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## COMMENT

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### DISCOVERING THIRD-PARTY FUNDING IN CLASS ACTIONS: A PROPOSAL FOR IN CAMERA REVIEW

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#### INTRODUCTION

Third-party funding increasingly is a feature of litigation in the United States.<sup>1</sup> One of the issues raised by third-party litigation funding is whether outside funders will positively or negatively impact the American judicial system. In particular, some commentators have observed that third-party funding arrangements have the potential to create conflicts of interest between attorneys and their clients due to the control that outside funders may attempt to exert over litigation.<sup>2</sup> This Comment addresses how those conflict-of-interest concerns impact discovery rules in the class action context. It ultimately concludes that because there is a potential for third-party funders to impair class counsel's adequate representation of absent class members, a class relying on third-party funding should be required to disclose the arrangement to the court for in camera review.

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<sup>1</sup> See Jason D. Russell, Matthew E. Delgado & Hillary A. Hamilton, *Third-Party Litigation Financing: Mandatory Disclosure on the Horizon?*, SKADDEN (Apr. 19, 2017), <https://www.skadden.com/insights/publications/2017/04/thirdparty-litigation-financing-mandatory-disclosure> [https://perma.cc/CJ4B-BLV3] (describing the results of a survey that showed a rise in the percentage of private practice attorneys and firms that use "alternative litigation funding" in the United States).

<sup>2</sup> See *infra* notes 42–63 and accompanying text.

This Comment begins with an overview of third-party litigation funding in the United States and the rules of discovery regarding a class's financial resources during the class certification phase of litigation. Next, it describes the debate over whether third-party funding will positively or negatively affect class counsel's ability to adequately represent the interests of absent class members. It also explains that because the empirical data on the issue is scarce, courts should develop discovery rules to help ensure that they will learn when and how third-party funders are supporting the litigants before them. Finally, after considering alternative potential discovery rules, this Comment concludes that requiring disclosure of third-party funding arrangements to the court for in camera review is the means most likely to balance the interests of class action plaintiffs and defendants, while simultaneously assisting the court in assessing the adequacy of representation under Rule 23.

### I. THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES

Third-party litigation funding “refers to the funding of litigation activities by entities other than the parties themselves, their counsel, or other entities with a preexisting contractual relationship with one of the parties, such as an indemnitor or a liability insurer.”<sup>3</sup> Generally, in exchange for providing capital, a third-party funder expects a positive return on its investment upon a settlement or successful judgment.<sup>4</sup> The funder's return typically is either a percentage or fixed portion of any settlement or judgment obtained.<sup>5</sup> The funding generally takes the form of a nonrecourse loan, which means that the party receiving funds is not required to repay the funder if the claim is unsuccessful.<sup>6</sup>

There are numerous potential beneficiaries of third-party funding agreements. This Comment addresses third-party funding of plaintiffs in the specific context of class actions, but class action plaintiffs are not the only types of third-party funding recipients. For example, sovereign nations and corporate litigants have started to take advantage of third-party funding more regularly.<sup>7</sup> These litigants

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3 AM. BAR ASS'N COMM'N. ON ETHICS 20/20, INFORMATIONAL REPORT TO THE HOUSE OF DELEGATES 1 (2012), [http://www.americanbar.org/content/dam/aba/administrative/ethics\\_2020/20111212\\_ethics\\_20\\_20\\_alf\\_white\\_paper\\_final\\_hod\\_informational\\_report.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf) [<http://perma.cc/DL8A-PSXV>].

4 See Matthew Bogdan, Note, *The Decisionmaking Process of Funders, Attorneys, and Claimholders*, 103 GEO. L.J. 197, 201 (2014) (“The common feature of these agreements is that repayment of the loans to the funder is generally contingent upon the successful completion of the lawsuit, either by a favorable trial judgment or a settlement.”).

5 See *id.* (noting that some funders are paid from “a portion of the litigation proceeds” while others are paid from interest accrued on their loan).

6 Stuart L. Pardau, *Alternative Litigation Financing: Perils and Opportunities*, 12 U.C. DAVIS BUS. L.J. 65, 66 (2011).

7 Bogdan, *supra* note 4, at 199.

sometimes turn to third-party funding not because they cannot afford the litigation, but rather so that they may use their own capital elsewhere.<sup>8</sup>

On the other side of the funding arrangement, many types of entities play the role of funder. Litigation funding in the United States began as a form of consumer lending in personal injury cases.<sup>9</sup> But recently, there has been an influx of dedicated commercial litigation funders that specialize in creating a portfolio of high-value litigation investments.<sup>10</sup> Major banks, like Credit Suisse and Citigroup, as well as hedge funds, have also started to invest in the high-end litigation financing market.<sup>11</sup>

The terms of funding arrangements can vary widely. Funding agreements contain numerous provisions that govern the amount of decisionmaking authority delegated to the litigation funder, the amount of recovery to which a funder is entitled, and whether the funder will receive a right of first recovery upon settlement or a successful judgment.<sup>12</sup>

The United States witnessed dramatic growth of the third-party funding industry in the last several years, in large part due to the economic climate.<sup>13</sup> Following the 2008 economic crisis, law firms had less capital to advance costs of litigation, so some attorneys sought to decrease their financial and personal risk.<sup>14</sup> In addition, banks—“traditional sources” of lending—became “scarce commodit[ies].”<sup>15</sup> At the same time, entrepreneurial investors sought opportunities less directly tied to the unpredictable financial markets.<sup>16</sup> Combined, these factors created a unique opportunity for litigation funders to increase their presence.<sup>17</sup> Even more, the rising cost of litigation has further persuaded parties to turn to third-party financing.<sup>18</sup>

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<sup>8</sup> Cf. Maya Steinitz, *Incorporating Legal Claims*, 90 NOTRE DAME L. REV. 1155, 1161 (2015) (explaining that corporations and sovereigns decide to pursue litigation based on many factors, such as “the cost of the capital that would be used to prosecute a claim (including opportunity costs)”).

<sup>9</sup> See *id.*

<sup>10</sup> See *id.* at 1164 (describing the “specialized private firms” that “have been funding commercial cases in the United States for at least a couple of decades”).

<sup>11</sup> Bert I. Huang, *Litigation Finance: What Do Judges Need to Know?*, 45 COLUM. J.L. & SOC. PROBS. 525, 526 (2012).

<sup>12</sup> See Victoria A. Shannon, *Harmonizing Third-Party Litigation Funding Regulation*, 36 CARDOZO L. REV. 861, 871-72 (2015) (describing the players and relationships in third-party litigation funding, including the variety of terms to which the parties might agree).

<sup>13</sup> See *id.* at 869 (explaining that third-party funding was once a “niche market,” but that it has grown exponentially in the United States).

<sup>14</sup> Jasminka Kalajdzic et al., *Justice for Profit: A Comparative Analysis of Australian, Canadian and U.S. Third Party Litigation Funding*, 61 AM. J. COMP. L. 93, 127-28 (2013).

<sup>15</sup> *Id.* at 128.

<sup>16</sup> See *id.* (noting a “desire for sound investment prospects” as one factor driving the increase in third-party funding agreements in the United States).

<sup>17</sup> See *id.*

<sup>18</sup> Shannon, *supra* note 12, at 869.

