

CONSUMER LITIGATION FUNDING: JUST ANOTHER FORM OF PAYDAY LENDING?

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I

INTRODUCTION

Consumer litigation funding is a controversial form of credit used by plaintiffs. While his lawsuit is pending, a plaintiff can obtain a cash advance from a financier who is not a party in the lawsuit. In exchange for the upfront cash, the plaintiff owes the financier the principal plus interest and fees out of the proceeds of the lawsuit. Such advances are nonrecourse in the sense that the financier cannot obtain repayment outside of the case. If the lawsuit proceeds are less than the total amount owed to the financier, the plaintiff must pay the financier only the lawsuit proceeds; if the plaintiff loses the case, then he owes nothing. Despite paying interest in exchange for a cash principal, this type of credit is not legally considered a “loan” in most states. Therefore, this article uses the terms “funding,” “litigation/legal funding,” “litigation/legal finance,” and “nonrecourse loan/advance” interchangeably to refer to consumer litigation funding with the caveat that the terminology for this credit product is currently being disputed.¹ Opponents of funding have analogized it to payday lending because both financial products involve high interest rates.² Payday lending is another form of high-cost, short-term credit. A consumer with proof of income and a bank account can obtain a payday loan with an obligation to fully or partially pay back the loan out of the consumer’s next paycheck.

In a 2015 case, *Oasis Legal Finance Group, L.L.C. v. Coffman*, the Colorado Supreme Court held that the same regulations that govern payday lending also

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1. Some states (for example, Colorado) consider funding a “loan” under state usury laws, but others define it as a financial service distinct from a loan (for example, Ohio, where the term “nonrecourse civil litigation advance” is used). See *Oasis Legal Fin. Grp., L.L.C. v. Coffman*, 361 P.3d 400, 401 (Colo. 2015); OHIO REV. CODE ANN. § 1349.55 (West 2016).

2. Sara Warner, *Like Payday Loans, Lawsuit Loans Increasingly Coming Under Fire*, HUFFINGTON POST (Oct. 20, 2014, 1:23 PM), http://www.huffingtonpost.com/sara-warner/like-payday-loans-lawsuit_1_b_5692187.html [<https://perma.cc/38A7-957Q>].

cover consumer litigation funding.³ Specifically, the court declared that such funding constitutes a “loan” that is governed under the Uniform Consumer Credit Act.⁴ In an amici curiae brief in support of Attorney General Coffman, the National Association of Consumer Advocates, the Center for Responsible Lending, the Consumer Federation of America, and the National Consumer Law Center argued that legal finance companies were making loans to consumers.⁵ These organizations argued that lenders should not be able to skirt the state’s usury regulation by manipulating the form of their financial services.⁶ In support of their position, they cited multiple situations in which payday lenders have attempted to dodge state governance.⁷ In the past, payday lenders have unsuccessfully argued that the advances they gave to consumers were not loans but instead deferred deposits of checks, sales of gift certificates, or Internet service transactions.⁸

But is consumer litigation funding just another form of payday lending, or are consumer advocacy organizations mistaken by grouping these two types of credit together? How should consumer litigation funding be governed? Optimal regulation of financial products requires policymakers to understand how the services operate and how consumers respond to them. State legislatures are rapidly addressing legal finance as it rises in popularity. Currently, nine states have stable laws in place to govern nonrecourse advances,⁹ and many others are considering bills that would implement statutory provisions to govern these advances.¹⁰ As regulators decide on an approach to address funding, they should not hastily group funding and payday lending together—they need to understand the nuances of these two business practices and their consequences for consumers.

This article provides a side-by-side comparison of payday lending and consumer litigation funding in order to aid policymakers. First, part II describes how these two alternative credit sources work and how borrowers use their cash advances. This article is the first to employ a large dataset from a national legal financier and provide an empirical analysis of the usage of legal finance. The findings demonstrate that the percentages of consumers that spend funding on

3. *Oasis*, 361 P.3d at 401; Jacob Gershman, *Payday Lending Rules Apply to Litigation Funding, Colorado Court Rules*, WALL ST. J. (Nov. 17, 2015, 12:36 PM), <http://blogs.wsj.com/law/2015/11/17/payday-lending-rules-apply-to-litigation-funding-colorado-court-rules/> [<https://perma.cc/9SJV-G5YG>].

4. *Oasis*, 361 P.3d at 401.

5. Brief Amici Curiae of National Association of Consumer Advocates et al. in Support of Respondents at 12, *Oasis Legal Fin. Grp., LLC v. Coffman*, 361 P.3d 400 (Colo. 2015) (No. 2013SC497) [hereinafter Consumer Organizations’ Brief].

