. Risk transfers would have to be structured so that the bearer of litigation risk receives some control of the litigation yet can count on the defendant to cooperate fully in the defense. Because insurance companies routinely find themselves financially responsible for someone else's litigation liability, such an arrangement is far from uncommon. Where defendants have purchased insurance *before* a litigation-triggering event has occurred, insurance policies can be written so as to give the insurer control over the litigation or at least to share control between the insurer and insured. Where litigation risk is transferred *after* a litigation-triggering event, one could similarly structure the policy so as to transfer control along with the risk. The prospect of a change in control might limit the kinds of cases that would be susceptible to risk transfers. Defendants would never relinquish control over suits for injunctive relief or suits that could have a significant effect on their reputations, but they might be willing to give up control where only money is at stake and where most of the financial risk can be transferred to the insurer or other capital provider. Policies also could be written—just as they are in conventional insurance—so that insurer and insured alike are obligated to cooperate fully in the defense of the lawsuit.

To align the incentives of defendants, insurers, and lawyers, ideally there would be an arrangement where the defendant retains some of the risks and rewards associated with a lawsuit (through what is often called "coinsurance"). If the insured is buying protection for judgments between \$5 and \$20 million, for example, and it pays the insurer \$6 million to take over the suit (a \$1 million premium plus the \$5 million expected value), the insured might bear 20 percent of losses beyond \$5 million and be entitled to a refund of 20 percent of any savings below \$5 million. Although the insured would have transferred most of the risk, it would still retain enough risk to align its incentives with those of the insurer and to help guarantee its full participation in the defense.

Moreover, as the goal would be to facilitate risk transfers on the defense side that are as effective as risk transfers via contingent fee arrangements on the plaintiffs' side, it would be important for attorneys who actually handle the litigation to reap some of the rewards and bear some of the risks as well. It is possible that the entity acquiring the risk from the defendant—most likely a team of attorneys backed by an investment fund—might take over the defense of the case itself. But as that group's business model would be premised on acquiring a diverse portfolio of litigation risk,[73] the group very likely would not have the time to handle all of the litigation in-house and would instead rely on outside counsel to run the litigation day-to-day. Moreover, provided that the defendant's original lawyers are handling the case well, the new risk bearer might very well want to keep those lawyers on rather than spending the money to bring in a new firm that knows nothing about the case and has a steep learning curve. To make sure that the lawyers actually running the case have appropriate incentives, however, the group assuming the risk very likely would want those lawyers to share some of the risks and be paid based at least in part upon their performance. One potential structure would be to change attorney billing arrangements so that once a risk transfer had been priced and negotiated, defense attorneys would no longer earn hourly fees. Instead, attorneys would be paid a fixed periodic fee that represents a discount off of what they (if they are staying on) had been charging to litigate the case and a share of any savings they achieve off of the agreed-upon transfer price.[74] In the example above, although the day-to-day litigators might not bear the risk of a judgment higher than the $5 million agreed-upon price, they might earn a share of any savings they achieve off of that price. Attorneys might thus receive enough from their fixed fees to cover overhead and expenses, and hope to profit based on their performance.

There are two things that such a fee arrangement might accomplish. First, and most obviously, it would ensure that once a risk transfer had been negotiated, the interests of litigants, attorneys, and capital providers would be very much aligned. All would benefit from an efficient resolution below the strike price agreed upon by all as the appropriate benchmark for success. There might be some scenarios where their interests do not completely converge. For example, when a case could be settled just below the strike price, the attorney litigating the case might

73 For a discussion of the value of diversification, see note 52 and accompanying text. See also Figure 1.

74 For one example of a similar fee structure imposed on law firms by an insurance company, see Carrie Menkel-Meadow, *Culture Clash in the Quality of Life in the Law: Changes in the Economics, Diversification and Organization of Lawyering*, 44 Case W Res L Rev 621, 655 n 163 (1994).

have a strong incentive to go to trial and hope for a defense verdict and a big windfall, whereas the capital provider bearing downside risk would prefer to settle and avoid a big loss. But even here the divergence might be quite narrow—for after all, going to trial would be time-consuming and expensive for attorneys who are earning fixed fees below their regular hourly rates. On the whole, such a risk-sharing arrangement would do a better job aligning interests than the hourly-billing arrangements that attorneys generally employ on the defense side.[75]

Second, and equally important, would be the prospective effect that such an alternative fee arrangement might have on attorney incentives during the due diligence phase before any risk transfer has actually been negotiated. As noted earlier, a major concern for capital providers willing to assume litigation risk is their ability to price the risk accurately.[76] A capital provider would always worry that no matter how thorough its due diligence, it will never understand the risk as well as the defendant and its lawyers. Moreover, to the extent that the defendant and its attorneys have incentives to underprice the risk, they could exploit the information asymmetry to their advantage.

However, if the defendant's attorneys knew that they were going to stay on and litigate the case—at a fee based in part on how much they could save off of the negotiated transfer price—the attorneys would no longer be inclined simply to try to dispose of the risk as cheaply as possible on behalf of their client. Although the client would hope for a low transfer price, and the attorneys would have some ethical duty to advance the client's interests, the attorneys' own financial incentives would favor a *higher* transfer price. After all, the higher the transfer price, the greater the likelihood that the attorneys will be able to come in below that price and earn a larger fee for their work. The prospective effect of a future contingent fee arrangement might dampen the attorneys' zeal on behalf of their original client—the defendant—and motivate the attorneys to consider as well the interests of their future client—the capital provider.

Although the prospect of a contingent fee arrangement would create a conflict of interest for attorneys during the due diligence and negotiation phase, this conflict may very well be in everyone's best interests—including the interests of the defendant. A defendant unable to reassure a potential litigation insurer that it is being completely honest and open will most likely be unable to find anyone willing to

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75 Consider Carrie Menkel-Meadow, *Ethics and the Settlement of Mass Torts: When the Rules Meet the Road*, 80 Cornell L Rev 1159, 1182 (1995) ("Like their brothers and sisters who have conflicts over contingent fees, hourly fee lawyers also have conflicts with clients over lavish hourly billing that can almost equal the huge verdicts plaintiffs' lawyers trade on.").

76 See Part I.A.

assume its risk. By waiving this potential conflict of interest and authorizing its attorneys to cooperate fully in the due diligence phase—even if the attorneys will be motivated in part by the prospect of a contingent fee if the suit is priced appropriately—a defendant can send reassuring signals to a potential capital provider about the thoroughness of the due diligence phase. So long as lawyer and client alike are honest with each other about the conflict of interest,[77] the conflict is more likely to facilitate risk transfers than to serve as an obstacle.

Moreover, the conflict would be most intense only during the due diligence and negotiation phase. Although conflicts might persist even after a risk transfer has been completed—as, for example, where the defendant and capital provider had different opinions about settlement—these sorts of conflicts can be handled contractually. The terms of the risk transfer would expressly allocate control over the suit so that the lawyer understands from whom he is supposed to take his orders. And any conflict of interest would be dampened by the largely aligned financial incentives of the defendant, the lawyer, and the capital provider that has assumed much of the risk. Risk transfers would be structured so that all three would stand to benefit from efficient resolutions below the negotiated price. Indeed, if there is some ambiguity inherent in such a three-way arrangement—and the defendant would expect some loyalty from the lawyer even if the lawyer is contractually obligated to obey the capital provider's instructions—this may not be such a bad thing. A defendant asked to relinquish control over its lawsuit as part of a risk-transfer agreement may find some reassurance in the prospect that its own lawyers will stay on and continue to represent it. Although the lawyers might be contractually obligated to heed the risk bearer's wishes, rather than the defendant's, the lawyers would be likely to conduct the litigation in a manner that is respectful of the defendant's management's time. The lawyers could be counted on, for example, to schedule depositions of corporate officers in a manner that is sensitive to their ongoing business responsibilities and business interests. Although contract terms might describe a fundamental transfer of control, in practice a successful risk transfer would be one where defendant, lawyer, and capital provider alike would be expected to cooperate in pursuit of a common goal and to respect one another's interests.

II. IS A MARKET IN LITIGATION RISK DESIRABLE?

If, as I suggest, litigation-risk transfers are feasible in the right category of cases and we can indeed pool litigation risk in those instances,

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77 For a discussion of how such conflicts should be handled under the ABA Model Rules of Professional Conduct, see notes 140–42 and accompanying text.

the question remains as to whether litigation-risk transfers are normatively desirable. Are there public policy reasons why we might wish not only to permit but perhaps even to facilitate litigation-risk transfers? Conversely, are there public policy reasons why litigation risk should reside with litigants even where they are willing to pay a premium to dispose of it? If profit-oriented lawyers are willing to stray from the traditional model of client service and team up with capital providers to make a market in litigation risk, should we encourage them to do so, should we dissuade them from doing so, or should we be indifferent?

I suggest in this Part that public policy weighs heavily in favor of permitting and even facilitating risk transfers for those defendants who so desire. Part III then takes up the question of what specifically we can do to facilitate the creation of a market in litigation risk, identifying a number of doctrinal and policy reforms that the bar, the bench, and other regulators might pursue.

A. The Affirmative Benefits of Litigation-risk Transfers

For many corporate defendants, if litigation risk is large enough, it can interfere with productive business plans and dampen economic activity. The discussion below addresses the costs that litigation can inflict on these corporations and on our economy more broadly. It also addresses the responsibility of the bar, the bench, and the government more broadly for these costs and argues that public policy should be tailored to allow and even facilitate litigation-risk transfers where they are feasible. Although I do not argue that government itself should solve the problem of inadequate litigation-risk management, I do suggest that government should make sure it does not stand in the way of private solutions.

1. Litigation as an unwanted risk.

American businesses face a host of risks that can affect their success, some of which they are well suited to bear and others of which they are not. Consider, for example, the range of factors that will affect the profits of a cornflakes manufacturer in any given year. Its profitability will depend on how many boxes of cornflakes consumers buy that year; how its brand of cornflakes fares compared with those of competitors; how much it can charge for its cornflakes; and how much it spends to produce, distribute, and sell those boxes of cornflakes. At first glance, all of these risks seem like core business risks: the company's ability to make a product consumers desire, to market that product effectively, and to manage its costs are all part of its core business mission. But many of the company's costs can depend in turn upon risks that the company is not as well suited to bear. If climactic conditions affect the corn crop and raise the costs of corn or if a fire burns down a factory, these can affect profits just as much as the success or failure of a marketing effort or production plan. Fortunately, the cornflakes manufacturer can utilize a host of risk-management devices to remove these risks from its balance sheet.[78] The company can buy corn futures to lock in the price of corn in advance and insulate it from fluctuations in crop prices. It can also buy insurance to cover property damage, reconstruction costs, and lost profits caused by a calamity like a fire.[79]

But when a company is sued for something that is not insured—either because the risk is uninsurable[80] or because the litigation-triggering event was unforeseeable—the company may face an unwanted risk that it cannot eliminate. The company might be sued by a supplier or a marketing partner over a business dispute; it might be sued by a competitor for patent infringement in its production processes; it might be sued by a consumer for alleged price fixing; or it might be sued by an employee for breach of an employment contract. A large portion of commercial litigation today stems from alleged wrongdoing that either is not insurable under standard commercial liability policies or at the very least is the subject of a serious coverage dispute with the defendant's insurer.[81] Once a company is sued, its financial condition may depend not only on its sales revenue and costs of production but also on how much it will cost to defend and resolve the lawsuit (and perhaps on how much of the loss, if any, might be recovered from an insurer).