## II. DISCOVERY OF PLAINTIFFS' FINANCIAL ARRANGEMENTS TO CONTEST CLASS CERTIFICATION

Rule 26(b)(1) of the Federal Rules of Civil Procedure (Federal Rules) delineates the scope of discovery in federal civil actions, instructing that “[p]arties may obtain discovery regarding any nonprivileged matter that is relevant to any party’s claim or defense and proportional to the needs of the case.”<sup>19</sup> The Advisory Committee on the Rules of Civil Procedure (Advisory Committee) explained, as part of the 2000 Amendments to Rule 26, that the purpose of the relevance requirement is to control inappropriately broad requests by focusing discovery on the “actual claims and defenses involved in the action,” rather than on information merely relevant to the subject matter of the suit.<sup>20</sup> However, the Advisory Committee also acknowledged that the dividing line “cannot be defined with precision” and that the relevance inquiry will depend on the circumstances of the case.<sup>21</sup> The 2015 Amendments to the Federal Rules followed the theme of managing overly broad discovery by rearranging the provisions of Rule 26 to emphasize that in addition to being relevant, discovery sought also must be proportional.<sup>22</sup>

Although a third-party funding agreement is unlikely to fall within the scope of discovery unless it is a topic of the lawsuit,<sup>23</sup> class actions ostensibly present an exception to that general rule since Rule 23 makes the adequacy of the class’s representation a formal requirement, regardless of the case’s subject matter. In reviewing the selection of class counsel, Rule 23(g) expressly requires the court to consider the resources that counsel will commit to representing the class.<sup>24</sup> Rule 23 also implicates the financial resources of the class because Rule 23(a)(4) asks whether the representative

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<sup>19</sup> FED. R. CIV. P. 26(b)(1).

<sup>20</sup> FED. R. CIV. P. 26(b)(1) advisory committee’s note to 2000 amendment.

<sup>21</sup> *Id.*

<sup>22</sup> See FED. R. CIV. P. 26(b)(1) advisory committee’s note to 2015 amendment (“The present amendment restores the proportionality factors to their original place in defining the scope of discovery. This change reinforces the Rule 26(g) obligation of the parties to consider these factors in making discovery requests, responses, or objections.”); see also Thomas Y. Allman, *The 2015 Civil Rules Package as Transmitted to Congress*, 16 SEDONA CONF. J. 1, 19 (2015) (“The intent [of Rule 26’s proportionality requirement] is to force parties and the courts to confront questions of discovery cost containment at the outset of litigation and thereby lessen the likelihood that pretrial costs will spin out of control.”).

<sup>23</sup> See Victoria Shannon Sahani, *Judging Third-Party Funding*, 63 UCLA L. REV. 388, 412-13 (2016) (noting that, because neither “the existence or terms of [a] funding agreement would . . . be relevant or material to any . . . pled claims and defenses relating to the merits of the case,” the third-party funding agreement “ordinarily would not be subject to general discovery . . . under the language of Rule 26”).

<sup>24</sup> FED. R. CIV. P. 23(g)(1)(A)(iv).

parties will adequately protect the interests of the class.<sup>25</sup> Since plaintiffs have the burden of proving that the proposed class meets Rule 23's requirements,<sup>26</sup> it would seem that a defendant is entitled to utilize discovery devices to develop facts showing that the class's financial circumstances counsel against certification.<sup>27</sup> Indeed, defendants contesting class certification have frequently argued that the class's financial resources are "relevant" to the adequacy of representation inquiry and therefore fall within the scope of discovery under Rule 26.<sup>28</sup>

While seemingly relevant, discovery into the class's financial resources is "rarely appropriate."<sup>29</sup> Relying on Rule 23(a)(4)'s adequacy of representation requirement, some older decisions suggest that a proposed class representative might not adequately represent the class if she lacks sufficient financial resources to litigate the case.<sup>30</sup> In contrast, courts today have generally concluded that the proposed class representative's financial resources are irrelevant to the adequacy of representation inquiry, especially when class counsel is working on a contingency fee basis and thus advancing the costs of the suit.<sup>31</sup>

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<sup>25</sup> FED. R. CIV. P. 23(a)(4); *see also* 7A CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 1767 (3d ed. 2017 update) (explaining that "several courts quite properly" have found that a class representative's large financial interest in the outcome of a class lawsuit "may encourage the representative to prosecute or defend the action vigorously," but noting that "the absence of a substantial personal stake does not necessarily mean" inadequate representation).

<sup>26</sup> *See Comcast Corp. v. Behrend*, 133 S. Ct. 1426, 1432 (2013) ("[A] party seeking to maintain a class action must affirmatively demonstrate his compliance with Rule 23. The Rule does not set forth a mere pleading standard." (internal quotation marks omitted)).

<sup>27</sup> *See* NICHOLAS M. PACE, RAND INST. FOR CIVIL JUSTICE, CLASS ACTIONS IN THE UNITED STATES OF AMERICA: AN OVERVIEW OF THE PROCESS AND THE EMPIRICAL LITERATURE 37 ("As with any civil litigation, the parties in a nascent class action can initiate discovery of relevant evidence in their opponent's control."); *see also* MANUAL FOR COMPLEX LITIGATION (FOURTH) §§ 21.141 (2004) [hereinafter MANUAL FOR COMPLEX LITIGATION] ("Precertification inquiries into the named parties' finances or the financial arrangements between the class representatives and their counsel are rarely appropriate, except to obtain information necessary to determine whether the parties and their counsel have the resources to represent the class adequately.").

<sup>28</sup> *See, e.g., In re Intel Corp. Microprocessor Antitrust Litig.*, 526 F. Supp. 2d 461, 464-66 (D. Del. 2007) (rejecting defendant's argument that Rule 23(a)(4)'s adequacy of representation requirement entitled it to discovery of the class representative's tax returns).

<sup>29</sup> MANUAL FOR COMPLEX LITIGATION, *supra* note 27, § 21.141; *see also* WILLIAM B. RUBENSTEIN, NEWBERG ON CLASS ACTIONS §§ 3:69, 3:74 (5th ed. 2016) (collecting cases that have held that the financial resources of the proposed representative are irrelevant to the adequacy of representation inquiry).

<sup>30</sup> *See, e.g., Grossman v. Waste Mgmt., Inc.*, 100 F.R.D. 781, 791 (N.D. Ill. 1984) ("A proposed class representative's financial responsibility is a relevant factor in determining adequacy of representation, particularly in the case of a proposed 23(b)(3) class where the plaintiff must finance the sending of notice to the class.").

<sup>31</sup> *See, e.g., In re Intel*, 526 F. Supp. 2d at 464 (noting that recent courts have "conclude[ed] that the financial status of class representatives is irrelevant to class certification issues and not discoverable, particularly where . . . counsel is contractually obligated to advance litigation costs and those costs are not recoverable unless recovery is obtained for the class").

Similarly, even though Rule 23(g) instructs that the court should consider the resources that counsel will commit, that factor is “seldom” a basis for inquiring into financial resources or fee arrangements.<sup>32</sup> The “relative unimportance” of this requirement may be due to the fact that “counsel’s largest financial contribution to the class is typically their own time,” rather than litigation expenses, which “tend to pale in comparison.”<sup>33</sup> Hence, if class counsel invested significant effort before moving for certification, there is a presumption that counsel will continue to litigate the action with the same amount of resources, and that presumption weighs in favor of an adequate representation finding.<sup>34</sup> In those instances when courts find representation to be inadequate based on the resources counsel is willing to commit to the litigation, it appears that a lack of resources is rarely the sole reason for that finding.<sup>35</sup>

The narrow circumstance in which courts are likely to find that the plaintiffs’ source of funding is relevant to the adequacy or representation inquiry is when a defendant can show that the class’s financial circumstances are likely to impair class counsel’s duty of loyalty to the represented plaintiffs.<sup>36</sup> For example, in *Martinez v. Barasch*—a dispute about employee benefit funds—the court found that representation was inadequate because of a readily apparent conflict of interest.<sup>37</sup> In that case, the named class representatives belonged to a labor union called UNITE, which had agreed to pay for the class’s legal fees.<sup>38</sup> However, the class also included members of a rival labor union called ATC.<sup>39</sup> The court reasoned that because UNITE funded the lawsuit, including class counsel’s fees, UNITE exercised influence and control over class counsel due to its ability to withdraw financing at any time.<sup>40</sup> Since class counsel had an “enormous incentive” to give greater consideration to the class members loyal to UNITE, and because the named

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<sup>32</sup> RUBENSTEIN, *supra* note 29, § 3:74.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*; *see also, e.g.*, Cullen v. N.Y. State Civil Serv. Comm’n, 566 F.2d 846, 847, 849 (2d Cir. 1977) (affirming the district court’s holding that a solo practitioner could not adequately represent a class of 22,000 members because of his inexperience and his lack of resources).