6. *Id.* at 32.

7. *Id.* at 32–36.

8. *Id.*; see also Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 18–25 (2002) (describing how payday lenders have disguised their loans).

9. See *infra* Table 3.

10. Heather Morton, *Litigation or Lawsuit Funding Transactions 2015 Legislation*, NAT’L CONF. OF ST. LEGISLATURES (Jan. 8, 2016), <http://www.ncsl.org/research/financial-services-and-commerce/litigation-or-lawsuit-funding-transactions-2015-legislation.aspx> [<https://perma.cc/PA87-9D9Y>].

utilities, car payments, bills, rent, mortgage payments, food, and unexpected expenses are comparable to the percentages of consumers that spend payday loans on these living expenses. Thus, on the surface, these two forms of high-cost credit that lie outside of the traditional banking system appear similar.¹¹ Beneath the surface, though, many differences emerge. There are two traits unique to legal finance on which policy guidelines should turn: funding is nonrecourse—in other words, financiers cannot collect anything beyond the lawsuit proceeds—and funding is tied to the complex litigation process.

Because funding is nonrecourse, its customers cannot fall into the debt spiral that regulators often worry about with respect to payday lending.¹² However, this does not mean that nonrecourse advances are innocuous. Using wisdom from the behavioral economics literature, part III explains that funding's relationship to litigation obscures its effect on the consumer's cash flow and that the involvement of litigation adds a layer of complexity and uncertainty to calculating the price of funding, a problem not implicated by payday loans. All in all, consumers may have an even more difficult time understanding the true cost of legal finance than that of payday loans.

Finally, part IV examines three types of policies—bans, restrictions on loan characteristics, and disclosure laws—that have been used to regulate payday lending and explores whether analogous laws would effectively govern funding and ensure that the product is transparent to consumers. From an economics perspective, policymakers should prohibit funding only when this financial product on net harms consumers. Empirical research is central to understanding whether this product will harm or help borrowers. A ban would not be the best approach at this time for two reasons: the legal finance industry has not reached a competitive equilibrium, and little empirical evidence currently exists as to the consumer welfare effects of funding. Restrictions on loan characteristics, such as caps on interest or limits on duration, would not be ideal because they are hard to implement, hurt low-income borrowers, and may be evaded by financiers. However, disclosure laws, coupled with attorney acknowledgments, would provide effective consumer protection because these laws could help plaintiffs understand the true cost of nonrecourse loans—something that is currently difficult given funding's tie to litigation, a complicated process with an uncertain end date.

This article makes the following two policy recommendations. First, to remedy the lack of empirical research upon which policymakers can make effective and educated decisions, states should partner with financiers to gather data on customer characteristics and outcomes in order to study the effects of

11. See Susan Lorde Martin, *Litigation Financing: Another Subprime Industry That Has a Place in the United States Market*, 53 VILL. L. REV. 83, 95 (2008) (arguing that litigation funding fits into the wide subprime lending market that includes payday lending).

12. See, e.g., David Silberman, *We've Proposed a Rule to Protect Consumers from Payday Debt Traps*, CONSUMER FIN. PROT. BUREAU BLOG (June 2, 2016), <http://www.consumerfinance.gov/about-us/blog/weve-proposed-rule-protect-consumers-payday-debt-traps/> [<https://perma.cc/N5PK-9KV3>].

funding on consumer welfare. Some states currently have reporting requirements for financiers,¹³ but because such data are at the aggregate level, they are not useful for analyzing consumer well-being. Second, to address the difficulty in comprehending the true cost of funding, states should implement robust disclosure laws that differ from those currently in place. Nine states have imposed funding disclosure requirements that are similar to those in the Truth in Lending Act for payday lending.¹⁴ These laws require, for example, a minimum font size, itemization of one-time fees, a schedule of repayments, and disclosure of the annual percentage rate (APR). In the funding context, however, these disclosures do not help plaintiffs understand the loans. Plaintiffs do not have legal expertise and likely lack the financial sophistication necessary to estimate when a nonrecourse advance will be due and how much the eventual interest and fees will amount to. Even for the savviest plaintiffs, such computations would be difficult. Financiers should use data analysis to provide borrowers an expected payment date and expected total payment—rather than just providing the APR and a schedule of the amount owed for a series of six-month intervals. Further, in order to prevent financiers from burying the cost disclosures deep in contracts or pressuring plaintiffs into signing without reading the disclosures, the disclosure laws should be coupled with attorney-acknowledgment provisions. These provisions, which five states have implemented, require attorneys to provide written acknowledgments to verify that costs of funding have been disclosed to the plaintiffs.¹⁵