The total cost of litigation to a corporate defendant—in terms of payments to lawyers and to plaintiffs—will depend only in part upon the company's business practices. Certainly the company that cuts corners in its business practices is more likely to be sued by consumers, employees, or business partners and to pay more for those suits that arise.[82] The discovery process is likely to uncover shoddy business prac-

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78 See note 16 (explaining why corporations insure even if their shareholders hold diverse portfolios of investments).

79 See, for example, *Duane Reade, Inc v St Paul Fire and Marine Insurance Co*, 279 F Supp 2d 235, 238–39 (SDNY 2003) (discussing the calculation of business interruption losses).

80 See, for example, *Weedo v Stone-E-Brick, Inc*, 405 A2d 788, 791 (NJ 1979) (noting that the "business risk" exclusion in commercial liability insurance policies excludes coverage for insured's faulty contract performance but covers incidental property damage caused by that faulty performance). See also *Modern Equipment Co v Continental Western Insurance Co, Inc*, 355 F3d 1125, 1131 (8th Cir 2004); *McGowan v State Farm Fire and Casualty Co*, 100 P3d 521, 525–26 (Colo App 2004).

81 See Samuel R. Gross and Kent D. Syverud, *Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial*, 90 Mich L Rev 319, 371–72 (1991) (noting that as compared to personal injury litigation, insurance is far from universal in commercial transaction litigation).

82 But consider Eric L. Talley, *Public Ownership, Firm Governance, and Litigation Risk*, 76 U Chi L Rev 335, 338 (2009) (finding that, at least for securities litigation, "the predictive relationship ... between governance choices and prospective litigation risk is relatively (and somewhat surprisingly) modest").

tices and to help a plaintiff's case. In contrast, the company that takes care in its dealings with these constituencies is not only less likely to be sued but also likely to pay less when it is sued.

But if some portion of a lawsuit's value is determined by a company's pre-lawsuit conduct, there is a great deal of litigation risk that is difficult to value based on a backward-looking examination of the company's business practices.[83] How much a company will end up paying in litigation expenses and judgments or settlements will depend upon the performance of its own lawyers and those of the plaintiff, on the views of the presiding judge and/or jury, and on a host of procedural rulings that may be only tangentially related to the merits. Some of these factors are completely beyond the party's control and others, though within its control, are not within the company's core business mission. Companies want their profits to turn on the quality of their products, the effectiveness of their marketing, and the care with which they manage production costs—not upon how well they handle litigation.

That a corporate defendant would rather not bear litigation risk does not always mean that the defendant will be in dire need of a risk-transfer solution. Whether the defendant will actually need a risk-transfer mechanism—and be willing to pay a premium to dispose of the risk—will depend upon the risk involved, its size relative to the company's balance sheet, and its affect on the company's business plans. As noted at the outset, the secondary and tertiary costs of litigation are at their highest when litigation threatens to interfere with pending business transactions. If a pending lawsuit is potentially big enough relative to the size of the company, a potential investor or lender may be unable or unwilling to spend the time to become comfortable enough with the risk. Absent a risk-transfer mechanism, the defendant in such instances must not only live with the cost and uncertainty of the suit but may also face a higher cost of capital and an inability to proceed with deals that otherwise make economic sense. Permitting defendants to dispose of their litigation risk in these instances would have significant economic benefits.

2. Litigation expense and the public interest.

The nontransferable nature of litigation risk makes litigation more costly, and this cost, in and of itself, would counsel in favor of permitting litigation-risk transfers. Just as public policy favors permitting people to buy insurance or hedge contracts for a variety of other risks, so too would public policy favor allowing the market to trade in litiga-

83 See id.

tion risk. But there is an additional public policy argument in favor of not just permitting, but actually *facilitating*, litigation-risk transfers that is not present in other areas of risk management. Unlike the many other risks that risk bearers may seek to offload, litigation risk is in some respects a problem created by the bench, the bar, and the government more broadly. The great uncertainty associated with civil litigation is a product of a system that the government has imposed on litigants. True, the machinery of the litigation system is largely controlled by litigants themselves. It is the defendant whose conduct typically gives rise to a suit and the plaintiff who gets to decide where to sue, what to claim, and what to seek in discovery.[84] But the options available to plaintiffs and defendants in litigation are the product of a system created by legislatures and presided over by the bench and the bar.

Nobody doubts that if the bench, the bar, or the legislature could reduce the primary costs of litigation without sabotaging justice or fairness, they certainly would have a responsibility to do so.[85] If discovery could be streamlined without sacrificing the free exchange of information, it would be incumbent upon government to make the salutary changes. Indeed, the rise of the modern administrative state, and the substitution of regulatory regimes and compensation schemes for litigation, rested on the belief that government was responsible for displacing civil litigation where doing so would be in the public interest.[86] Moreover, the rise of managerial judging within the civil litigation system reflects an acknowledgment among judges that if the bench can find ways to reduce the burdens on litigants (and courts) by streamlining the process and promoting quick, efficient settlements, it should do so.[87] The perennial question is not whether government *should* reduce litigation costs where possible but rather whether it can do so without sacrificing the goals of civil litigation. If government can

84 See *Schlagenhauf v Holder*, 379 US 104, 114 (1964) ("The chain of events leading to an ultimate determination on the merits begins with the injury of the plaintiff.").

85 See Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J Legal Stud 307, 308 n 1 (1994) ("Some changes in the legal system might make it simultaneously more accurate and cheaper, but it is usually obvious that such changes are desirable (from the economic perspective employed here) and thus analytically uninteresting to consider them.").

86 See Jonathan T. Molot, *Principled Minimalism: Restriking the Balance between Judicial Minimalism and Neutral Principles*, 90 Va L Rev 1753, 1799 (2007).

87 See Jonathan T. Molot, *An Old Judicial Role for a New Litigation Era*, 113 Yale L J 27, 40 (2003). Moreover, with the evolution of the class action device, judges have had to take on the additional responsibility of checking its excesses and guarding against both partisanship and agency problems. See, for example, William B. Rubenstein, *The Fairness Hearing: Adversarial and Regulatory Approaches*, 53 UCLA L Rev 1435, 1444 (2006); Bruce Hay and David Rosenberg, *"Sweetheart" and "Blackmail" Settlements in Class Actions: Reality and Remedy*, 75 Notre Dame L Rev 1377, 1400 (2000).

ease the burdens without sacrificing fairness or accuracy, it is hard to see why it would not.

If we all agree that government is responsible for reducing primary dispute resolution costs where possible, then it should not be controversial to suggest that government also should do what it can to reduce secondary and tertiary litigation costs. Indeed, the beauty of tackling secondary and tertiary costs, rather than primary costs, is that one can make progress without any significant effect on the fairness or accuracy of the civil litigation system. The risk-transfer mechanism I have described would not change civil procedure. Discovery, motion practice, and trial practice would remain untouched. By facilitating risk transfers, government could thus reduce litigation costs without any of the negative consequences that so often riddle procedural reform efforts.

I am not urging that government itself should relieve litigants of litigation risk or bankroll a litigation-risk transfer mechanism but rather merely asserting that the bench, the bar, and the executive and legislative branches of government should do what they can to facilitate private sector solutions and avoid standing in their way. My suggestions for reform are outlined in Part III.

B. Evaluating Possible Side Effects on Litigant and Lawyer Behavior

Before proceeding to suggest these reforms, however, it is important to ask whether there are any policy reasons that would counsel against such efforts. Would the economic benefits of litigation-risk transfers bring with them any negative side effects that might counsel against permitting them? Are there instances in which the law should prohibit, rather than facilitate, risk transfers? Before I urge lawyers to create litigation risk markets and urge judges, legislators, and regulators to support lawyers in this endeavor, I have to consider a few potential dangers.

Given that our system of litigation relies so heavily on settlement as an alternative to adjudication,[88] at first glance there is no obvious reason why a defendant to a lawsuit should not be able to dispose of litigation risk via some mechanism other than settling with the plaintiff.

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88 See, for example, Miller, 80 Tex L Rev at 2115 (cited in note 8) ("A lawsuit is essentially a sale. The defendant buys a valuable asset from the plaintiff, in the form of a release of claims if the case is settled, or a verdict with *res judicata* effect if the case goes to a verdict."); Rubenstein, 89 Georgetown L J at 372 (cited in note 3) ("In complex class actions, defendants purchase a commodity—finality. They buy from the plaintiffs' representative the plaintiffs' rights to sue."); Robert H. Mnookin and Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding* Pennzoil v. Texaco, 75 Va L Rev 295, 295 (1989) ("It is through negotiation, not adjudication, that legal conflict is typically resolved."). But see Owen M. Fiss, *Against Settlement*, 93 Yale L J 1073, 1085 (1984) ("To be against settlement is only to suggest that when the parties settle, society gets less than what appears, and for a price it does not know it is paying.").