<sup>36</sup> *See, e.g.*, Stanich v. Travelers Indem. Co., 259 F.R.D. 294, 322 (N.D. Ohio 2009) (explaining “that courts have allowed discovery of fee and retainer agreements between class counsel and named plaintiffs where the information contained therein is clearly relevant to potential conflicts with absent class members,” but nonetheless rejecting defendant’s discovery request because the defendant failed to explain “the specific relevance of fee and retainer agreements” and instead “merely [sought] them because the agreements potentially contain[ed] information supportive of [its] inadequacy arguments”).

<sup>37</sup> 2004 WL 1367445, No. 01 Civ. 2289, at \*6 (S.D.N.Y. June 16, 2004); *see also* Kamean v. Local 363, Int’l Bhd. of Teamsters, 109 F.R.D. 391, 395 (S.D.N.Y. 1986) (finding class representatives inadequate because the organization funding the lawsuit was affiliated with one union, and many class members belonged to a “rival union”).

<sup>38</sup> *Martinez*, 2004 WL 1367445, at \*6.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

plaintiffs had interests divergent from members of the class loyal to ATC, neither were adequate representatives for the class.<sup>41</sup>

### III. THE EFFECT OF THIRD-PARTY FUNDING ON THE ADEQUACY OF REPRESENTATION

Because the discoverability of the class's financial resources is tied to adequacy of representation considerations, an important question presented by third-party funding of class actions is how these financing arrangements affect the relationship between class counsel and the represented plaintiffs. There is a debate among scholars on that issue, which this Part describes. Despite the recent growth of third-party funding in the United States, the corroborating empirical evidence for both sides of that debate is unavailable. That lack of evidence is an important consideration when assessing how courts should treat the discoverability of third-party funding arrangements.

#### A. *Litigation Funders as Improper Controllers*

A principal argument against third-party funding arrangements is that they will cause inadequate representation by placing the power to control litigation in the hands of the funder, thereby undermining counsel's duty of loyalty to the client.<sup>42</sup> Examples of ways in which funders may attempt to control litigation include "overt" forms, such as requiring the right to choose counsel and the right to formal settlement authority.<sup>43</sup> Funders also may engage in less obvious forms of control.<sup>44</sup> For example, repeated interactions between a funder and counsel may lead to a working relationship, and as a result, the funder may be able to exercise significant influence over counsel's decisionmaking.<sup>45</sup> A funder may also threaten to withdraw financing unless the litigation proceeds according to its own strategic preferences.<sup>46</sup>

Although the concern that third-party funders will come to control litigation is present in almost any case involving third-party funding agreements, the concern is more pronounced in the class action context. It is a fundamental

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<sup>41</sup> *Id.*

<sup>42</sup> See John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 340 (2010) ("The key policy issue in litigation finance is whether the funder will interfere with the attorney-client relationship between counsel and the actual plaintiffs, thereby stripping the client of control.").

<sup>43</sup> Steinitz, *supra* note 8, at 1168.

<sup>44</sup> *Id.*

<sup>45</sup> See *id.* ("[A]ny repeat-play relationship between [a] funder and . . . litigation counsel gives [the] funder informal but significant influence over the conduct of the case.").

<sup>46</sup> See *Martinez*, 2004 WL 1367445, at \*6 (finding representation to be inadequate because a third-party funder could threaten to withdraw financing at any time and thus exert inappropriate influence and control over litigation counsel).

principle of American litigation that “clients, not their counsel, define litigation objectives.”<sup>47</sup> Class actions, however, present a well-known exception.<sup>48</sup> In the class action context, class counsel “exercise[s] nearly plenary control over all important decisions in the lawsuit,”<sup>49</sup> incentivized by the potential of obtaining a portion of any successful recovery by the class.<sup>50</sup> Delegation of authority in this manner is a necessary feature of class action litigation because the named representative in a given action typically will possess only a nominal stake in the outcome of the case,<sup>51</sup> and “small recoveries do not provide the incentive for any individual to bring a solo action.”<sup>52</sup> Moreover, the class of plaintiffs often is “dispersed and disorganized.”<sup>53</sup> Accordingly, the class device is needed to “aggregat[e] . . . relatively paltry potential recoveries into something worth someone’s (usually an attorney’s) labor.”<sup>54</sup>

Because class actions often lack a plaintiff sufficiently interested in monitoring its representatives, the class action structure increases the likelihood that a third-party funder will obtain control of the class, given the few checks on its actions.<sup>55</sup> This concern is even more problematic if an attorney has contracted directly with a funder for financial resources because the attorney in that arrangement has duties to the funder separate from her professional duties to the class.<sup>56</sup>

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47 Deborah L. Rhode, *Class Conflicts in Class Actions*, 34 STAN. L. REV. 1183, 1183 (1982); see also MODEL RULES OF PROF’L CONDUCT r. 1.2(a) (AM. BAR ASS’N 1983) (“[A] lawyer shall abide by a client’s decisions concerning the objectives of representation and . . . shall consult with the client as to the means by which they are to be pursued.”).

48 See John C. Coffee, Jr., *Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 678-79 (1986) (“[A]lthough our law publicly expresses homage to individual clients, it . . . recognizes their limited relevance in [the class action] context.”).

49 See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3 (1991).

50 See *Third Circuit Task Force Report on Selection of Class Counsel*, 74 TEMP. L. REV. 689, 691 (2001); see also *id.* (noting that the driving force for the plaintiffs’ bar in most class actions is the “opportunity to share in the plaintiffs’ risk and ultimately in any reward they may receive”).

51 See Coffee, Jr., *supra* note 48, at 679 (noting that class members may “suffer[] relatively small injuries”).

52 *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 617 (1997) (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997)).

53 Macey & Miller, *supra* note 49, at 3.

54 *Amchem*, 521 U.S. at 617 (quoting *Mace*, 109 F.3d at 344).

55 JOHN BEISNER ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, *SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES* 9 (2009), <http://www.instituteforlegalreform.com/uploads/sites/1/thirdpartylitigationfinancing.pdf> [<https://perma.cc/P22P-TG98>].

56 *Id.*; see also Julia H. McLaughlin, *Litigation Funding: Charting A Legal and Ethical Course*, 31 VT. L. REV. 615, 650 (2007) (“[Litigation investment contracts] threaten to undermine the duty of loyalty owed to a client by creating a contractual relationship with a third party, potentially creating a conflict of interest between the duty of loyalty the attorney owes to the client and the duty of fair dealing the attorney owes to third parties.”).