II

PAYDAY LENDING VERSUS CONSUMER LITIGATION FUNDING: FUNCTIONAL SIMILARITIES AND DIFFERENCES

A payday loan is a one-to-two-week cash advance of no more than \$1,000.¹⁶ Lenders charge about 10–20% per \$100, which is equivalent to a 260–520 APR.¹⁷ Payday lending has pervaded the universe of alternative credit in the United States: there are over twenty thousand payday outlets, more than the number of McDonald's, J.C. Penney, and Target outlets nationwide.¹⁸ A customer typically applies for a payday loan by going to a brick-and-mortar lender and supplying proof of income and personal information; personal information can include the customer's government-issued identification, monthly bills, and most recent

13. See ME. STAT. tit. 9-A, § 12-107 (2016); NEB. REV. STAT. § 25-3309 (2016); VT. STAT. ANN. tit. 8, § 2260 (2016).

14. See *infra* Table 3.

15. See IND. CODE § 24-12-2-1 (2016); ME. STAT. tit. 9-A, § 12-104 (2016); NEB. REV. STAT. § 25-3303 (2016); OHIO REV. CODE ANN. § 1349.55 (West 2016); TENN. CODE § 47-16-104 (2016).

16. Neil Bhutta et al., *Payday Loan Choices and Consequences*, 47 J. MONEY, CREDIT & BANKING 223, 227 (2015).

17. Paige Marta Skiba, *Regulation of Payday Loans: Misguided?*, 69 WASH. & LEE L. REV. 1023, 1027 (2012).

18. Michael A. Stegman, *Payday Lending*, J. ECON. PERSP., Winter 2007, at 169, 169–70.

checking account statement.¹⁹ Though some payday lenders obtain a subprime credit score to evaluate loan applications,²⁰ a consumer's payday loan obligations and repayment behavior, including default, are not reported to the national credit bureaus, such as Equifax. Thus, payday lending does not directly affect the consumer's traditional credit score.²¹

To obtain a payday loan, the customer writes a postdated check or agrees online to a debit authorization that covers the loan amount plus interest and fees.²² The lender can cash the check or debit the account on or after the loan's due date—that is, the customer's subsequent payday.²³ Borrowers may also “roll over,” or renew, their loan by paying the associated fees. They will then gain an extra earnings cycle to pay off the principal and any additional interest.²⁴ Rollovers are the norm. According to the Consumer Financial Protection Bureau, 80% of payday loans are renewed within fourteen days.²⁵ A study conducted in 2014 showed that 50% of all payday loans were in a renewal chain at least ten loans long.²⁶ Approximately 48% of new consumers roll over their loans at least once.²⁷ While payday loan use may be perfectly rational for cash-constrained consumers,²⁸ critics view renewals as evidence of a debt trap: “borrowers are tempted into borrowing \$300 for two weeks expecting to pay \$45, but wind up paying many times that amount as they borrow repeatedly.”²⁹ Approximately five million payday loan customers get caught in this cycle of debt a year, estimated to cost them \$3.4 billion annually.³⁰ Payday loans may also indirectly affect consumers' ability to pay off other debts.³¹

According to a report issued by the Pew Charitable Trusts, 53% of borrowers used their first payday loan for utilities, car payments, credit card bills, or prescription drugs; 10% for mortgage or rent; 5% for food; 16% for unexpected expenses such as emergency medical bills; and 8% for “something special” such

19. Bhutta et al., *supra* note 16, at 227.

20. *E.g., id.* at 239–40.

21. *Id.* at 227.

22. *Id.*

23. *Id.*

24. *Id.* at 227–28.

25. KATHLEEN BURKE ET AL., CONSUMER FIN. PROT. BUREAU, CFPB DATA POINT: PAYDAY LENDING 4 (2014).

26. *Id.*

27. *Id.* at 4–5.

28. *See Skiba, supra* note 17, at 1026–27 (“From an economist's perspective, credit in general allows consumers to smooth consumption over time, meaning that they borrow from future good times to help make it through current tough times.”).

29. DONALD P. MORGAN & MICHAEL R. STRAIN, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 309, PAYDAY HOLIDAY: HOW HOUSEHOLDS FARE AFTER PAYDAY CREDIT BANS 9 (2008).

30. KEITH ERNST ET AL., CTR. FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY PAYDAY LENDING 2 (2004), <http://www.responsiblelending.org/payday-lending/research-analysis/CRLpaydaylendingstudy121803.pdf> [<https://perma.cc/AM8S-UG5B>].