Once we are willing to accept settlement as an adequate substitute for adjudication, why should we restrict defendants to settling only with plaintiffs?[89] If the defendant can find a willing intermediary to absorb litigation risk, it is hard to see why we should stop the defendant from doing so. So long as the risk-transfer mechanism prices litigation risk accurately—and the defendant ends up paying an amount that is roughly comparable to what it would pay to the plaintiff after a judgment or settlement—litigation-risk transfers would have no negative effect on deterrence or compensation. Indeed, this is especially so if the defendant continues to bear some litigation risk through coinsurance, as I discussed above.[90] Whatever policy reasons remain for limiting the sale of claims on the plaintiffs' side,[91] these policy reasons do not appear to apply on the defense side.[92]

But upon closer analysis, three potential objections arise to litigation-risk transfers for defendants. First, one might object that even if the litigation-risk transfer mechanism I have in mind would price litigation accurately—and accurately predict settlements and/or judgments—nonetheless risk transfers would change litigation dynamics in such a way as to alter the balance of power between defendants and plaintiffs. By transferring litigation risk from a one-off, risk-averse defendant to capital providers and lawyers who hold a diverse portfolio of litigation risk and view litigation as their core business, risk transfers would improve defendants' bargaining position vis-à-vis plaintiffs. In a suit of uncertain value, a one-off defendant may not be able to present a credible threat of proceeding to trial. Once litigation risk is transferred, however, those representing the defendant would view each suit as just one in a larger pool and could afford to lose one or two large judgments at trial if necessary.[93] The new risk bearers would thus be in a better po-

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89 Consider Carrie Menkel-Meadow, *Whose Dispute Is It Anyway?: A Philosophical and Democratic Defense of Settlement (in Some Cases)*, 83 Georgetown L J 2663, 2668 (1995) ("[H]ow can we tell good settlements from bad ones, and when should we prefer adjudication to settlement?").

90 See Part I.C.

91 For a general discussion, see Michael Abramowicz, *On the Alienability of Legal Claims*, 114 Yale L J 697 (2005). I question the wisdom of these restrictions. See Molot, *A Market in Litigation Claims* at *25 (cited in note 17).

92 Although one might fear that defense-side risk transfers might undermine deterrence, risk transfers that are priced accurately should have the same deterrent effects as settlements with plaintiffs. Indeed, the prohibition in many jurisdictions against insuring punitive damages—based on a fear of freeing the insured ex ante to commit repugnant acts—might not apply to litigation-risk transfers effected *after* a litigation-triggering event already has occurred. See, for example, *Northwestern National Casualty Co v McNulty*, 307 F2d 432, 440 (5th Cir 1962) (noting that if the insured "were permitted to shift the burden to an insurance company, punitive damages would serve no useful purpose").

93 Scholars have observed how litigation dynamics and bargaining power may depend upon whether the parties are repeat players—like contingent fee plaintiffs' attorneys and insur-

sition to threaten the plaintiff with trial and, in so doing, might be able to negotiate a less expensive settlement.[94]

Indeed, this potential enhancement of defendants' bargaining leverage might be one of the most attractive features of litigation-risk transfers from the perspective of corporate defendants. Capital providers might be able to charge less for risk transfers if they expect that they will be able to dispose of cases for less than defendants could. And even if these capital providers retain much of the savings as profit, defendants resentful of the litigation system—and of the plaintiffs who have sued them—may gain satisfaction simply from knowing that plaintiffs are likely to recover less. To those in corporate America who view plaintiffs' firms with distrust, a risk-transfer mechanism would work to "starve the beast" that has plagued them with lawsuits.

But to those who believe that the "haves" already come out ahead in litigation, a system of risk transfers would only aggravate this problem.[95] To plaintiffs' lawyers and their clients who believe that the litigation system imposes a needed check on corporate misconduct and a source of compensation for its victims, any mechanism that reduces plaintiff recoveries would be unwelcome. The normative value of risk transfers for defendants might thus depend upon whether one adopts a plaintiffs' or defendants' view of the litigation system.

Moreover, there is a second respect in which someone might worry about the effect of a risk transfer upon litigant behavior. To the extent that those assuming litigation risk are less fearful of going to trial, this may not only improve their bargaining leverage vis-à-vis plaintiffs but also lead to more trials. In an overburdened court system that relies heavily on settlements to clear dockets, any mechanism that takes the pressure off parties to settle might be disfavored by judges.

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ance companies—or one-time litigants. See, for example, Gross and Syverud, 90 Mich L Rev at 381–82 (cited in note 81).

94 This would not be true, however, if the original defendant could use the prospect of insolvency to negotiate a lower settlement. See note 57.

95 See, for example, David Rosenberg, *Class Actions for Mass Torts: Doing Individual Justice by Collective Means*, 62 Ind L J 561, 564 (1986) ("Because defendant firms are in a position to spread the litigation costs over the entire class of mass accident claims, while plaintiffs, being deprived of the economies of scale afforded by class actions, can not, the result will usually be that the firms will escape the full loss they have caused."); Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 L & Socy Rev 95, 124–25 (1974) (explaining that the "haves" enjoy certain advantages in the areas of legal services, institutional facilities, rules, and the parties involved). See also generally David Rosenberg, *Mass Tort Class Actions: What Defendants Have and Plaintiffs Don't*, 37 Harv J on Legis 393 (2000) (exploring the "social costs of biasing the allocation of litigation power"); Herbert M. Kritzer and Susan S. Silbey, eds, *In Litigation: Do the "Haves" Still Come Out Ahead?* (Stanford 2003). For an exploration of what scholars mean by procedural "equality" or "inequality," see William B. Rubenstein, *The Concept of Equality in Civil Procedure*, 23 Cardozo L Rev 1865, 1867–68 (2002) (explaining the three types of equality: equipage equality, rule equality, and outcome equality).

Finally, one might question whether shifting litigation risk would not only dampen defendants' incentives to settle but also change lawyers' incentives. Recall from above that the litigation-risk transfers I have in mind would allocate at least some of litigation's risks and rewards to lawyers.[96] In addition to earning a modest fixed fee to cover expenses, lawyers would share in the savings they achieve off of the price negotiated for a lawsuit—thereby aligning the interests of lawyer, client, and capital provider. As a result, not only would capital providers on the defense side have an incentive to duke it out with plaintiffs for cheaper settlements, but defense lawyers too would have stronger incentives to extract cheaper settlements. This change in lawyer incentives might intensify the partisanship problems that already plague large, complex litigation.[97]

Ultimately, I suggest that while these three concerns may be strong enough to warrant careful monitoring of any risk-transfer mechanism, they are not strong enough to offset the very strong benefits that could be reaped from risk transfers in appropriate cases. For one thing, it would seem unfair to deprive defendants of a risk-transfer mechanism that the system allows to plaintiffs. Having decided to permit plaintiffs to shift some litigation risk in this country—through contingent fee arrangements that make it much easier for plaintiffs to bring lawsuits and collect from defendants[98]—it would be unfair to deprive defendants of a risk-transfer mechanism. To those who fear that risk transfers on the defense side will unduly enhance defendants' bargaining positions, the most obvious (and parallel) way to offset this effect would be to expand upon the contingent fee arrangement and permit plaintiffs to sell their claims for cash and not merely trade away one-third to their lawyers in exchange for legal representation in the case.[99] Such a risk-transfer mechanism would enhance bargaining power on the plaintiffs' side and ensure that plaintiffs have adequate resources to pursue meritorious claims.[100] Moreover, even if defense-side risk trans-

96 See notes 73–77 and accompanying text.

97 See, for example, Molot, 84 Va L Rev at 973–74 (cited in note 2) ("To the extent that attorneys manipulate legal processes rather than apply the law, the social utility of the legal profession declines."); Deborah L. Rhode, *Institutionalizing Ethics*, 44 Case W Res L Rev 665, 670 (1994) (noting a "wide range of partisan practices that obstruct the search for truth").

98 See, for example, Gross and Syverud, 90 Mich L Rev at 349–50 (cited in note 81).

99 I address plaintiff-side risk transfers in a companion article. See Molot, *A Market in Litigation Claims* at *9 (cited in note 17). Many states already have done away with restrictions on the sale of claims. See Abramowicz, 114 Yale L J at 700 (cited in note 91); Peter Charles Choharis, *A Comprehensive Market Strategy for Tort Reform*, 12 Yale J Reg 435, 464 (1995); Painter, 71 Chi-Kent L Rev at 641–42 (cited in note 26); Marc J. Shukaitis, *A Market in Personal Injury Tort Claims*, 16 J Legal Stud 329, 330 (1987).

100 Although I reserve for another article the implications of plaintiff-side risk transfers, see Molot, *A Market in Litigation Claims* at *9 (cited in note 17), it is worth noting briefly why risk

fers did work to the disadvantage of some plaintiffs in some cases, the availability of defense-side risk transfers might in the long run inure to the benefit of plaintiffs generally. To the extent that risk transfers succeeded in alleviating some of the burdens on corporate defendants, this might obviate the need for defendant-fueled reform efforts that would be much more damaging to plaintiffs, such as proposals for damages caps, class action reform, or the elimination or restriction of punitive damages. If risk transfers could dampen the zeal for more dangerous procedural reform, this in and of itself would be of great value.

Nor do I believe that we should allow our pro-settlement inclinations to stand in the way of litigation-risk transfers for defendants. It is true that a defendant who can settle with someone other than the plaintiff may be less desperate to settle with the plaintiff and that a new bearer of litigation risk may be a bit less fearful of trial. But often, the question is not *whether* a case will settle but *when*. Companies with pending deals may seek risk transfers because the timing of the litigation life cycle does not match the timing of the deal cycle. The company may dispose of the risk so it can proceed with its deal at a time when the suit is not ripe for a settlement. But the suit may very well settle later on, when discovery is further along and both parties have adequate information upon which to base a settlement. Indeed, given that insurance companies already settle the vast majority of suits in which they are involved—despite the fact that they hold diverse portfolios of litigation risk—it is far from clear that a risk bearer providing after-the-event litigation insurance would be all that much less likely to settle than a defendant or a conventional insurer who is on the hook because it sold a conventional, before-the-event insurance policy.[101] Moreover,

transfers on the plaintiffs' side generally could be expected to enhance plaintiffs' bargaining power. The range of jury awards for many types of lawsuits is thought by many to have a log-normal distribution—with a high incidence of small recoveries and a few large outliers that skew the mean toward a higher amount than the median. See note 52. A one-time plaintiff deciding how much to accept in settlement of such a suit will likely look at the median—asking his lawyer what most plaintiffs in his position would likely recover at trial. The one-time plaintiff will not likely forego an amount that exceeds what most plaintiffs are likely to collect at trial in the hope of winning the lottery and being one of the lucky few plaintiffs who wins a huge, windfall verdict. A repeat-player defendant like an insurance company, in contrast, would look at the mean, knowing that if it goes to trial every time, it will eventually lose one of the very large judgments. To the extent that the insurer can offer the plaintiff an offer just above the median, it should be able to strike a settlement for an amount that represents a significant savings off the mean. If we substitute a repeat-player plaintiff for a one-time plaintiff, however, this would enable those on the plaintiffs' side to bargain based on the higher mean, rather than the lower median, and hold out for higher settlements. See notes 93–94.