Assuming that funders can and will take control of litigation, opponents of third-party litigation funding argue that the presence of funders creates the possibility of a conflict of interest between the funder's goals and counsel's duty of loyalty to the client.<sup>57</sup> In this way, funders potentially cause conflicts of interest "similar to those that exist between contingency fee lawyers and their clients."<sup>58</sup> First, funders have "incentives to prioritize monetary relief over nonmonetary relief" since monetary relief directly affects their financial return in the litigation.<sup>59</sup> Second, funders may attempt "to settle early in order to maximize profits across a portfolio [of cases] rather than in a particular case."<sup>60</sup> Conversely, funders might push for trial to build their future marketability, even if that causes a decreased net financial gain in a single case.<sup>61</sup> Funders also pursue expensive trials so that they can use that reputational advantage to be "effective in eliciting early and high settlements in later cases."<sup>62</sup> Third, funders with formal settlement authority may seek to block a reasonable settlement by threatening to withdraw funding unless given rights to a greater share of any aggregate recovery.<sup>63</sup>

Third-party funding arrangements, however, can create additional conflicting incentives besides those that typically arise under contingency fee arrangements. Funders and attorneys repeatedly interact in the litigation market, and it is likely that "relationships among them will develop over time."<sup>64</sup> Attorneys may feel pressure to refer clients to favored funders, even if the client's needs "suggest a different firm may be more appropriate, and *vice versa*."<sup>65</sup> Some litigation funders have fiduciary obligations to investors

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<sup>57</sup> See BEISNER ET AL., *supra* note 55, at 8.

<sup>58</sup> Steinitz, *supra* note 8, at 1168; see also Elizabeth Chamblee Burch, *Judging Multidistrict Litigation*, 90 N.Y.U. L. REV. 71, 80 (2015) ("Competing interests, attorney funding, and contingent fees can lead to quick or collusive settlements, underfunded litigation, exorbitant attorneys' fees, coercive settlement terms, and misallocated settlement proceeds.").

<sup>59</sup> Steinitz, *supra* note 8, at 1168.

<sup>60</sup> *Id.*

<sup>61</sup> Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1315 (2011).

<sup>62</sup> *Id.* Because outside funders prefer to keep their investments confidential, it is likely that they use the benefits of reputational gains in confidential client pitches and settlement negotiations.

<sup>63</sup> The holdout concern is a recurring problem in aggregate litigation. For instance, the *Vioxx* multidistrict litigation settlement presented a similar ethical issue because it required each participating attorney to recommend the settlement to 100% of her eligible clients and to withdraw from representing any who refused. See Burch, *supra* note 58, at 82-83 (describing the *Vioxx* settlement and the ethical concerns it presented).

<sup>64</sup> BEISNER ET AL., *supra* note 55, at 8.

<sup>65</sup> *Id.*; see also, e.g., Anne Urda, *Legal Funding Gains Steam but Doubts Linger*, LAW360 (Aug. 14, 2008), <http://www.law360.com/articles/66244/legal-funding-gains-steam-but-doubts-linger> [<https://perma.cc/S2V5-UHKR>] (describing an interview with the founder of a litigation funding firm, in which he explained that after he developed a relationship with others in the legal community, lawyers began to refer clients to his firm as well as others for emergency funding).

that conflict with the interests of class members, either because the funders are publicly traded on foreign markets or because they have decided to privately securitize their pool of litigations.<sup>66</sup> And unlike contingency fee lawyers, who mainly provide lawyering services and owe a duty of loyalty to their clients, funders tend to be “financiers only” without an analogous duty.<sup>67</sup>

### B. *Litigation Funders as Effective Monitors*

Some advocates of third-party litigation funding reject the premise that funders will seek to and actually control litigation.<sup>68</sup> Other advocates of third-party funding instead argue that litigation funders *should* influence litigation strategy because their presence, under the correct circumstances,<sup>69</sup> may be harnessed to resolve the principal–agent problems created by contingency fee-funded class actions.<sup>70</sup> These proponents argue that, similar to the idea of the lead plaintiff under the Private Securities Litigation Reform Act of 1995 (PSLRA),<sup>71</sup> litigation funders have “skin in the game” because they desire a high return on the money that they invest in a case.<sup>72</sup> A greater recovery for the plaintiffs will result in a greater return for the funder since “the return to the funder is presumably a percentage of the class counsel’s fees, which are in turn dependent on the overall size of the recovery.”<sup>73</sup> Hence, when the funder’s incentives are consistent with the class, the funders may act as a counterweight to class counsel and ensure better representation of the class.<sup>74</sup> Even more, due to third-party funds, litigating may not “threaten[] [a] law

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<sup>66</sup> Steinitz, *supra* note 8, at 1168.

<sup>67</sup> *Id.* at 1160; *see also* Jack B. Weinstein, *The Democratization of Mass Actions in the Internet Age*, 45 COLUM. J.L. & SOC. PROBS. 451, 469–70 (2012) (“The basic problem is that the person who puts up the money does not have a direct obligation to the client—at least as far as precedent suggests.”).

<sup>68</sup> *See infra* note 83 and accompanying text.

<sup>69</sup> Importantly, the degree to which third-party funding agreements will create divergent interests in representative litigation is heavily dependent on the terms of the funding agreement, including the ways in which the third-party funder will recover and how the third-party funder will compensate the lawyer for his services. *See, e.g.*, Steinitz, *supra* note 61, at 1302, 1327–29 (proposing broad reforms to minimize conflicts of interest between attorneys, funders, and clients, but nevertheless acknowledging that litigation funding scholarship often incorrectly “debates the merits and demerits of litigation funding en masse, as if there is one type of funding in question”).

<sup>70</sup> *See, e.g.*, Samuel Issacharoff, *Litigation Funding and the Problem of Agency Cost in Representative Actions*, 63 DEPAUL L. REV. 561, 583 (2014) (proposing, for thought, “that courts, which are uncertain about the propriety of a proposed class action, or are concerned about the headless class problem, could seek to bring in funders as a way to get an incentivized monitor on the return to the class”).

<sup>71</sup> Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

<sup>72</sup> Issacharoff, *supra* note 70, at 582.

<sup>73</sup> *Id.*

<sup>74</sup> *See id.* (explaining that a funder’s “direct tie to the overall performance of the case may yield better incentives and actually narrow the agency gap between the class and its agents”); *see also* Coffee, Jr., *supra* note 42, at 342 (“A structure in which the class has both a class counsel and a separate litigation funder is inherently one in which ‘agents are watching agents.’”).

firm's solvency or ability to take on other matters," so an attorney's loyalty is less likely to be divided between her interest in self-preservation and her clients' interests: she "can afford to be a faithful representative."<sup>75</sup> In sum, proponents of third-party funding suggest that funders may actually be the best situated to address the agency gap between the class and its counsel.

### C. *The Empirical Evidence: Uncertain*

The effect of third-party funding on the adequacy of representation is uncertain.<sup>76</sup> Empirical data has been difficult to obtain because funding arrangements typically are confidential.<sup>77</sup> While some funders may reveal general financials—e.g., "yearly profits, growth margins, or their total annual investment in litigation"—they usually do not disclose details for specific cases.<sup>78</sup>

There is some evidence showing that third-party funders will seek and obtain control of litigation. For example, some litigation funders have expressly stated their desire to direct the course of litigation once they invest.<sup>79</sup> Moreover, a Florida appeals court found a third-party funder to be a real party in interest because the funder "had veto power over whether the litigation was filed, who would file it and how it would be pursue[d]," as well as "final say over any settlement agreements proposed to the plaintiffs."<sup>80</sup>

But some evidence suggests funders will not control litigation. For instance, in England and Wales, the Civil Justice Council, an agency of the U.K.'s Ministry of Justice, published a Code of Conduct for Litigation Funders, to which major litigation funding firms contributed.<sup>81</sup> The Code contains a provision that states, "funders are prevented from taking control of litigation or settlement negotiations and from causing the litigant's lawyers to act in breach of their professional duties," and it provides a "Complaints

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<sup>75</sup> Elizabeth Chamblee Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1316 (2012).

<sup>76</sup> Cf. Deborah R. Hensler, *Happy 50th Anniversary, Rule 23! Shouldn't We Know You Better After All This Time?* 165 U. PA. L. REV. (forthcoming 2017) (observing that there is a dearth of empirical data on class actions filed in the United States and initiating a dialogue about a research agenda "for systematically investigating . . . key characteristics of class action litigation").