31. *See Bhutta et al., supra* note 16, at 228 (“[Payday] loans affect consumers' ability to meet their financial obligations in general.”).

as gifts, vacation, or entertainment.³² The Payday Loans column in Table 1 depicts this breakdown. The fact that 68% of borrowers are using their payday loans for living expenses suggests that consumers are using these loans as a last resort. Empirical research supports the notion that payday loan customers are liquidity-constrained. Both Carter and Bos et al. provide evidence that such customers are using pawnshops as a second form of credit to help meet their payday loan interest payments and roll over their loans.³³ According to Agarwal et al., consumers' liquidity dramatically deteriorates in the five months before they take out payday loans.³⁴ Carter et al. show that credit union members who borrowed from payday lenders had lower levels of liquidity than the members who did not.³⁵

In consumer litigation funding, a personal injury plaintiff can obtain a \$500 to \$100,000 cash advance in return for repayment of the principal plus interest and fees from the lawsuit proceeds.³⁶ The plaintiff can apply for funding anytime prior to the resolution of the case. The maximum advance is much larger than the maximum payday loan principal—\$1000. Like those in payday lending, the interest rates in funding are high: they can vary from 2–15% per month, resulting in APRs over 200%.³⁷ Unlike payday lending, which mostly occurs at physical outlets, most consumer legal finance takes place online.³⁸ A plaintiff can fill out an application for a cash advance on the Internet and communicate with the funder via telephone.³⁹ Whereas payday loan applications focus on the

32. PEW CHARITABLE TRS., *PAYDAY LENDING IN AMERICA: WHO BORROWS, WHERE THEY BORROW, AND WHY* 14 (2012). Survey participants were asked: Thinking back now to (that FIRST/the) time you took out a (online payday loan/payday loan/auto title loan), which of the following best describes what specifically you needed the money for?

1. To pay rent or a mortgage
2. To pay for food and groceries
3. To pay a regular expense, such as utilities, car payment, credit card bill, or prescription drugs
4. To pay an unexpected expense, such as a car repair or emergency medical expense
5. To pay for something special, such as a vacation, entertainment, or gifts
6. (Do not read) Other (specify).

Id. 7% of respondents replied with something other than the categories above. *Id.*

33. See Marieke Bos et al., *Balancing Act: New Evidence and a Discussion of the Theory on the Rationality and Behavioral Anomalies of Choice in Credit Markets*, in *RESEARCH HANDBOOK IN BEHAVIORAL LAW AND ECONOMICS* (Joshua C. Teitelbaum & Kathryn Zeiler eds., forthcoming); Susan Payne Carter, *Payday Loan and Pawnshop Usage: The Impact of Allowing Payday Loan Rollovers*, 49 J. CONSUMER AFF. 436, 436 (2015).

34. See Sumit Agarwal et al., *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?*, 99 AM. ECON. REV. (PAPERS & PROC.) 412, 415 (2009).

35. See Susan Payne Carter et al., *Pecuniary Mistakes? Payday Borrowing by Credit Union Members*, in *FINANCIAL LITERACY: IMPLICATIONS FOR RETIREMENT SECURITY AND THE FINANCIAL MARKETPLACE* 145, 148 (Olivia S. Mitchell & Annamaria Lusardi eds., 2011).

36. Jean Xiao, Note, *Heuristics, Biases, and Consumer Litigation Funding at the Bargaining Table*, 68 VAND. L. REV. 261, 265 (2015).

37. *Id.*

38. See Susan Lorde Martin, *Financing Litigation On-Line: Usury and Other Obstacles*, 1 DEPAUL BUS. & COM. L.J. 85, 85–86 (2002) (“There are now many small, private firms advertising on the Internet that will give plaintiffs money in exchange for a share of the proceeds of the litigation . . .”).

39. See, e.g., *Apply Now in Seconds*, OASIS FIN., <https://www.oasisfinancial.com/apply/ApplyForm/>

consumer's ability to pay (that is, proof of income and bank account in good standing), funding applications focus on basic information about the lawsuit. The financier assesses the strength of the consumer's case by looking at factors such as potential damages and the likelihood of gaining a favorable settlement or winning the trial.⁴⁰ The funder also gathers information on attorney's fees and other debts that would take priority, such as medical liens.⁴¹

With the exception of some financiers checking to see whether plaintiffs have filed for bankruptcy, consumer credit status is unimportant because repayment comes from lawsuit proceeds.⁴² Attorneys disburse repayments from case proceeds to funders after attorney's fees and debts to other higher-priority creditors are paid.⁴³ As with payday lending, a plaintiff's funding obligations and repayment behavior are not reported to the national credit bureaus.⁴⁴ Therefore, legal finance does not directly affect the plaintiff's traditional credit score.