101 For a discussion of how the participation of repeat-player institutional litigants changes the nature of litigation, see Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 L & Socy Rev 275, 277 (2001) (noting that repeat players are motivated to reach a settlement within the liability insurance limits when the defendant would be paying with his own money).

the risk-transfer mechanism described in Part I would apply to only a subset of cases that are of great economic importance but may not be all that large in absolute numbers. It is unlikely that risk transfers would lead to enough additional trials to have a meaningful impact on court dockets.

Finally, the concern about sharp lawyer practices following risk transfers is no different on the defense side than on the plaintiffs' side. By facilitating contingent fee arrangements for defense lawyers, risk transfers would simply provide defense lawyers with economic incentives more like those of contingent fee attorneys on the plaintiffs' side than traditional hourly fee attorneys on the defense side—incentives which may in some instances make them *more* eager to settle rather than less (for hourly fee attorneys may have incentives to drag out litigation and bill more hours).[102] If we are able to cope with the partisanship problems that stem from plaintiffs' contingent fee arrangements, we should be able to handle contingent fee arrangements on the defense side as well. Risk transfers might end up having a major impact on the economics of law practice—particularly for those firms that concentrate on representing large corporations in commercial matters and are not used to the contingent fee arrangements that dominate the practices of plaintiffs' firms.[103] But this change in law practice would not be a reason to oppose risk transfers. To the contrary, for the many large firms that work so hard today to maximize billable hours and associate leverage, such a change in billing practices might offer an attractive way to increase profits without sacrificing attorney morale.[104]

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102 See Robert H. Mnookin, *Negotiation, Settlement and the Contingent Fee*, 47 DePaul L Rev 363, 365 (1998) (indicating that under an hourly fee arrangement, "[i]f discovery is protracted and settlement comes late in the process, defense counsel will be compensated for additional time invested in the case"); Bruce L. Hay, *Optimal Contingent Fees in a World of Settlement*, 26 J Legal Stud 259, 260 (1997) ("[I]f the client controls the settlement decision, she is generally better off using a contingent fee instead of an hourly fee."); Jonathan T. Molot, *How U.S. Procedure Skews Tort Law Incentives*, 73 Ind L J 59, 89–91 (1997) ("[I]f each hour of plaintiffs' and defendants' attorneys' time were of equal value (and both sides were equally optimistic about the benefits of proceeding), plaintiffs' attorneys would be more eager to settle than defendants."); Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J Legal Stud 189, 189 (1987) (noting that in a contingent fee arrangement, the lawyer is both the agent of the defendant and the principal with respect to his own interest in the claim).

103 See Molot, *A Market in Litigation Claims* at *29–30 (cited in note 17).

104 See, for example, Susan Saab Fortney, *Soul for Sale: An Empirical Study of Associate Satisfaction, Law Firm Culture, and the Effects of Billable Hour Requirements*, 69 UMKC L Rev 239, 247–48 (2000) (noting the increasing billable hour requirements since the 1960s); Ronald J. Gilson and Robert H. Mnookin, *Sharing among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 Stan L Rev 313, 348 (1985) (discussing competitive pressures faced by firms).

III. WHAT CAN BE DONE TO FACILITATE A MARKET IN LITIGATION RISK?

If, as I have argued, litigation risk markets are both feasible and desirable, the question arises as to why they do not exist. If lawyers could find capital to relieve litigants of risk, and litigants, society, and lawyers themselves would benefit from such a business model, then why are lawyers not already doing it? Part of the explanation lies in the obstacles I explored in Part I. Although it may be feasible to price and transfer litigation risk in appropriate cases, Part I explained that the category of cases in which risk transfers could work is quite narrow. Given the transaction costs associated with pricing litigation risk and the structuring costs that non-insurance company capital providers would bear in trying to absorb litigation risk, Part I suggested that risk transfers would work only where the tertiary costs of litigation are at their highest—most likely where large-scale litigation threatens to interfere with even larger-scale deals. Where a litigant simply wants certainty—and does not need it at a particular moment to complete a pending deal or to attract new capital from investors or lenders—that litigant will likely be better off waiting for a settlement with the plaintiff than trying to offload its litigation risk to a third party. Moreover, even where a deal is pending, parties to the deal may be able to find ways to negotiate around the problem, thus further narrowing the category of cases in which litigation-risk transfers would actually be employed if they were made available.[105] Because the category of cases where risk transfers are feasible is so narrow, it is understandable that neither litigators nor deal lawyers generally think of a risk transfer as a potential solution to their clients' legal problems.

Perhaps if some lawyers were to stray from the traditional client-service model and start a business absorbing litigation risk, these innovative lawyers could educate other lawyers on where risk transfers would make sense. This new breed of "clientless" lawyers would market their offerings to litigators and deal lawyers who are likely to come across cases where risk transfers would help.

But even if risk transfers were made available, and litigators and transactional lawyers were educated on where they would make economic sense, it is possible that these litigators and deal lawyers would nonetheless be reluctant to consider risk transfers as a real option for their clients. The mere fact that litigation-risk transfers are novel and untested would mean that their treatment under an array of legal doc-

105 Indeed, where a third-party litigation insurer prices litigation risk for deal participants, the deal participants may choose to use that price as a basis for their negotiations and retain the risk themselves, thereby avoiding having to pay the insurer a premium.

trines and government policies would be uncertain. Risk-averse lawyers would likely worry about a number of legal doctrines and government policies that could be interpreted either to disfavor litigation-risk transfers or, at the very least, to raise doubts about their utility. Litigators and deal lawyers alike might therefore advise their clients against participating in a litigation-risk transfer for fear of adverse legal consequences.

If we believe that making a market in litigation risk is a good idea (as I argued in Part II), then we would need not only to educate lawyers and capital providers on how a risk-transfer market might work (as I attempted to do in Part I) but also to consider carefully the legal doctrines and government policies most likely to bear upon the feasibility and utility of litigation-risk transfers. I do not pretend to be able to anticipate all the ways that my proposed market in litigation risk would test traditional legal doctrines. Precisely because litigation-risk transfers are largely untried, it is impossible to foresee all the doctrinal questions they will raise. Some questions, however, I am reasonably certain will arise. I address these questions below, suggesting that most of them can be addressed with relatively modest clarifications or revisions of existing doctrine. This should not be a surprise, given that at least one form of litigation-risk transfer is so routine in our system—namely, the contingent fee arrangement employed by plaintiffs. If risk transfers can be accommodated on the plaintiffs' side, it should not be too difficult to adjust the relevant legal doctrines to accommodate defense-side risk transfers as well.[106]

There are four areas of law and policy in particular that are likely to loom largest for lawyers contemplating participating in litigation-risk transfers—either as agents for clients or as principals in their own right. I suggest below that if we want to encourage litigators and deal lawyers to consider risk transfers as an option for their clients—and to encourage entrepreneurial lawyers to raise capital and create a litigation-risk transfer market—we would likely want to address the following four areas. First, to reassure litigators, we might need to clarify or

106 As noted earlier, the risk being transferred pursuant to a conventional contingent fee arrangement is somewhat different from that being transferred when defendants buy litigation insurance (or when plaintiffs sell claims). See notes 21–24 and accompanying text. Whereas I envision defendants buying protection against higher-than-expected judgments, contingent fee plaintiffs generally are buying protection against higher-than-expected litigation expenses. That said, plaintiffs seek this protection in many instances because they fear that their recovery may be too small to cover litigation costs. In these instances the risk driving the risk-transfer decision for the plaintiff is thus the same one that motivates a defendant: namely, the risk that a judgment or settlement will come in higher or lower than expected. (In other instances, however, plaintiffs may be forced into a contingent fee even if they are confident of a large recovery because they simply do not have the cash to cover legal fees or the ability to borrow it.)

reform the discovery rules. Under existing discovery doctrine, a litigator considering a risk transfer for his client might worry that his client's negotiations with a potential risk bearer, and the materials shared with that third party, would somehow be revealed to the plaintiff, thereby weakening the defendant's position in the underlying litigation. Without clarification of the discovery rules to protect against such disclosure, the litigator might not go down the path of even considering a risk transfer. Second, to satisfy transactional lawyers, we might seek to clarify the accounting rules and securities laws that would govern the treatment of a litigation-risk transfer on a company's financial statements. A corporate lawyer might not advise his client to take advantage of a market in litigation risk unless he is confident that the accounting rules and securities laws are structured to ensure that his client will reap the benefits of a risk transfer. A third area in need of clarification or reform might be the law regulating insurers. An innovative lawyer will have a hard time convincing a hedge fund or investment bank to participate in a new litigation risk market—even if the premiums are very attractive—if he cannot reassure the lawyers representing that hedge fund or investment bank that its participation is permitted by prevailing insurance law. Lawyers for hedge funds or investment banks may worry that if their clients engage in risk-transfer transactions they may be prosecuted by insurance regulators for engaging in the business of insurance without an insurance license. Fourth, and finally, the law governing lawyers themselves may interfere with litigation-risk transfers. A lawyer considering participating in a risk-transfer transaction may worry not only about the negative consequences of risk transfers for his client but also for himself. When lawyers straddle the roles of client advisor and deal broker, they risk breaching their professional obligations and subjecting themselves to professional sanction. If we think litigation-risk transfers could be of value, it is important that professional standards be interpreted to permit lawyers to facilitate these risk transfers.

Although the doctrinal clarifications and policy reforms I explore below will never alone create a market that does not today exist—and they by no means exhaust the doctrinal problems likely to arise—these changes might help facilitate the creation of a market that, as I have argued above, would be of great value to litigants, lawyers, and society.

A. Risk Transfers and Litigation Dynamics: Treatment under Discovery Rules

The body of law most likely to cause concern among litigators contemplating risk transfers for their clients is the law governing civil discovery. There are two ways in which the discovery rules can bear upon the feasibility and utility of litigation-risk transfers. First, as discussed in Part I, it is essential that both sides to a litigation-risk transfer have full information. Yet, defendants may often fear that anything they turn over during due diligence to a potential litigation insurer may end up in the hands of the plaintiff. To facilitate litigation-risk transfers, it might be important to make clear, at both the federal and state level, that defendants will not lose work product or attorney-client privilege protection upon sharing protected information with a potential "litigation insurer" during the pre-transfer due diligence process. I have suggested above that, under existing law, defendants generally should be able to preserve these protections, relying on the same common interest privilege that is often invoked when litigants need to share information with conventional liability insurers and potential acquirers.[107] But if that is the better interpretation of existing discovery doctrine, it nonetheless would help if the guidance on this point were clearer. One target for reform efforts would thus be to obtain clarification on the point from the relevant rules committees, courts, or legislatures.