<sup>77</sup> See Shannon, *supra* note 12, at 912 & n.286 (explaining that "[e]mpirical research would be ideal" to develop an appropriate regulatory landscape for third-party funding, but noting that robust data is difficult to obtain because private funders are unwilling to share their proprietary data).

<sup>78</sup> Kalajdzic et al., *supra* note 14, at 137.

<sup>79</sup> See, e.g., Selvyn Seidel, *Time to Pass the Baton?*, FULBROOK CAP. MGMT. LLC (Nov./Dec. 2012), <http://www.fulbrookmanagement.com/time-to-pass-the-baton> [<https://perma.cc/32BC-Y9Q9>] (arguing against the "control doctrine" by taking the position that once a case is funded, the third-party funder should be able to control the litigation).

<sup>80</sup> *Abu-Ghazaleh v. Chaul*, 36 So. 3d 691, 694 (Fla. Dist. Ct. App. 2009).

<sup>81</sup> *Code of Conduct*, ASS'N LITIG. FUNDERS, <http://associationoflitigationfunders.com/code-of-conduct> [<https://perma.cc/M8W9-3A8M>].

Procedure” for noncompliance with the Code.<sup>82</sup> In practice, Burford Capital—one of the most prominent third-party litigation funders in the U.S. market and a firm subject to the Code—has publicly disclaimed any role in the direction of the litigation or the decisions regarding settlement.<sup>83</sup>

Regardless of which side of the third-party funding debate eventually “wins,” the important takeaway for the adequacy of representation inquiry at this point is the observation that the “ethical issues are real.”<sup>84</sup> While some funders create arrangements to stay entirely out of the conduct of the litigation, other “funders want to be involved in developing and pursuing the case . . . and in settlement,” which “may lead to divided loyalties as between lender and client.”<sup>85</sup> That difficulty is compounded by the “shadowy roles” that litigation funders play.<sup>86</sup> Because the funder’s involvement is not announced to the court, it is more difficult for a presiding judge to supervise litigation, especially if one side consists of nominal parties who are ultimately coordinated by a funder beyond the court’s direct control.<sup>87</sup>

#### IV. A DISCOVERY RULE: UNSATISFACTORY SOLUTIONS AT BOTH ENDS OF THE SPECTRUM

Because of the potential for third-party funders to impair class counsel’s duty of loyalty, it is important to develop a discovery framework that informs courts of a third-party funder’s involvement in the case.<sup>88</sup> This Part explores a rule of nondisclosure, as well as a rule of near-mandatory or mandatory

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<sup>82</sup> *Id.*

<sup>83</sup> See *FAQ*, BURFORD CAP., <http://www.burfordcapital.com/faqs> [<https://perma.cc/FM5A-ZM2A>] (“We don’t get any rights to manage the litigation in which we invest . . . . Nor do we get any rights to control the settlement of the litigation, which remains wholly in the litigant’s control.”).

<sup>84</sup> CIVIL RULES ADVISORY COMM., MINUTES OCTOBER 30, 2014, at 13, <http://www.uscourts.gov/file/17940/download> [<https://perma.cc/ZUL7-3ZLV>].

<sup>85</sup> *Id.*

<sup>86</sup> Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455, 485 (2012) (citation omitted).

<sup>87</sup> *Id.*; see also CIVIL RULES ADVISORY COMM., *supra* note 84, at 14 (recording the observation of one judge that, because the court is unlikely to know that a third-party funder is present, it “is like ghost-writing,” and that it would be helpful to know who is behind the litigation).

<sup>88</sup> Discovery rules for third-party funding arrangements outside of the class action context are beyond the scope of this Comment. However, I briefly note that class actions are different from ordinary litigation because “outside of representational lawsuits the law generally assumes that parties always adequately represent themselves.” PRINCIPLES OF THE LAW OF AGGREGATE LITIGATION § 1.05 (AM. LAW INST. 2010). Hence, in nonrepresentative litigation, the Advisory Committee’s observation that the topic of third-party funding may be “outside the normal scope of disclosure and discovery” seems pertinent. CIVIL RULES ADVISORY COMM., AGENDA BOOK OCTOBER 30-31, 2014, at 119, <http://www.uscourts.gov/file/15487/download> [<https://perma.cc/W3X9-B7HV>]. The Advisory Committee explained, “[I]t is not at all clear that the way to police lawyers’ ethics is for trial courts to take the lead. Traditionally, that is the job of state bar ethics committees and the like. Judges who become aware of questionable conduct thus may refer matters to the state bar.” *Id.*

disclosure, and it concludes that these solutions, which occupy opposite ends of the discovery spectrum, are unsatisfactory.

#### A. *Nondisclosure*

The Federal Rules currently do not require disclosure of third-party funding agreements before certification of the class.<sup>89</sup> However, a blanket rule of nondisclosure in the class action context is an unacceptable approach given important due process considerations. As the Supreme Court explained in *Hansberry v. Lee*, due process requires adequate representation of the interests of absent class members in order for those members to be bound by the judgment.<sup>90</sup> Under a nondisclosure framework, funding arrangements that create conflicts of interest are unlikely to be disclosed until the settlement stage of the class suit when, under Rule 23(e)(3), the parties seeking approval of a settlement must identify any agreement made in connection with that settlement.<sup>91</sup> Hence, the potential for inadequate representation until the conclusion of the case weighs against a hands-off approach to disclosure of third-party funding agreements.

Also, inattention to the potential loyalty problems that third-party litigation funding creates would be inconsistent with important class action jurisprudence. Over the past fifteen years, major class action cases have highlighted the need to ensure that class representatives faithfully represent the interests of class members who “lack the ability or incentive to monitor . . . those who act on their behalf.”<sup>92</sup> For example, in *Amchem Products, Inc. v. Windsor*, the Supreme Court held that a class action settlement was improper because it treated all asbestos-injured plaintiffs as a single class despite diverging interests between those plaintiffs with current injuries and those with exposure-only injuries.<sup>93</sup> The worry was that the settling parties “achieved a global compromise with no structural assurance

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<sup>89</sup> See CIVIL RULES ADVISORY COMM., *supra* note 84, at 14 (including one judge’s observation that the “judges on her court have not yet agreed whether they can compel disclosure of third-party financing” but that the issue “belongs in the array of things that judges should be aware of”); see also Kalajdzic et al., *supra* note 14, at 137 (“[T]here is no precedent or common practice that would require disclosure of a third party-funding arrangement to a judge or to the opposing litigants.”).

<sup>90</sup> See 311 U.S. 32, 42 (1940) (“[T]his Court is justified in saying that there has been a failure of due process only in those cases where it cannot be said that the procedure adopted, fairly insures the protection of the interests of absent parties who are to be bound by it.”); see also PRINCIPLES OF THE LAW OF AGGREGATE LITIGATION § 1.05 (AM. LAW INST. 2010) (“The requirement of adequate representation is a creature of due process that exists in class actions and other representational lawsuits where parties stand in judgment on behalf of others.”).

<sup>91</sup> FED. R. CIV. P. 23(e)(3).

<sup>92</sup> Issacharoff, *supra* note 70, at 578.

<sup>93</sup> See 521 U.S. 591, 626 (1997) (“[F]or the currently injured, the critical goal is generous immediate payments. That goal tugs against the interest of exposure-only plaintiffs in ensuring an ample, inflation-protected fund for the future.”).

of fair and adequate representation for the diverse groups and individuals affected.”<sup>94</sup> The Court expressed similar concerns about the misaligned incentives between the class representatives and the large group of nonparticipating class members in *Ortiz v. Fibreboard Corp.*<sup>95</sup> Ensuring adequate representation by counsel runs parallel to this theme.<sup>96</sup>

Finally, a nondisclosure rule is inconsistent with the spirit of recent reforms that have attempted to address the agency costs that representative litigation creates. For instance, the 2003 Amendments to Rule 23 required courts to scrutinize formally the selection of class counsel, thereby providing for greater judicial oversight of absent class members’ interests.<sup>97</sup> Some have interpreted this requirement even further, contending that trial judges ought to act as fiduciaries of the class,<sup>98</sup> although that is not a universally accepted interpretation.<sup>99</sup> Regardless of how broadly one interprets this amendment, a rule of nondisclosure would violate the spirit of it.