Because repayment comes from the leftover case proceeds, if any, the plaintiff pays either the full amount due to the funder or the entire remaining portion of the case proceeds—whichever amount is less.⁴⁵ If the plaintiff loses the lawsuit, he pays nothing.⁴⁶ This is why a funding advance is often referred to as a nonrecourse loan. This configuration does not allow a plaintiff to roll over his debt.⁴⁷ The due date of the principal and interest is the date of case resolution. Because of the nonrecourse nature of the advance, funding consumers cannot fall into the cycle of interest payments that payday loan consumers do.

Funding cannot cause borrowers to fall into a debt cycle directly but can affect borrowers' financial health indirectly. Plaintiffs who take out nonrecourse loans may obtain considerably lower proceeds from the lawsuit because of the high interest and fees. After paying the financier, consumers might fall into higher levels of debt elsewhere. This is analogous to the situation in which payday borrowers go to pawnshops to repay payday loans.⁴⁸ That is, credit demand spills over into other markets because of the interest paid to the first lender.

For example, assume that a plaintiff will receive a \$10,000 settlement in two years. He owes 30% of the \$10,000 to his attorney, and for his \$1,000 cash advance

[<https://perma.cc/TUP5-7PDR>] (last visited Aug. 19, 2016).

40. Xiao, *supra* note 36, at 265.

41. Nicholas Beydler, Comment, *Risky Business: Examining Approaches to Regulating Consumer Litigation Funding*, 80 UMKC L. REV. 1159, 1163 (2012).

42. *Id.*

43. See OHIO REV. CODE ANN. § 1349.55(B)(6)(c) (West 2016) (explaining that the legal services provider will disburse the lawsuit proceeds owed to the funder).

44. See VT. STAT. ANN. tit. 8, § 2254(a)(11) (2016) (“A consumer litigation funding company shall not . . . [r]eport a consumer to a credit reporting agency if insufficient funds remain from the net proceeds to repay the company.”).

45. Xiao, *supra* note 36, at 263.

46. *Id.*

47. If a plaintiff wanted more cash, he could seek another funder to buy out the first funder's cash advance. The first funder can choose to buy out its own advance if it learns from the attorney that the plaintiff's case value has significantly increased.

48. See PEW CHARITABLE TRS., *supra* note 32, at 16, 17.

from a funder, he owes \$3,400 at the end of his case. Without funding, he gets \$7,000 in two years. With funding, he gets \$4,600 on net, after paying the attorney and financier. With \$2,400 in interest going to the funder, the consumer may have to use credit cards to pay off his mortgage, car expenses, and other debts that he could not cover with the \$4,600. Credit card rates are high, and he may accumulate many months of debt. If an option other than funding was available to get a \$1,000 advance, then the consumer may not have needed to take out the credit card loan. In this analysis, it is important to note that taking the \$1,000 funding at the beginning may have been perfectly rational and that he may have ended up in a worse financial position without it. The point of this example is to illustrate a potential indirect effect of nonrecourse advances: a consumer may seek high-interest credit options after his lawsuit has resolved because of the large, and potentially unexpected, amount going to the funder.

The populations of payday lending and consumer litigation funding customers are not mutually exclusive, but they also do not completely overlap. Payday lending requires a current inflow of income and a checking account. Funding has no such requirements, and plaintiffs may be cut off from their source of income temporarily or permanently after their accidents. While commentators have reported that nonrecourse advances are generally used on living essentials,⁴⁹ this article examines data from a national funder and provides more specific statistics on the usage of these advances.

The data are from a national legal financier for advances that the company made from 2014 to 2015 (N=37,799).⁵⁰ Data include the date of the plaintiff's funding and his geographic location. Upon receipt of the funding, each consumer wrote a couple of lines about the expected use of their advance. Key words in consumers' answers, such as "mortgage" and "utilities," were used to formulate categories comparable to the ones in the Pew Charitable Trusts payday lending study.⁵¹ Because customers could write down several things for which they would use their funds, percentages were calculated both exclusively—where the

49. See Martin, *supra* note 11, at 84–85; Mariel Rodak, Comment, *It's About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effect on Settlement*, 155 U. PA. L. REV. 503, 514 (2006).

50. We had data from 2011 to 2013 and 2016 for some, but not all, consumers. Results are very similar when calculated with 2011–2016 data. The national financier was promised anonymity in exchange for participating in this study. Researchers interested in accessing this data should contact the authors for more information.