A second way in which the discovery rules might bear upon the utility of litigation-risk transfers concerns the effect that such a transfer, once accomplished, might have on subsequent bargaining dynamics with the plaintiff. When a defendant elects to shift some litigation risk to a third party, must the plaintiff be informed of this transfer? And, if so, should the plaintiff be privy to the terms upon which the transfer was effected? Under Federal Rule of Civil Procedure 26 and many corresponding state discovery rules, a defendant's insurance policies are not only discoverable but subject to mandatory disclosure.[108] To the extent that a litigation-risk transfer counts as "insurance," one might assume that it must be turned over to the plaintiff.

But there are strong countervailing reasons why litigation-risk transfers should be treated differently from other insurance arrangements for discovery purposes. If a defendant and a litigation insurer are able to agree on a risk transfer after thorough due diligence, the terms of their agreement will reveal a great deal about their views of the litigation. In some cases a defendant-insurer team might want to disclose the existence and terms of a risk transfer to a plaintiff with unrealistically high settlement expectations. Indeed, the defendant-insurer team could use the risk transfer terms to show the plaintiff that it is being unrealistic and to signal a willingness to proceed to trial if the plaintiff does not agree to a reasonable settlement. But in other cases, the defendant-insurer team may prefer not to reveal the terms, or even the existence, of the risk transfer. After all, the agreement is likely to reveal (1) the

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107 See notes 47–51 and accompanying text.

108 FRCP 26(a). But see note 110.

expected value of the suit from the defendants' perspective; (2) the maximum exposure that the defendant is genuinely worried about (and has insured against); and (3) the likelihood that the suit will come in at the maximum rather than at the expected value (reflected in the risk premium charged). To require the defendant to turn over to the plaintiff its expectations regarding settlement and trial would violate the core principle that underlies work product doctrine. Each litigant is supposed to be able to work diligently, without fear of discovery from the other side, to come up with its impression of a suit and its strategy for litigating it.[109] The discovery rules should never require one party to reveal to the other its core expectations and fears. Indeed, the very fact that the defendant has purchased after-the-event insurance is something that arguably could be protected as work product. If a defendant is sufficiently concerned about a liability to go out and purchase after-the-event litigation insurance, this itself may provide the plaintiff with a strong sense of the defendant's perceptions of the merits. There is therefore a strong argument that work product protection should apply to the existence, as well as the terms, of a litigation-risk transfer agreement.[110]

Moreover, the costs of withholding this information from the plaintiff are not nearly as great as the costs associated with other materials that might be protected by work product or attorney-client privilege. In many instances, these protections prevent the discovery of materials that are relevant and calculated to lead to admissible evidence. In the case of insurance agreements, however, discovery is permitted almost entirely in order to facilitate settlement, and not in the hope that it

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109 See *Upjohn v United States*, 449 US 383, 396 (1981) (holding that communications between attorneys and clients regarding responses to questionnaires and interview questions are privileged and not subject to discovery); *Hickman v Taylor*, 329 US 495, 512 (1947) (holding that, under Rule 26, lawyers are not required to produce private memoranda and personal recollections as part of discovery).

110 Even without invoking work product protection, one can interpret the text of the federal rule governing insurance agreements to distinguish after-the-event litigation-risk transfers from conventional insurance policies and to exclude the former from discovery. Rule 26 provides for disclosure of: "(1) any *insurance agreement* under which (2) any *person carrying on an insurance business* (3) may be *liable to satisfy part or all of a judgment* which may be entered in the action *or to indemnify or reimburse for payments made to satisfy the judgment*." FRCP 26(a)(1)(C) (emphasis added).

First, as the discussion of insurance regulation below explores, it is far from clear that a litigation-risk transfer agreement would count as an "insurance agreement," even if it were offered by a conventional insurance company. See notes 127–35 and accompanying text. Second, where the entity absorbing litigation risk is an investment fund, rather than an insurance company (as I envisioned in Part I), it arguably would not be a "person carrying on an insurance business." Third, to the extent that risk transfers are done to facilitate deals, then the risk transfer might be structured so that the risk bearer would not be "liable to satisfy part or all of a judgment," nor would it have "to indemnify or reimburse" the defendant "for payments made to satisfy the judgment." The hedge contract would protect, not the defendant company itself, but rather an investor in that company seeking to safeguard its investment against a decline in value attributable to a bad outcome in the lawsuit.

will lead to admissible evidence. Withholding litigation-risk transfer agreements from discovery should have no bearing upon the plaintiff's ability to prove its case on the merits. Just as we do not allow a plaintiff to introduce at trial the terms of a settlement offer made by the defendant during settlement negotiations,[111] so too would it be irrelevant that the defendant has negotiated a kind of settlement with a third-party capital provider. Whether the defendant communicates its views on a lawsuit's value and risks to the plaintiff during settlement negotiations or to a third-party capital provider during negotiations over a risk-transfer agreement, these settlement communications cannot be used in a trial on the merits.

One might object that even if litigation-risk transfer agreements are irrelevant to the merits, they are relevant to settlement dynamics, and permitting defendants to withhold litigation-risk transfer agreements would only aggravate the already strong pro-defendant effects these agreements can have. As noted earlier, some might fear that litigation-risk transfers will bolster defendants' bargaining leverage by rendering litigation risk less daunting and more easily borne.[112] A defendant-insurer team might be more willing to proceed to trial than an ordinary defendant because it will have spread the risk of a loss over a larger pool of cases. If the plaintiff does not know that this has occurred, however, it may mistake the defendant's willingness to proceed to trial for confidence on the merits, and this may, in turn, lead the plaintiff to accept less in settlement. Moreover, if a litigation insurer is going to have some control over litigation and settlement decisions, it would potentially be unfair for the plaintiff to be negotiating a settlement without knowing who on the defense side has ultimate authority over settlement decisions. Indeed, judges presiding over settlement conferences often require that someone be present who has ultimate settlement authority.[113] In those instances the litigation insurer would either have to be present itself, or it would have to authorize the lawyers to settle on its behalf.

So long as the litigation insurer permits the plaintiff and/or judge to deal with someone who has ultimate authority to settle—ordinarily a lawyer who would represent the defendant-insurer team—I do not think it should be a problem for the defendant-insurer team to withhold from the plaintiff the details of their risk-transfer agreement. If the plaintiff gets to deal with someone authorized to settle, it should not matter where that authorized agent is getting the money for the

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111 See FRE 408.

112 See notes 93–95 and accompanying text.

113 See, for example, *In re Novak*, 932 F2d 1397, 1405, 1407 (11th Cir 1991); *Heileman Brewing Co v Joseph Oat Corp*, 871 F2d 648, 656 (7th Cir 1989).

settlement. The allocation of litigation risks and rewards is neither relevant to the merits nor calculated to lead to admissible evidence, and the plaintiff simply should not be able to compel its disclosure.

These arguments for refusing discovery of risk-transfer agreements on the defense side should not be all that controversial when one considers the treatment of risk-transfer agreements involving lawyers on the plaintiffs' side. Where a plaintiff and his lawyer agree to a contingent fee arrangement that gives the lawyer a larger share of any recovery beyond an agreed-upon expected recovery, certainly we would not require them to divulge to the other side the terms of their agreement and the strike price they have set for success. Likewise, if a lawyer for a defendant were to work for a contingent fee—under which the lawyer would similarly receive a success bonus for resolving the suit below a particular strike price[114]—once again the terms of that agreement would not be discoverable. Moreover, if a law firm were large enough that the lawyers were able to absorb some of the downside risk of an adverse judgment— and not just the litigation costs—once again discovery of the terms of that agreement would not be permitted. Whether a lawyer receives a bonus for success or a penalty for failure is simply not the other side's business. The only difference between these sorts of contingent fee arrangements and the risk transfers I propose in this Article is that my proposed risk transfers may involve large enough liabilities that the lawyers would rely on some third-party capital, rather than absorbing all of the downside risk themselves. Although the introduction of a nonlawyer third party[115] certainly may affect a court's approach to the question under attorney-client privilege doctrine, it should not affect work product doctrine. Nor should it detract from the fundamental principle that each side in a lawsuit should be free to assess and manage its litigation risk safe in the knowledge

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114 Such arrangements are not as common on the defense side, for reasons I explore in Part I, see notes 22–23 and accompanying text, but they are by no means extraordinary. I have spoken to a number of lawyers at traditional hourly fee commercial litigation firms that offer what they call "alternative billing arrangements" along these lines.

115 I explore the consequences of plaintiff-side risk transfers to third-party capital providers in the next article in my broader project. See Molot, *A Market in Litigation Claims* at *9 (cited in note 17). Where plaintiffs shift risk through an outright sale of a portion of a claim, rather than through a conventional contingent fee arrangement, neither the introduction of a third-party capital provider nor the sale of more than one-third of the recovery should change the treatment under the discovery rules. My reason for facilitating plaintiff-side risk transfers is that without such a market in legal claims, disparities in resources and risk aversion can sometimes lead to lower plaintiff recoveries than the merits of lawsuits may warrant. By shifting risk to an entity with a diverse pool of litigation risk and ample resources, we can address these disparities and improve plaintiff recoveries where appropriate. Contingent fee arrangements certainly help on this count, but I argue that they do not do enough. See id at *24–25.

that its deliberations and decisions will be protected from discovery by the other side.

B. Risk Transfers and Financial Statements: Treatment under Accounting Rules and Securities Laws

Whereas litigators would worry about the effects of a risk transfer on litigation dynamics, transactional lawyers would worry about a risk transfer's effects on their clients' business success and, in particular, on their clients' relationships with investors or lenders. These corporate lawyers would most likely consider litigation-risk transfers in those instances where litigation risk has become a cause of concern for a client's investors or lenders, thereby threatening to increase the client's cost of capital (by reducing its equity value or raising the interest rate it must pay on its debt). A risk transfer would offer a way to reassure investors and lenders and thereby reduce the cost of capital to the company. But whether a litigation-risk transfer will actually serve this purpose—and effectively reassure investors and lenders that the problem has been solved—may depend upon the treatment of litigation-risk transfers under accounting rules and securities laws.

If we want litigation-risk transfers to reduce the secondary and tertiary costs of litigation—and achieve the economic benefits explored earlier in the Article[116]—it is important that the securities laws and accounting rules distinguish two different ways that a corporate defendant might use an after-the-event litigation liability transfer to affect its financial statements. Companies should receive full credit for transactions that involve genuine risk transfers, so that investors and lenders understand that the risk has been contained and the company is protected against an adverse litigation outcome. Conversely, securities laws and accounting rules should not permit corporate defendants to fool investors and lenders with transactions that may resemble litigation-risk transfers in form but really are designed simply to disguise losses and smooth earnings without transferring any risk. The discussion below addresses the treatment of genuine risk transfers first, before proceeding to distinguish similar-looking, but substantively quite different, accounting gimmicks that have been the subject of prominent government investigations.