Similarly, the PSLRA created a rebuttable presumption that the most adequate plaintiff to represent a class is the class member, or group of members, with the largest financial interest in the relief sought.<sup>100</sup> The most adequate plaintiff, subject to the approval of the court, is then to select and retain counsel to represent the class.<sup>101</sup> Underlying this reform was the belief that the self-interest of an investor with the largest stake in the outcome of a particular litigation would incentivize that investor to monitor the work of counsel, and the rest of the class would benefit from the lead plaintiff’s closer

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<sup>94</sup> *Id.* at 627.

<sup>95</sup> 527 U.S. 815, 856 (1999) (acknowledging that after *Amchem*, “a class divided between holders of present and future claims . . . requires . . . separate representation to eliminate conflicting interests of counsel”).

<sup>96</sup> See FED. R. CIV. P. 23(g) advisory committee’s note to 2003 amendment (noting that prior to the addition of subsection (g), proposed class counsel was evaluated under Rule 23(a)(4) and that subsection (g) “builds on that experience” because of the importance of determining the adequacy of class counsel).

<sup>97</sup> *Id.* (explaining that the addition of subdivision (g) to Rule 23 was intended to address the reality that the selection and activity of class counsel are “often critically important” to the successful prosecution of a class action suit, and to recognize the “importance of judicial evaluation of the proposed lawyer for the class”).

<sup>98</sup> See, e.g., *Reynolds v. Beneficial Nat’l Bank*, 288 F.3d 277, 279-80 (7th Cir. 2002) (“We and other courts have gone so far as to term the district judge in the settlement phase of a class action suit a fiduciary of the class, who is subject therefore to the high duty of care that the law requires of fiduciaries.”).

<sup>99</sup> See, e.g., *Issacharoff*, *supra* note 70, at 582 (“[J]udges are poorly positioned to serve as effective fiduciaries. Most notably judges are unlikely to have the case knowledge to assess the wisdom of litigation and settlement decisions independent of the representations made to them by the parties.”).

<sup>100</sup> See 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(aa-cc) (2012) (“In general . . . the court shall adopt a presumption that the most adequate plaintiff in any private action arising under [the PSLRA] is the person or group that has either filed the complaint or made a motion in response to a notice under subparagraph (A)(i); in the determination of the court, has the largest financial interest in the relief sought by the class; and otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.”).

<sup>101</sup> See *id.* § 78u-4(a)(3)(B)(v).

scrutiny.<sup>102</sup> This is indicative of a “central theme” in the legislative history of the PSLRA: a concern that “plaintiffs’ lawyers, rather than faithfully representing investors, were acting for their own benefit.”<sup>103</sup>

Congress, through the Class Action Fairness Act of 2005 (CAFA),<sup>104</sup> also attempted to increase the monitoring of class counsel by delegating some oversight to government officials. Under CAFA, a class action settlement with a nationwide market impact must be accompanied by notice to certain federal and state officials.<sup>105</sup> Congress inserted this requirement into the statute on the theory that review by public officials would deter misconduct by class counsel for fear of governmental oversight.<sup>106</sup> Hence, CAFA provides yet another example of the legislative branch reinforcing the importance of the adequacy of representation requirement. Given these concerns, a rule of nondisclosure for third-party funding arrangements, in light of potentially high agency costs, seems imprudent.

## B. Discovery by Other Parties

### 1. A Presumption of Relevance and Chilling Effects

Permitting other parties to discover third-party funding arrangements is unlikely to be successful in informing courts of the information they need unless there is a presumption of relevance, which would likely create a chilling effect on third-party funding of class actions. Rule 26(b) requires the moving party to show the relevance of the information it is seeking, so a movant seeking to compel production of its adversary’s third-party funding agreement will rarely succeed unless the movant already knows the terms of the funding agreement and can identify examples of potential conflicts of interest that are likely to arise. For instance, the court in *Kaplan v. S.A.C. Capital Advisors, L.P.* denied a motion to compel production of the plaintiffs’ litigation funding agreement and related documents, even though the defendants argued that discovery of the litigation funding agreement was relevant to the appointment

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<sup>102</sup> Issacharoff, *supra* note 70, at 579.

<sup>103</sup> Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641, 641-42 (1997).

<sup>104</sup> Pub. L. No. 109-2, 119 Stat. 4-14 (codified as amended in scattered sections of 28 U.S.C.).

<sup>105</sup> 28 U.S.C. § 1715(b) (2012).

<sup>106</sup> See Elizabeth J. Cabraser, *The Consequences of CAFA: Challenges and Opportunities for the Just, Speedy, and Inexpensive Determination of Class and Mass Actions*, 13 SEDONA CONF. J. 181, 196 (2012) (“The optimistic view of CAFA was that it could lead to new levels of cooperation and discourse among federal and state governmental authorities and state courts. The governmental notification provisions give the United States and affected states . . . unprecedented opportunities to speak up and work to improve class action settlements.”).

of class counsel and the adequacy of representation inquiry.<sup>107</sup> The court reasoned that the “plaintiffs’ admission that they . . . entered into a litigation funding agreement [did] not, of itself” establish that the fee arrangement would produce conflicts of interest, and the defendants provided “no nonspeculative basis for raising such concerns.”<sup>108</sup>

Because it is unlikely that a movant will successfully obtain discovery of a litigation funding agreement under Rule 26(b),<sup>109</sup> it is likewise improbable that the parties will actually litigate the effect of the third-party funding agreement on the adequacy of representation inquiry for the benefit of the court. Thus, in order for Rule 26 discovery to effectively address the potential ethical issues that third-party funding raises, a court would need to create a presumption of relevance to improve the chances that a movant will succeed on its motion to compel, such that the movant could use the information to inform the court about adequacy of representation concerns.

However, permitting discovery of third-party funding agreements in the class action context is likely to create a “chilling” effect, especially if there is a presumption of relevance. If the funding agreement is almost certainly going to be discoverable in class actions due to the adequacy of representation requirement, third-party funders may be unwilling to support class suits out of fear that the litigation will turn into a battle of financial might, decreasing the probability of a high return. In other words, a funder may fear that if third-party funding agreements are discoverable, defendants will be able to learn the amount of financing that a funder is willing to commit to the litigation and then seek to outspend the funder, thereby decreasing the funder’s return. As the court in *Ferraro v. General Motors Corp.* cautioned when granting a motion to compel a class representative’s fee arrangement with class counsel, the proper focus of financial discovery should be “narrow”: if the defendant has the ability to obtain broad discovery of the financial resources of his adversary, “a defendant might be tempted to overwhelm the plaintiff’s financial resources rather than to seek a resolution of the case.”<sup>110</sup>

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<sup>107</sup> 2015 WL 5730101, No. 12-CV-9350, at \*5 (S.D.N.Y. Sept. 10, 2015).