51. Below are the key words used to form the categories:

1. Regular expenses = "utility," "electric," "water," "internet," "lights," "car," "vehicle," "bill," "payment," "drug,"
2. Mortgage/rent = "mortgage," "rent," "apt," "home," "house,"
3. Food = "food," "grocer[y, ies],"
4. Unexpected expenses = "medical," "emergency," "funeral," "crisis"
5. Gifts/vacation/entertainment = "gift," "present," "holiday," "Christmas," "vacation"
6. Money/Income Needed = "money," "income."

Note: The programming picked up multiple endings of these words (for example, "car" and "cars").

consumer does not mention key words in any other category—and non-exclusively.

Table 1 depicts the results. Under the exclusive reporting method, about 38% of plaintiffs used their advances for regular expenses, 7% for mortgage or rent, 1% for food, 2% for unexpected expenses, and 1% for gifts, vacation, and entertainment; 7% indicated two or more of these five categories, whereas 4% expressly indicated that money was needed but did not state the purpose for which it was needed. Under the non-exclusive reporting method, about 44% of plaintiffs spent their advances on regular expenses, 12% on mortgage or rent, 2% on food, 2% on unexpected expenses, and 1% on gifts, vacation, and entertainment; 9% stated expressly in their comments that money was needed. Calculations show that 51% indicated categories one to three, which consist of living expenses, without indicating categories four or five. This is lower than the payday lending statistic of 68% but still comparable. The percentage may be lower due to the freeform way in which consumers recorded the use(s) of their advances.

Table 1. Consumer Use of Payday Loans and Litigation Funding⁵²

| Category | Payday Loans (%) | Litigation Funding (Exclusive %) | Litigation Funding (Non-Exclusive %) |
|---|------------------|----------------------------------|--------------------------------------|
| Regular Expenses (utilities, car payments, bills) | 53 | 38 | 44 |
| Mortgage or Rent | 10 | 7 | 12 |
| Food | 5 | 1 | 2 |
| Unexpected Expenses (emergency, medical expenses) | 16 | 2 | 2 |
| Gifts, Vacation, or Entertainment | 8 | 1 | 1 |
| Indicated that Money/Income was Needed | --- | 4 | 9 |
| More Than One Category | --- | 7 | --- |

52. The statistics about payday loans in this table come from a 2012 study by the Pew Charitable Trusts, cited in footnote 32. The statistics about consumer litigation funding are calculations the authors made with data from a national legal financier.

Similar to those of payday lending, consumers of litigation finance are using their nonrecourse loans for living expenses, which signals that these plaintiffs are cash-constrained. Though no empirical studies confirm that these customers are indeed liquidity-constrained, several commentators have opined that this is the case.⁵³ Both Rodak and Martin have recognized the comparability of legal finance to other subprime forms of lending.⁵⁴ Litigation funding can “provide[] opportunities for low-income borrowers to buy homes, cars[,] and other goods by obtaining credit that is unavailable to them in the prime market”⁵⁵ and can “empower people without access to more traditional credit sources.”⁵⁶

In sum, both payday lending and consumer legal funding are alternative credit sources that lie outside of mainstream banking. Both types of credit involve high interest rates, and a majority of borrowers of both use their cash advances on living essentials. On the surface, it appears that these two markets and the customers who populate them are quite similar. However, looking more in-depth, this is not the case. The most poignant differences are that funding is nonrecourse and repayment is tied to litigation. Unlike that of payday lenders, the focus of funders is not on a consumer’s ability to pay, but instead on the performance of the asset, which is the plaintiff’s case. Because funding is nonrecourse, legal finance customers cannot get into the spiral of debt that payday customers can. Further, payday loan contracts are simple. Even if borrowers do not understand compounding interest, they know the due date of their cash advance (that is, their next payday) and the amount due. Although payday borrowers likely understand their obligations to the lender, they may mispredict their ability to repay,⁵⁷ whereas funding plaintiffs are unlikely to comprehend their obligations to the financier in the first place; funding’s tie to litigation complicates the repayment calculus. In order to estimate the total interest and fees owed, a plaintiff must accurately predict the size and date of his settlement, a date which is often years into the future. Part III provides evidence on these points.

III

A BEHAVIORAL ECONOMICS PERSPECTIVE

Traditional economic theory tells us that consumers decide whether or not to take a cash advance with repayment down the road by balancing the anticipated

53. See, e.g., STEVEN GARBER, RAND CORP., ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN, AND UNKNOWN 10, 12 (2010) (“Presumably, then, most recipients of non-recourse loans either have exhausted their ability to obtain financing from more common sources or they are attracted to legal funding because they like the fact that the amount they must repay can be no larger than the amount they recover from their lawsuits.”).