Under existing rules, when a publicly held corporation is a defendant to a lawsuit, the effect of the lawsuit on its financial statements will depend upon whether the liability is "probable" and whether the amount

116 See Part II.A.

of the loss "can be reasonably estimated."[117] If the defendant is likely to lose the suit and is able to estimate the damages, then the defendant must accrue a liability for the expected loss on its financial statements. If, on the other hand, the defendant thinks it is more likely that it will win the suit or is unable to estimate the damages, then the lawsuit will not be reflected on its financial statements. Generally, companies will lump together estimates for a number of contingent liabilities and reflect them all in a single line item on their financial statements. By lumping together liabilities rather than segregating them, a defendant can prevent a plaintiff from knowing the price it has assigned to any one lawsuit.

Where a lawsuit is potentially big enough to affect a corporate defendant's financial condition, this system of accruing for litigation liability may not provide adequate assurance to investors or lenders concerned about the risk. If the defendant does not accrue a liability for a lawsuit because it believes it is likely to win, investors may worry about the risk of a large loss, even if that risk is remote. These concerns will only be intensified, moreover, if the defendant is likely to lose (or settle) but has not accrued a liability because it cannot reasonably estimate the size of the likely damages award. Indeed, even where a company *does* accrue a liability based on its estimate of the likely loss, that reserve will only reflect its own estimates—essentially, the company's best guess about the lawsuit. There is no guarantee that the actual outcome will not turn out to be far worse, and given that litigants often are biased regarding the strength of their own litigation positions,[118] investors may reasonably suspect that the estimate liabilities will be understated. Indeed, if the size of the potential liability is large enough relative to the size of the company, and if there are potential outcomes that far exceed the most likely loss reflected in the company's reserves, then investors and lenders may worry about the litigation and either withhold their capital or else raise the cost of that capital by reducing their valuation of the company (in the case of an equity investment) or demanding a higher interest rate (in the case of debt).

If, however, a company were able to transfer litigation risk to a third party and to receive accurate accounting treatment for that risk transfer, then the transaction could very well alleviate these investor or lender concerns. To the extent that a third-party litigation insurer's due diligence places a price on a lawsuit, this process will render the size

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117 FASB, *Statement of Financial Accounting Standards No 5*, online at http://www.fasb.org/pdf/fas5.pdf (visited Jan 11, 2009).

118 See Robert Cooter, et al, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J Legal Stud 225, 225 (1982).

of the loss "reasonably estimable."[119] Although a range of outcomes would still be possible, the risk-transfer process would at least provide a third party's assessment of the expected value that could be used for accounting purposes. Second, and more important, if the company actually goes through with a risk transfer, then the value assigned to the loss during due diligence will become more than simply an estimate. The company will be able to say to its lenders and shareholders not only that it has accrued a liability for the lawsuit, but also that the accrual will be enough to cover the liability. Essentially, the company can say: "We have accrued for this liability and unlike other litigation liabilities that often are just estimates, this particular accrual represents what we actually will pay for the lawsuit."

No change should be required to accounting or securities laws for a company to be able to use litigation-risk transfers to reassure the capital markets in this manner. Indeed, where a defendant holds conventional before-the-event liability insurance that is sufficient to cover all or part of a potential litigation loss, the company will take that insurance into account and accrue a liability only for the portion of the liability, if any, that is unlikely to be covered by insurance. The same could thus be true where a defendant purchases after-the-event coverage. Where the risk-transfer agreement requires the defendant to pay the expected value and premium to the risk bearer upfront, the defendant would simply reflect these expenses on its financial statements and be done with it. It would not have to record accrued liabilities for additional potential losses, as any loss beyond that covered by the risk-transfer agreement would most likely be neither "probable" nor "reasonably estimable." The risk-transfer agreement would essentially have the same effect on the company's financial statements as a settlement, disposing of the risk and reflecting the payout as an expense.[120] Clarification of this point from the relevant authorities would help those seeking to build a market in litigation risk, but the existing regime need not be changed for risk transfers to be reflected accurately on a company's financial statements.

Although I have suggested that the securities laws and accounting rules are structured to afford litigation-risk transfers the accounting

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119 A company that does not want to have to take a reserve for pending litigation might refuse even to consider a litigation-risk transfer for fear that once the lawsuit is priced by an impartial third party, the loss will then become reasonably estimable and it will have to take a reserve. See id. This poses yet another obstacle to the creation of a market in litigation risk.

120 A risk transfer might also help where a defendant has some conventional liability insurance coverage but its insurer has disputed its obligation to cover the loss. A defendant that cannot take full accounting credit for the insurance—because the coverage is in dispute—can buy litigation insurance to cover the coverage dispute and then reduce its accrued liabilities accordingly.

treatment they deserve, some lawyers and accountants might fear otherwise based on government investigations of litigation-related transactions that resemble the risk transfers embraced by this Article but that were undertaken for very different purposes. Genuine litigation-risk transfers should not be confused with similar-looking transactions that some companies and insurers have used in the past to hide large losses and to smooth earnings.

When a corporate defendant transfers litigation liability to a third party, this not only affects the *amount* that the defendant will pay but also the *timing* of its payment. Rather than paying a single lump sum to the plaintiff in a judgment or settlement at the conclusion of the litigation, the defendant may make a stream of premium payments to the insurer who will, in exchange, accept responsibility for the final payment to the plaintiff. In some instances, defendants and insurers may know for sure the amount of the liability and may seek to transfer litigation liability simply in order to convert a prominent, large one-time payment into a stream of smaller monthly payments that are unlikely to be noticed among the company's many other insurance expenses. In the 1990s, some insurers developed what they called "loss mitigation" policies that they marketed to their customers to accomplish precisely this sort of accounting sleight of hand. The loss mitigation products offered by these insurers have recently fallen into disrepute, however, as a result of prominent government investigations. Indeed, when American International Group, Inc (AIG) sold one such loss mitigation policy to Brightpoint, Inc,[121] the parties were investigated and fined by both the SEC and the New York Attorney General for smoothing earnings and violating relevant accounting rules and securities laws.[122] Such prominent investigations of abusive transactions may make it harder for innovative lawyers to convince their more risk-averse colleagues regarding the virtues of genuine litigation-risk transfer transactions. If we want to reduce the secondary and tertiary costs of litigation by facilitating these litigation-risk transfers, we must distinguish between sham transactions designed simply to affect the *timing* of a defendant's payments and genuine risk transfers designed to address uncertainty over the *amount* that a defendant will pay. Authori-

121 See note 69 for a discussion of how the current credit crisis has affected AIG and the feasibility of a market for litigation-risk transfers.

122 See SEC, *SEC Charges American International Group and Others in Brightpoint Securities Fraud; AIG Agrees to Pay $10 Million Civil Penalty* (Sept 11, 2003), online at http://www.sec.gov/news/press/2003-111.htm (visited Jan 11, 2009) (noting that AIG was fined $10 million for helping Brightpoint conceal $11.9 million in losses). The Brightpoint investigation may have contributed to the reluctance among conventional insurers to participate in the after-the-event litigation insurance market. See note 27 and accompanying text.

ties were correct to go after AIG and Brightpoint for a sham transaction designed to smooth earnings and fool investors. But if we want to foster a market in litigation risk, it is vital that authorities distinguish genuine risk transfers from sham transactions and allow participants in risk transfers to reap the full benefits of those transactions on their financial statements.

C. Risk Transfers and Insurance Regulation: Treatment under Insurance Law

A third area of law that has the potential to obstruct litigation-risk transfers is insurance law. I have suggested that the capital providers most likely to participate in this market are not insurance companies but rather investment funds, for they are more willing to absorb risks that are not susceptible to actuarial analysis.[123] Lawyers seeking to build a market in litigation risk would therefore be wise to look to hedge funds to supply the necessary risk capital. But these hedge funds would themselves hire lawyers to make sure they can lawfully participate in the litigation-risk-transfer business and earn a profit in exchange for relieving litigants of risk. And lawyers for hedge funds would likely advise their clients *against* participating if they feared that participation would subject the hedge funds to recriminations from insurance regulators. If insurance regulators were to treat all litigation-risk transfers as insurance—requiring capital providers to register as insurance companies and punishing those who do not—this would sharply curtail the pool of available capital and render risk transfers much harder to accomplish, and much more expensive. Just as I argued above that litigation-risk transfers should be distinguished from insurance for discovery purposes,[124] so too should they be distinguished from insurance for regulatory purposes. If we want to facilitate risk transfers, it is vitally important that insurance regulators not overreach and try to regulate these risk transfers as insurance.

There are a great many risk-transfer mechanisms available in the financial markets today—ranging from publicly traded options to one-off hedge contracts—which do not qualify as insurance contracts and are not subject to insurance regulation. Whether a particular risk transfer counts as insurance is a question that is determined by insurance regulators in each state. Insurance providers generally are exempt from federal

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123 See notes 63–65 and accompanying text.

124 See notes 109–10 and accompanying text.

regulation,[125] and different states may take different approaches to the conceptually difficult question of just what constitutes "insurance."[126]

As New York law looms large in this field and looms especially large for the many investment funds with offices in New York who might be interested in profiting from litigation-risk transfers, it is worth considering how litigation-risk transfer agreements between defendants and investment funds are likely to be treated under New York law. By statute, New York insurance regulators are authorized to regulate (and to sanction those who do not submit to regulation) any entity in New York that sells insurance contracts.[127] An "insurance contract" is defined as "any agreement or other transaction whereby one party, the 'insurer', is obligated to confer benefit or pecuniary value upon another party, the 'insured' or 'beneficiary', dependent upon the happening of a fortuitous event."[128] "'[F]ortuitous event' means any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party."[129]

This is quite a broad definition—so broad, in fact, that it could be interpreted to apply to a great many risk transfers that have never been viewed by regulators as insurance. A hedge contract that compels an investment bank to make a payment to an airline if oil prices exceed a specified threshold has never been regulated as insurance. But it certainly could fit this definition. After all, "one party [the investment bank] would be obligated to confer pecuniary benefit upon another party [the airline] depending upon the happening of a fortuitous event [a spike in oil prices] . . . which is . . . to a substantial event beyond the control of the parties."