<sup>108</sup> *Id.*

<sup>109</sup> The Newberg treatise helpfully collects older cases addressing the relevance of a third-party funding agreement to the adequacy of representation inquiry, and those cases also show that it is very difficult for a defendant to successfully make a relevance showing without preexisting knowledge of the specific terms of the agreement. *See, e.g.*, NEWBERG ON CLASS ACTIONS §§ 3:69, 3:74 (5th ed.) (citing *Coffin v. Bowater Inc.*, 228 F.R.D. 397, 405 (D. Me. 2005) for the proposition that “adequate representation was not undermined by [a] labor union’s advancing attorney’s fees to class counsel” because the defendant made “no colorable showing” that the union would “exercise inappropriate control over this litigation” and *Mershon v. Elastic Stop Nut Div. of Harvard Indus., Inc.*, Civ. No. 87-1319, 1990 WL 484152, at \*12 (D.N.J. Mar. 23, 1990) for the proposition that “[t]hird party funding, in and of itself, does not make the named plaintiffs antagonistic to the interests of the class”).

<sup>110</sup> 105 F.R.D. 429, 432 (D.N.J. 1985).



A chilling effect would undercut the most obvious potential benefit of third-party funding: the possibility that such funding will allow parties with insufficient resources to vindicate their rights in court.<sup>111</sup> And even if a chilling effect did not materialize, litigation driven by parties trying to outspend each other would lead to results that run contrary to the 2015 Amendments to Rule 26, which specifically emphasize proportionality.<sup>112</sup>

## 2. Mandatory Disclosure and the Insurance Analogy

In the fall of 2014, the Advisory Committee considered a joint proposal from the U.S. Chamber Institute for Legal Reform and other organizations to amend Rule 26(a)(1)(A) to require initial disclosure to other parties of third-party investments in litigation.<sup>113</sup> One of the reasons offered in that proposal was that if a litigant must pay a third-party funder part of proceeds of any recovery, that party may be inclined to reject an otherwise reasonable settlement offer in hopes of obtaining a larger sum of money, especially if the funder will receive a disproportionate share of the first dollars in a settlement.<sup>114</sup> The Advisory Committee correctly rejected that proposal.<sup>115</sup>

The Advisory Committee first acknowledged that the proposal's arguments in favor of mandatory initial disclosure of third-party funding agreements resemble those in favor of requiring disclosure of insurance agreements.<sup>116</sup> Under Rule 26, an insurance agreement must be disclosed to other parties, without awaiting a discovery request, if the insurer is potentially liable for paying for or reimbursing the insured party for all or part of the judgment.<sup>117</sup> The 1970 Amendment to the Federal Rules, which added this requirement,

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<sup>111</sup> See Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 591-92 (2010) (concluding that even if third-party funding is likely to produce more litigation, it is equally likely to provide greater access to justice).

<sup>112</sup> See *supra* text accompanying note 22.

<sup>113</sup> CIVIL RULES ADVISORY COMM., *supra* note 88, at 113. At least one court has mandated disclosure of third-party funding arrangements in class actions. In January 2017, the Northern District of California issued a districtwide standing order that requires disclosure “[i]n any proposed class, collective, or representative action” of “any person or entity that is funding the prosecution of any claim or counterclaim.” Standing Order for All Judges of the Northern District of California, Contents of Joint Case Management System ¶ 19 (Jan. 17, 2017), <http://www.cand.uscourts.gov/news/210> [<https://perma.cc/A4PL-NNJ3>]. Likewise, some members of Congress have proposed mandatory disclosure of third-party funding agreements in class actions. See, e.g., H.R. 985, 115th Cong. § 1722 (2017) (proposing that “[i]n any class action, class counsel shall promptly disclose in writing to the court and all other parties the identity of any person or entity, other than a class member or class counsel of record, who has a contingent right to receive compensation from any settlement, judgment, or other relief obtained in the action”).

<sup>114</sup> CIVIL RULES ADVISORY COMM., *supra* note 88, at 119.

<sup>115</sup> See *id.* at 122.

<sup>116</sup> *Id.* at 119.

<sup>117</sup> FED. R. CIV. P. 26(a)(1)(A)(iv).

explained that disclosure would “enable counsel for both sides to make the same realistic appraisal of the case,”<sup>118</sup> in light of a history of many cases settling for “the coverage limit.”<sup>119</sup> Analogously, the proposal before the Advisory Committee contended that third-party funding arrangements may allocate a disproportionate share of a settlement to the funder, and disclosure of the funding agreement would aid in realistic appraisal of settlement possibilities.<sup>120</sup>

Even so, the Advisory Committee properly concluded that because of the dissimilarities between third-party funding and insurance agreements, the analogy is not a sufficient basis for mandatory disclosure. Since third-party funds tend to cover expenses and costs—rather than satisfy a settlement payout or judgment—the negotiation-to-the-coverage-limit logic does not map onto third-party funding practices.<sup>121</sup> Perhaps a defendant may be persuaded to change its offer once it knows that the plaintiff has significant financial resources to continue litigating.<sup>122</sup> Or, it is possible that if the funder carries a significant amount of settlement authority, a defendant would need to know the funder’s view of the litigation in order to accurately negotiate.<sup>123</sup> In these situations, though, it seems that a plaintiff would have an incentive to reveal that information voluntarily to the defendant in order to reach an amenable settlement.<sup>124</sup>

Aside from these general arguments, the need for Rule 26 mandatory disclosure of third-party funding agreements to aid settlement negotiations is even less applicable in the class action context. Rule 23(e)(3) already provides that “[t]he parties seeking approval [of a settlement] must file a statement identifying any agreement made in connection with the [settlement] proposal.”<sup>125</sup> This provision presumably requires disclosure of a funding agreement between class counsel and third-party funders when a settlement is submitted for judicial approval.<sup>126</sup> After reviewing the agreement, the judge might decide that the settlement “is not fair to class members and decline to approve the settlement.”<sup>127</sup> Or, as Professor Deborah Hensler explains,

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118 FED. R. CIV. P. 26(b)(2) advisory committee’s note to 1970 amendment.

119 CIVIL RULES ADVISORY COMM., *supra* note 88, at 119.

120 *Id.*

121 *Id.* at 119-20.

122 *Id.* at 120.

123 *Id.*

124 *Id.*

125 FED. R. CIV. P. 23(e)(3).

126 Deborah R. Hensler, *Third-Party Financing of Class Action Litigation in the United States: Will the Sky Fall?*, 63 DEPAUL L. REV. 499, 515-16 (2014).

127 *Id.* at 515.

Under Rule 23(e)(1), the judge could direct that the notice to class members of a pending settlement include the terms of the litigation financing agreement, so that class members would understand how their share of the settlement would be affected by these terms, and either have the chance to object to the terms or opt out . . . . The potential for such attention would likely constrain class counsel and third-party litigation investors from agreeing to terms that were clearly against class members' interest.<sup>128</sup>

Because Rule 23 already requires disclosure of the funding agreement at the settlement stage, a mandatory disclosure rule based on the parallel insurance logic is unnecessary.

### 3. The Developing Nature of Third-Party Funding

A sweeping conclusion regarding the presumptive relevance of a third-party funding arrangement, or the inclusion of third-party funding in the list of required disclosures, is premature at this point. As the Advisory Committee observed, third-party funding “takes many forms that may present distinctive questions.”<sup>129</sup> Further, “the questions raised by third-party financing are important [b]ut . . . have not been fully identified, and may change as practices develop further.”<sup>130</sup> Since third-party funding is an “understudied and evolving phenomenon,” adopting a mandatory or near-mandatory disclosure rule at this time risks creating a framework based on what may ultimately become “outlier[]” situations in the future.<sup>131</sup>

## V. A PROPOSED MIDDLE GROUND: IN CAMERA REVIEW

In camera review of third-party funding arrangements is a preferable middle ground between the other solutions discussed because of the broad discretion that it affords to the reviewing court. The Honorable Jack Weinstein suggested this rule, which imposes an affirmative obligation on parties with third-party funding agreements to disclose such arrangements to the court for in camera review, either at the outset of litigation or upon the formation of the agreement if formed thereafter.<sup>132</sup> In camera review does not require a time-consuming Rule amendment because Rule 23(g)(1)(C) already authorizes courts to order disclosure of information about fee arrangements

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<sup>128</sup> *Id.* at 515-16.