54. Martin, *supra* note 11, at 84–85; Rodak, *supra* note 49, at 514 (citation omitted).

55. Rodak, *supra* note 49, at 514.

56. Martin, *supra* note 11, at 85.

57. Ronald Mann, *Assessing the Optimism of Payday Loan Borrowers*, 21 SUP. CT. ECON. REV. 105, 123 tbl.2 (2013) (showing that approximately 40% of borrowers mispredict how long it will take for them to repay their payday loan).

monetary and nonmonetary benefits against current and future costs.⁵⁸ Despite often being labeled as predatory, high-interest credit products can be completely rational when customers have no other credit options and the benefit of \$300 today outweighs the cost of forgoing \$300 plus fees the next pay period. However, empirical studies from behavioral economics have documented that borrowers are not perfectly rational and are indeed susceptible to shortcomings and biases during the decisionmaking process.⁵⁹ For example, Skiba and Tobacman found that over half of payday loan customers defaulted within one year of their first loan and that those who defaulted typically had already repaid or serviced five loans, a sign that borrowers were failing to optimize their well-being.⁶⁰ The authors discovered that this behavior was not consistent with a rational model of decisionmaking but instead better aligned with a model that captures mispredictions about self-control behavior and future patience (the so-called quasi-hyperbolic discounting model).⁶¹ That is, the consumer is not as patient as he believes he will be in the future,⁶² leading him to mispredict the likelihood of successfully retiring his debt the next payday. This part of the article uses insights from behavioral economics to explain how borrowers may interact with payday lending and funding differently in the decisionmaking process. Particularly, it elaborates on how legal finance's tie to litigation obscures its effect on the consumer's cash flow and complicates the calculus of repayment.

First, funding's relationship to lawsuits hides its impact on consumers' cash flow due to the effects of salience, differential mental accounting, and lack of the pain of payment.⁶³ Research has shown that customers do not heed certain components of price and thus underestimate price if these components are not salient.⁶⁴ Consumers automatically pay more attention to product features that are different from the typical characteristics in a "reference" product,⁶⁵ while they have to exert more cognitive effort to consider less salient product attributes.⁶⁶ Payday loan features are quite standard in the realm of lending. The benefit is the upfront cash; the costs are the interest and fees. Consumers can see that these costs come out of their paychecks. Even though borrowers may not understand how annualized interest rates work,⁶⁷ borrowers are well aware that they owe, for

58. See Bos et al., *supra* note 33.

59. See generally Stefano DellaVigna, *Psychology and Economics: Evidence from the Field*, 47 J. ECON. LITERATURE 315 (2009).

60. Paige Marta Skiba & Jeremy Tobacman, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default* 1–3 (Vanderbilt Law & Econ., Research Paper No. 08-33, 2008).

61. *Id.* at 3.

62. *Id.* at 9.

63. See *infra* notes 64–74.

64. See, e.g., Raj Chetty et al., *Salience and Taxation: Theory and Evidence*, 99 AM. ECON. REV. 1145, 1145 (2009) (finding that "consumers underreact to taxes that are not salient").

65. See Pedro Bordalo et al., *Salience Theory of Choice Under Risk*, 127 Q.J. ECON. 1243, 1243–44 (2012).

66. Chetty et al., *supra* note 64, at 1165.

67. See Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy:*

example, a \$300 principal plus \$60 in fees the next payday. In contrast, litigation funding is more opaque. Repayment of an advance comes out of the income the plaintiff receives in the form of a settlement or trial award. Because, procedurally, repayment comes out of the one-time case proceeds rather than regular income, funding's effect on income is not salient, and consumers are likely to underestimate the costs of legal finance, which are realized years after the advances are disbursed to plaintiffs. Not only are the costs less salient than those of payday lending but the benefits are more salient. Unlike most financial products that provide upfront cash, funding is nonrecourse. This striking difference will lead customers to focus on the fact that they cannot get into a debt spiral and to pay more attention to the benefits than the costs of obtaining an advance.

Differential mental accounting and the lack of pain of payment only worsen the undervaluation of costs and accentuation of benefits. Research demonstrates that consumers do not perceive all money to be equal—in other words, money is not fungible.⁶⁸ People judge money differently based on the source of the funds.⁶⁹ Though it is clear to customers that payday loan repayments come out of their bank accounts, they may not consider settlement or trial award money as a part of their income because they categorize the cash distinctly in their minds. Consumers may be more willing to spend money from their lawsuit proceeds than from other sources of income, such as wages, to pay for funding, simply due to the different mental labels they put on the accounts.