But as broad as the statutory definition is, a strong argument can be made as to why it should not be interpreted to apply to the litigation-risk transfer agreements described in this Article. A significant difference between litigation-risk transfers and conventional liability insurance policies is that while liability insurance clearly protects against a "fortuitous event" that might give rise to liability, after-the-event litigation-risk transfers would be executed only *after* a fortuitous event has occurred. The risk that is being shifted is not the risk of a fortuitous event but rather the risk of paying more or less for an event that already has occurred. Moreover, if an aggressive insurance regulator were to argue that the event protected against is the *payment* of a set-

125 See 15 USC § 1011. The principal exception to this exemption from federal regulation is for a narrow category of antitrust violations, including boycotts. See 15 USC § 1012(b).

126 See, for example, *Feinstein v Attorney General of New York*, 326 NE2d 288, 293 (NY 1975).

127 NY Ins Law § 1101(b)(1)(A) (McKinney).

128 NY Ins Law § 1101(a)(1).

129 NY Ins Law § 1101(a)(2).

tlement or judgment, rather than the accident or business dispute that gives rise to a lawsuit, then such an event might not properly be characterized as "fortuitous." A settlement or judgment is the natural and expected conclusion of a lawsuit and is by no means fortuitous. The amount paid by the defendant in legal fees and judgments or settlements may be higher or lower than expected, but it is difficult to characterize payments made by the defendant to its lawyers and the plaintiff as fortuitous events. Moreover, the amount actually paid to dispose of the lawsuit—in payments to lawyers and plaintiffs—may not be "beyond the control of the parties." A defendant's total payout will depend in large part upon its own litigation strategy (or the litigation strategy of the capital provider to whom it has transferred the risk): Will it hire the best legal counsel money can buy and pay more in fees in the hopes of a better litigation outcome, or will it hire someone less expensive and perhaps less effective? Will it offer an early settlement? How much will it offer? If this settlement offer is rejected or countered, will it choose to take the case to trial or to increase its offer? A defendant will likely pay a costly adverse judgment (exceeding the agreed-upon strike price in a litigation-risk transfer agreement) only if it decides to proceed to trial, rather than to settle the case before trial.

It is true that the amount ultimately paid will also depend upon the actions of the plaintiff and, if no settlement is reached, upon the decision of the presiding judge or jury. An aggressive insurance regulator might therefore argue that the outcome is "to a substantial extent beyond" the control of the defendant and its counterparty. But if a judgment or settlement ends up being higher or lower than what a defendant and risk bearer expected, this will just as likely reflect a poor initial estimate on the part of the defendant and/or risk bearer as a fortuitous event later in the litigation. Indeed, in most instances, the purchaser of a litigation-risk transfer will be an investor in a company that is seeking to protect its overall investment in the event that its estimate of a particular liability of that company is wrong and the overall investment ends up being worth less as a result of this mistaken valuation.[130] Just like a stock option (which protects against a change in stock prices)[131] or a credit-default swap (which protects against a bond's loss of value), a litigation-risk transfer agreement really transfers the risk that a liability or asset has been *mispriced*, rather than the risk that some *fortuitous event* will occur and alter its value. Indeed, the very

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130 See notes 119–29 and accompanying text.

131 See Grundfest and Huang, 58 Stan L Rev at 1277 (cited in note 4) (noting that, under the real options model, "it makes sense for a plaintiff to pursue a risk claim with a negative expected value if . . . the possibility of uncovering some sort of smoking gun that will lead to a [high recovery] is large enough").

reason that litigation-risk transfers have been unappealing to insurers is that this risk of *mispricing* is a very different risk from the risk of a fortuitous event that insurance companies use actuarial analysis to price and pool. The distinction that has led traditional insurance companies to shy away from *offering* after-the-event litigation policies also should lead insurance regulators to shy away from *regulating* after-the-event litigation-risk transfers.

The New York Court of Appeals, in a different but analogous context, used similar reasoning to exclude an agreement for prepaid legal services from the statutory definition of insurance. The risk bearer in *Feinstein v Attorney General of New York*[132] had charged a fee in advance in exchange for which it would provide a variety of legal services over a number of years for a large group of individual union members.[133] Although the agreement thus transferred the risk that a group of beneficiaries would experience higher-than-expected legal needs and incur higher-than-expected legal expenses over the duration of the agreement, the court nonetheless held that this risk transfer did not count as insurance under New York law. Examining the "fortuitous event" language of the statute, the court explained that "for many of the legal services involved ... there is no fortuitousness, in any ordinary sense of the word, in the event which precipitates the retention of a lawyer, such as the drafting of a will, a separation agreement, the purchase of a house, and many others of the same kind."[134] While the need for legal services might be triggered by an accident in some instances, in other instances it would be triggered by the beneficiary's own life decisions.

The court also explained why insurance regulation in this context would not be consistent with the underlying purposes of the insurance law. "[T]he proposed plans," it explained, "do not pose the dangers that the Insurance Law was designed to obviate. Those dangers embrace inadequate coverage of determinable actuarial risks, excessive premiums on an actuarial basis, and fiscal irresponsibility."[135] Just as insurance companies are ill equipped to absorb risks that are not susceptible to actuarial analysis, so too are insurance regulators ill equipped to regulate risk transfers that are not susceptible to actuarial analysis, as insurance regulators would not be able to use actuarial analysis to check whether the premiums are fair, the coverage is adequate, or the risk bearer will have adequate resources to be able to meet its obligations. For this reason, a prepaid legal services plan was not regulated as insurance, even if it did entail a risk transfer. By analogy, one might similarly conclude

132 326 NE2d 288 (NY 1975).
133 Id at 290–91.
134 Id at 293.
135 Id.

that litigation-risk transfers engaged in by hedge funds should not be regulated as insurance. Just like the legal services agreements in *Feinstein*, litigation-risk transfers do not involve fortuitous events easily susceptible to actuarial analysis. Insurance regulators would be ill equipped to assess whether premiums for these risk transfers are fair or adequate.

One might object that even if litigation-risk transfer agreements resemble prepaid legal services agreements insofar as neither involves a fortuitous event easily susceptible to actuarial analysis, nonetheless the risk of insolvency looms larger in one context than the other. A law firm that sells prepaid legal services may become insolvent and disband, leaving the holders of prepaid legal services unprotected. But the risk that a law firm will underprice its legal services agreements by so much as to drive it into insolvency seems, at first blush, quite remote. By contrast, when an investment fund absorbs the risk that a defendant will suffer a devastatingly large adverse judgment, there would appear to be a significant credit risk. And, if there is a genuine risk that an investment fund absorbing litigation risk from a defendant will itself become insolvent before the lawsuit is concluded, this credit risk may substantially undermine the value of the risk transfer that the defendant is seeking. An aggressive insurance regulator may want to intervene in order to make sure that investment funds that offer litigation-risk transfer contracts are financially sound and able to live up to their financial commitments.

I suggest, however, that insurance regulators would be poorly equipped to play this regulatory role. To assess an insurance company's solvency, insurance regulators must use actuarial analysis to examine a broad array of risks that are susceptible to actuarial analysis—not just a single insurance contract but a broader pool of risks on that insurance company's balance sheet.[136] To engage in this inquiry and decide whether an insurer has sufficient assets available to cover future insurance claims, insurance regulators can look at actuarial statistics for various insurance product lines (for example, homeowners insurance, property and casualty insurance for businesses, and so forth) that are kept not just by individual companies but by the insurance industry as a whole.[137]

To get a sense of the risks on the balance sheet of a non–insurance company capital provider, in contrast, requires a type of analysis that insurance commissioners are poorly equipped to undertake. To evaluate

136 Regulators also consider the company's reinsurance policies to see how much of the risk it has passed on to reinsurers.

137 Indeed, insurance companies tend to use standard forms for most policies so that each company can look to statistics on claims for the entire industry when pricing policies and setting reserves, and insurance regulators can look to the same industry-wide sources in evaluating the health of each insurer.

whether an investment fund is overleveraged, one would want to look at its various assets (for example, how much it holds in stocks, bonds, options, commodities, illiquid contracts), consider the risks associated with each asset class, and compare these available assets to the fund's liabilities. This is what an investment fund's prime broker does each day—extending credit and setting collateral requirements after evaluating the overall credit risk of the fund as a whole. Moreover, given that the only entities likely ever to purchase litigation-risk transfers are sophisticated business entities involved in large-scale litigation, these entities will be much better positioned than insurance regulators to protect their own interests and make sure that the investment fund's obligation is guaranteed by a creditworthy entity, like its prime broker, which is in a position to evaluate the fund's credit risk and to require appropriate collateralization.[138] (Indeed, Part I of this Article discussed at length the structures that a defendant and an investment fund might utilize to allocate credit risk to a third-party guarantor, like the fund's prime broker.) If insurance regulators were to intervene and try to regulate hedge funds that participate in litigation-risk transfer agreements, they would do little good and very likely do a great deal of harm, for their intervention would likely dissuade many capital providers from offering risk transfers at all. If as a matter of public policy we wish to facilitate risk transfers and reduce the secondary and tertiary costs of litigation, it is important that insurance regulators not stand in the way.

D. Risk Transfers and Lawyers' Professional Roles: Treatment under the Law Governing Lawyers

Finally, if we want to facilitate the creation of a market in legal risk, we may need to reassure lawyers not only that their litigation clients, corporate clients, and hedge fund clients can reap the rewards of litigation-risk transfers without adverse consequences but also that the lawyers themselves can participate without subjecting themselves to professional sanction. Lawyers navigating litigation-risk transfers are likely to encounter a number of ethical questions. The discussion below does not attempt to anticipate all the ethical questions likely to arise, let alone provide definitive answers to those questions. The discussion does, however, suggest that many of the problems likely to arise can be handled relatively easily under existing doctrine. Where more difficult problems arise—and risk transfers threaten to upset prevailing professional norms—I offer only preliminary suggestions, the first steps in a broader effort to grapple with market-oriented lawyers

138 But see note 69 and accompanying text.

who stray from the traditional model of client service. The longer-term goal is to update the legal profession's self-conception so as to accommodate lawyers who seek to make markets in legal risk.