<sup>129</sup> Memorandum from Hon. David G. Campbell, Advisory Comm. on Civil Rules, to Hon. Jeffrey S. Sutton, Chair, Comm. on Rules of Practice and Procedure 4 (Dec. 2, 2014), <http://www.uscourts.gov/file/17932/download> [<https://perma.cc/57GC-HYQ9>].

<sup>130</sup> *Id.*

<sup>131</sup> Sahani, *supra* note 23, at 406.

<sup>132</sup> Weinstein, *supra* note 67, at 470.

when considering appointment of class counsel.<sup>133</sup> Instead, in camera review simply would allow the court to ask relevant questions, such as (but not limited to): Does the third-party funder have a role, however indirect, in strategic litigation decisionmaking? What incentives does the third-party funder have, and are those consistent with the class? And under what conditions can the third-party funder withdraw financing?<sup>134</sup>

Normatively, in camera review is desirable because it ensures that judges are aware of the presence and terms of a third-party funding agreement. In turn, increased knowledge better allows judges to address the important due process considerations enmeshed in the adequacy of representation inquiry. The proposal is also consistent with the spirit of Rule 23, which balances those due process considerations with the plaintiffs' privacy under the work product doctrine. In particular, there are colorable arguments that litigation funding agreements and associated documents contain information protected under the work product doctrine, which establishes a "zone . . . in which lawyers can analyze and prepare their client's case free from scrutiny or interference by an adversary."<sup>135</sup> Indeed, the 2003 Advisory Committee Note to Rule 23(g) suggests that courts should consider work product protection when requiring disclosure of fee arrangements.<sup>136</sup> In camera review is consistent with that guidance because it allows judges to review documents relating to third-party funding agreements—to better understand potential issues of due process and conflicts of interest—without revealing the information to adversarial parties or resulting in waiver of work product protections.<sup>137</sup>

Admittedly, there are some potential drawbacks to in camera review, but they are not insurmountable. First, in camera review sacrifices the clarity that a rule of mandatory disclosure or a rule of nondisclosure would provide. Because Rule 23 affords a judge considerable discretion, the judge would have

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<sup>133</sup> FED. R. CIV. P. 23(g)(1)(C).

<sup>134</sup> For a comprehensive set of questions that courts ought to ask about third-party funding agreements, see Huang, *supra* note 11, at 529-32.

<sup>135</sup> *Miller UK Ltd. v. Caterpillar, Inc.*, 17 F. Supp. 3d 711, 734 (N.D. Ill. 2014); see also, e.g., *id.* (finding that documents containing plaintiff's lawyers' mental impressions, theories, and strategies about the case, which had been given by plaintiff to prospective third-party litigation funding sources to obtain an investment, were protected by the attorney work product doctrine, and that those documents did not cease to be protected because they may also have been prepared or used to help plaintiff obtain financing).

<sup>136</sup> See FED. R. CIV. P. 23(g) advisory committee's note to 2015 amendment ("Some information relevant to class counsel appointment may involve matters that include adversary preparation in a way that should be shielded from disclosure to other parties.").

<sup>137</sup> See *Miller UK Ltd.*, 17 F. Supp. 3d at 736 (explaining that waiver of work product protections results from the disclosure in a way that "substantially increase[s] the opportunity for potential adversaries to obtain the information" (alteration in original) (quoting *Appleton Papers, Inc. v. EPA*, 702 F.3d 1018, 1025 (7th Cir. 2012))).

a number of options following in camera review. A judge could find, for instance, that concerns about “chilling effects” and work product doctrine are not present and order disclosure of the agreement to the other side, thereby taking advantage of the benefits of adversarial briefing. Or, a judge could limit review of the funding arrangement to in camera review and require that class counsel send opt-out notifications to potential plaintiffs with certain information about the funding agreement. This would allow potential plaintiffs to decide for themselves whether to join the action.<sup>138</sup> Because funders might be uncertain about a judge’s temperament for third-party funding in relation to class certification, the in camera rule may also lead to the undesirable chilling effect.

While important, the lack of clarity, if an issue, can be counterbalanced by the reviewing judge. For example, it is possible for a judge to use the Rule 16 discovery conference<sup>139</sup> to establish the parameters of review or to use Rule 83<sup>140</sup> to notify parties about the judge’s individual practices, which could include an ex ante description of the review process.<sup>141</sup>

Second, one might think that requiring judges to review third-party funding agreements in camera will exhaust scarce judicial resources, especially since judges traditionally benefit from adversarial briefing on class certification.<sup>142</sup> But a judge may be able to rely on the defendants’ resources even under an in camera rule. For instance, the judge might allow defense counsel to suggest questions about the third-party funding arrangement “but not be privy to the answers.”<sup>143</sup> Nonetheless, judicial resources should not control the analysis because, even though third-party funding has been increasing in the United States, the funding of class action lawsuits has been relatively limited.<sup>144</sup> Thus, even if judges were called upon to review every third-party funding agreement in the class action context, the burden on the

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<sup>138</sup> Lyon, *supra* note 111, at 601.

<sup>139</sup> See FED. R. CIV. P. 16 (granting judges broad discretion to hold pretrial conferences and control discovery).

<sup>140</sup> See FED. R. CIV. P. 83 (authorizing district courts to “adopt and amend rules governing [their] practice,” provided that the “local rule [is] consistent with—but not duplicat[ive of]—federal statutes and rules,” and authorizing a judge to “regulate practice in any manner consistent with federal law, [the Federal Rules of Civil Procedures, the bankruptcy rules], and the district’s local rules”).

<sup>141</sup> Sahani, *supra* note 23, at 408 (noting how existing rules, like Rule 83(b), already allow judges “to take into account third-party funding”).

<sup>142</sup> See, e.g., *Gbarabe v. Chevron Corp.*, No. 14-cv-00173-SI, 2016 WL 4154849, at \*2 (N.D. Cal. Aug 5, 2016) (rejecting a plaintiff’s suggestion that the court review its third-party funding agreement in camera and instead requiring disclosure to the defendant since in camera review would “deprive [the defendant] of the ability to make its own assessment and arguments regarding the funding agreement and its impact, if any, on plaintiff’s ability to adequately represent the class”).

<sup>143</sup> Huang, *supra* note 11, at 533 n.34.

<sup>144</sup> See Shannon, *supra* note 12, at 878 n.93 (“Third-party funding of class actions is not yet prevalent in the United States . . .”).

judiciary as a whole likely would be low. Although this state of affairs might change in the future due to the recent entry of sophisticated and dedicated litigation funding firms, it is unlikely that in camera review will create an onerous burden on the judiciary, for now.

#### CONCLUSION

Scholars on both sides of the litigation funding debate appear to agree that judicial scrutiny of third-party funding arrangements under Rule 23 is an uncontroversial check on the presence of an outside funder.<sup>145</sup> What has been unclear is how this check should operate. In camera review is a desirable approach because it balances plaintiffs' interests in keeping their financial circumstances confidential, defendants' desire to settle for a reasonable amount notwithstanding an influx of plaintiff-side resources, and the court's need to review third-party funding arrangements to determine the adequacy of representation. In camera review thus affords a reviewing judge the discretion needed to effectively supervise the parties before the court.

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<sup>145</sup> Compare Steinitz, *supra* note 61, at 1330 (arguing for regulation of third-party funders, such as “[c]ourt supervision similar to that required in the class action context”), with Lyon, *supra* note 111, at 576, 601 (concluding that third-party funding presents “limited dangers” and explaining that in class actions, a court could “require that the source and amount of funding for the class action be disclosed in opt-out notifications to potential plaintiffs”).