1. Ethical questions covered by existing norms.

A good example of an ethical problem likely to be triggered by litigation-risk transfers and yet to be handled easily under existing professional norms is the conflict of interest that many litigators would confront. As noted earlier, a third-party capital provider considering a risk transfer but concerned about information asymmetries would likely want to enlist the defendant's own litigators in its quest for complete information. To make sure that the defendant and defense counsel are not hiding anything, the litigation insurer might make a risk transfer contingent upon the defendant's litigators staying on in the representation under a modified contingent fee arrangement. Recall that during the negotiation of the risk transfer, the lawyer would thus face a conflict between his client's desire to negotiate as low a transfer price as possible and his own financial interest (and the risk bearer's interest) in setting a higher transfer price and increasing the chances of earning a larger contingent fee. Moreover, even after a risk transfer is complete, the conflicts might continue, as the lawyer would represent *both* the defendant *and* the risk bearer and might also have his own financial interests to consider.[139]

Although the risk transfer that would trigger such a conflict would be novel, the conflict itself would not be all that different from the many other conflicts that lawyers grapple with every day. So long as all parties to a litigation-risk transfer understand the lawyer's conflict of interest and are willing to waive the conflict, litigators can facilitate risk transfers and remain on firm footing under prevailing professional norms. Indeed, when it comes to the due diligence and negotiation phase, litigators could rely specifically on Model Rule of Professional Conduct 2.3, which permits a lawyer to "provide an evaluation of a matter affecting a client for the use of someone other than the client if the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client."[140] It further provides that when "the evaluation is likely to affect the client's interests materially and adversely" the lawyer can provide the evaluation so long as "the client gives informed consent."[141] As for the post-transfer litigation phase, the Model Rules similarly

139 See Part I.C.

140 Model Rules of Professional Conduct (MRPC), Rule 2.3(a) (ABA 2008).

141 Id at Rule 2.3(b).

permit the lawyer to continue on behalf of the defendant and the risk bearer so long as both consent.[142]

Long ago, Justice Louis Brandeis highlighted the good that lawyers can do as "lawyers for the situation,"[143] and this notion that lawyers can serve as intermediaries is no longer as controversial as it was when Brandeis introduced it nearly a century ago.[144] No doubt, litigators would have to pay close attention to the conflicts that arise from litigation-risk transfers—and to be scrupulously open about the conflicts with all concerned—but so long as litigators are careful, they should be able to facilitate these transfers while complying with their professional obligations.

Deal lawyers and lawyers for hedge funds likewise could look to existing doctrine to manage the ethical dilemmas they are most likely to confront when they help facilitate litigation-risk transfers. The dilemmas confronted by deal lawyers would likely be different in nature from those of litigators, but these dilemmas would not be so novel as to test prevailing professional norms.

Whereas a risk transfer may create a conflict of interest that tests a litigator's loyalty to his client, deal lawyers and hedge fund lawyers confronted with legal uncertainty and low risks of detection or punishment may find themselves in the very different position of wanting to be too eager to facilitate their clients' business goals. A hedge fund that is uncertain about whether a litigation-risk transfer constitutes insurance, and about whether it has to set up a registered insurance company in order to profit from litigation risk, is likely to consider not only the law on insurance but also the likelihood of detection and punishment by insurance regulators. Unlike retail insurance businesses that market their products widely and publicly, litigation-risk transfers would be marketed only to sophisticated businesses, and in some cases the deals would be revealed only to the defendant and a narrow group of investors. In many cases it is thus highly unlikely that a risk transfer would ever attract the attention of an insurance regulator. The question that arises for a hedge fund lawyer, then, is whether he can take

142 Id at Rule 1.7(b)(4).

143 See David Luban, *The* Noblesse Oblige *Tradition in the Practice of Law*, 41 Vand L Rev 717, 721 n 18 (1988) ("Brandeis coined the term 'lawyer for the situation' at his confirmation hearings for the Supreme Court. When accused of unethical law practice for simultaneously representing several parties to the same transaction, Brandeis replied that he viewed himself as counsel for the situation rather than for any single party."), citing Jerome Frank, *The Legal Ethics of Louis D. Brandeis*, 17 Stan L Rev 683 (1965). See also Geoffrey C. Hazard, Jr, *Ethics in the Practice of Law* 58–68 (Yale 1978); John S. Dzienkowski, *Lawyers As Intermediaries: The Representation of Multiple Clients in the Modern Legal Profession*, 1992 U Ill L Rev 741, 744 n 11 (noting that Professor Hazard, as Reporter to the ABA Commission responsible for the Model Code of Professional Responsible, worked to include a provision addressing the lawyer as an intermediary, as argued by Justice Brandeis).

144 See Dzienkowski, 1992 U Ill L Rev at 744 n 11 (cited in note 143).

the low risk of detection and punishment into account when advising his client on whether the fund's participation in a risk transfer would violate applicable insurance laws. The same might be true for a securities lawyer (or accountant) advising on how a company should reflect a litigation-risk transfer on its financial statements. After all, if litigation liabilities are lumped together on the books of a company, someone scrutinizing those books would not even know enough to ask whether the company was allowed to take full credit for a risk transfer relating to a particular piece of litigation. Low risks of detection may thus taint the advice that the hedge fund lawyer or securities lawyer will give on the legal consequences of a risk transfer.

While this ethical dilemma may cause lawyers some concern, the dilemma is by no means unique to litigation-risk transfers. There are many instances in which lawyers must advise clients on how to handle a difficult legal question, knowing that the client's conduct is unlikely ever to be detected and challenged. The most prominent example of this is the "audit lottery" confronted by tax lawyers. If there is a very high chance that a particular deduction would be disallowed by the IRS if detected, but there is a very low chance that the client will be audited, may the lawyer take the remote likelihood of an audit into account in advising the client on whether to take the deduction? The Model Rules prohibit lawyers from advising their clients to pursue an unlawful, even if likely to be undetected, course. The Model Rules do not, however, "preclude the lawyer from giving an honest opinion about the actual consequences that appear likely to result from a client's conduct."[145] The corporate lawyer or hedge fund lawyer contemplating a risk transfer would have to navigate uncertainties just as tax lawyers do every day—at least until the market for litigation-risk transfers has evolved enough for test cases to be brought and clarity on the underlying legal questions to be achieved. Although the dilemmas might be challenging, they would not be all that different from the many other challenges that lawyers face. They certainly would not be novel enough to upset prevailing professional norms.

2. A broader challenge to the profession's self-conception.

But if litigators, transactional lawyers, and hedge fund lawyers should be able to navigate the ethical dilemmas surrounding litigation-risk transfers just as they do many other ethical dilemmas, the lawyer who actually starts a risk-transfer business is more likely to test prevailing professional norms and provoke a broader reevaluation of the legal

145 MRPC, Rule 1.2(d), comment 9 (cited in note 140).

profession's self-conception. These lawyers would find themselves in the uncharted territory of forging relationships with capital providers and counterparties, rather than with clients. They would not fit Justice Brandeis's model of "lawyer for the situation," for their goal would not be to advance the interests of all concerned but to advance their own financial interests through profitable deals. In this respect, the lawyers would not be acting as lawyers at all, but rather as entrepreneurs, and they would have to be very careful to make sure that deal participants did not look to them for legal advice.

But there is also a respect in which these entrepreneurs would be acting as lawyers. Their success at being able to price and manage lawsuits would arise from the very same skills, training, and experience utilized by their colleagues who maintain the traditional model of client service. Their job would be to manage legal risk, just as client-serving lawyers do. The only difference is that these lawyers would manage legal risk for their own account.

To the extent that we consider client service to be the core, defining feature of lawyering, it is possible that under the law governing lawyers these lawyers-turned-entrepreneurs would no longer be deemed members of the legal profession. That certainly would be one way to avoid the problems that might arise if capital providers, counterparties, or courts were mistakenly to rely on them as lawyers. These lawyers-turned-entrepreneurs might simply make clear to all involved that they are businessmen and businesswomen, not lawyers, and that they have no professional obligations to anyone.

But I think it would be a mistake to exclude this group from the legal profession altogether. For one thing, it would not be in anyone's interests to relieve these lawyer-entrepreneurs of all professional duties. If we want them to engage in fair dealing with counterparties, capital providers, and courts, why not keep them within the legal profession and subject them to some regulation? Given the effects that risk transfers could have on litigation dynamics, it is far from clear that the legal profession would want to relinquish any control or oversight over the lawyer-entrepreneurs presiding over a litigation-risk-transfer business.

Moreover, I suggest that the legal profession should embrace these lawyer-entrepreneurs, rather than exclude them, not just to prevent them from doing harm, but also because of the good they can do. I have argued in this Article that a market in litigation risk would have the potential to reduce the secondary and tertiary costs of litigation and facilitate productive economic activity. If litigation-risk transfers have the potential to do this good, we should embrace the lawyer-entrepreneurs who endeavor to make them possible.

Finally, we should embrace lawyer-entrepreneurs as lawyers because of what they have in common with practicing lawyers. Law schools have long seen a portion of their graduates go into business instead of law, and law firms have long seen a portion of their lawyers leave not just the firm but the profession. Law schools and law firms embrace these "lapsed lawyers" as their alumni, in part for the selfish reason that they are potential donors or clients and in part out of a recognition that legal training may be valuable in business, and not just law practice. But the lawyer-entrepreneurs I envision in this Article would have a great deal more in common with practicing lawyers than the usual lawyer-turned-businessman would have. These lawyer-entrepreneurs would rely every bit as much on their legal education and training as their colleagues who continue to serve clients. True, they would have to learn a fair bit about business to succeed. They would have to raise capital, market their offerings, and negotiate deals for their own account rather than someone else's. But practicing lawyers today perform many of these functions as well. Law practice, after all, is itself a business, and a large, complex one at that. Moreover, the general counsel in corporate America often plays a dual role—serving as both a lawyer for a corporate client and a business executive who is himself a key member of the client's management team. That lawyer-entrepreneurs would need to rely on business skills, as well as legal training, does not distinguish them from their colleagues in law firms or corporate legal departments. To be sure, these "clientless" lawyers would be different in important respects from traditional client-serving lawyers, and the law governing lawyers would have to pay close attention to the differences and impose distinct obligations on these clientless lawyers. This new breed of lawyers would test professional norms and require us to think hard about how best to regulate them. But, the commonalities in my view outweigh the differences, and the legal profession would be wise to embrace this new market-making lawyer as one of its own.

CONCLUSION

This Article has suggested that if litigation is too costly, much of this cost must be evaluated not in terms of the actual dollar amounts spent on litigation, but rather in terms of the secondary and tertiary costs associated with the concentration of these primary costs upon entities ill suited to bear them. If we want to reduce litigation's drag on the economy, we should focus not only on streamlining the litigation process, but also on developing risk-transfer mechanisms that enable litigants to cope with litigation risk. The Article suggested that litigation risk can be transferred in at least some contexts, it argued that the social benefits of risk transfers in those contexts would far outweigh the social costs, and it highlighted several areas where doctrinal changes or clarifications would help facilitate litigation-risk transfers. The Article's broader aim was to expand the legal profession's self-conception so that lawyers consider it within their professional role not only to advise clients on litigation risk but also in some cases to relieve legal-risk bearers of risk.