Research also shows that a customer experiences pain or disutility when he spends money to pay for a good or service, potentially through loss aversion.⁷⁰ When the consumer gives the money to the vendor, the amount of money in his bank account decreases. If his reference point was the level of money in the account prior to the payment, then he experiences a “loss.”⁷¹ Psychologically, this loss negatively impacts him more than an addition to his account of the same magnitude would positively impact him.⁷² Thus, when making decisions, people tend to avoid the choice that they perceive will result in loss.⁷³ The role of the pain associated with loss is to mitigate consumer overestimation of benefits and underestimation of costs during the decisionmaking process.⁷⁴ For payday lending, this disutility comes every two weeks when the consumer pays off either

Theory and Evidence, 52 J. ECON. LITERATURE 5, 12 (2014) (summarizing studies in which consumers did not understand compounding interest).

68. See generally Richard H. Thaler, *Mental Accounting Matters*, 12 J. BEHAV. DECISION MAKING 183 (1999) (giving an overview of research demonstrating that not money is not fungible).

69. *Id.* at 196–97.

70. See Drazen Prelec & George Loewenstein, *The Red and the Black: Mental Accounting of Savings and Debt*, 17 MARKETING SCI. 4, 25 (1998).

71. See Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependent Model*, 106 Q.J. ECON. 1039, 1039 (1991).

72. See *id.* (“[L]osses and disadvantages have greater impact on preferences than gains and advantages.”).

73. See *id.* at 1057.

74. Prelec & Loewenstein, *supra* note 70, at 25.

the whole loan plus interest or that term's interest. However, for litigation funding plaintiffs, this disutility likely never occurs. After a case resolves, the attorney usually disburses the principal, interest, and fees that are owed to the financier and then gives the plaintiff any remaining proceeds. Because the plaintiff does not write a check or physically make a payment to the financier, he does not experience the loss associated with his cash advance.

Second, funding's tie to litigation complicates the repayment calculus. The price of payday lending is initially clear: the consumer has to pay \$10–\$20 per \$100 borrowed per pay cycle. On the other hand, the price of funding is complex even at the outset because of the financial service's relationship to lawsuits. A simple example illustrates this point. Assume that a financier follows the industry's best disclosure practices, which have been incorporated into disclosure regulations by some states,⁷⁵ and provides the following repayment schedule for a \$1,000 cash advance with a 10% additive monthly interest rate⁷⁶:

| | |
|---------------------------------------|---------|
| Total amount to be repaid by consumer | |
| if at 6 months: | \$1,600 |
| if at 12 months: | \$2,200 |
| if at 18 months: | \$2,800 |
| if at 24 months: | \$3,400 |
| if at 30 months: | \$4,000 |
| if at 36 months: | \$4,600 |
| if at 42 months: | \$5,200 |

For any other financial product, this type of repayment schedule adequately informs consumers because the length of time depends on factors that are not directly related to the product. For payday lending, repayment duration depends on spending and borrowing in other areas of the customer's life. However, for funding, repayment depends on the outcome of the associated asset—the case.

Personal injury plaintiffs do not have the necessary financial or legal expertise to evaluate potential lawsuit outcomes or the ability to compute corresponding probabilities (for example, a 62% chance of settling at \$X in nine months or a 38% chance of winning a trial award of \$Y in twenty-five months). A huge portion of the U.S. population is neither financially nor contractually literate.⁷⁷ Many people lack an understanding of numeracy (that is, “the capacity to do a simple calculation related to compounding of interest rates”), inflation, and risk diversification.⁷⁸ Research shows that those who are less financially sophisticated

75. See, e.g., ME. STAT. tit. 9-A, § 12-104 (2016).

76. Interest rates are not necessarily additive for all funders; interest rates can be compounded. We use an additive rate for simplicity.

77. See Lusardi & Mitchell, *supra* note 67, at 11–12 (summarizing the results of existing empirical studies on financial literacy in the U.S. adult population); Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 237–38 (2002) (concluding that millions of Americans have low contractual literacy).

78. Lusardi & Mitchell, *supra* note 67, at 10 (explaining what constitutes financial literacy).

are more likely to make investment mistakes and engage in high-cost borrowing like payday loans.⁷⁹ Additionally, many people are unable to extract important aspects of transactions from lengthy and complex contract documents.⁸⁰ Thus, even with a payment schedule like the one above, plaintiffs will be unable to compute a reasonable estimate of the actual price of the nonrecourse advance.

IV

WHAT POLICIES ARE OPTIMAL?

Parts II and III reviewed the similarities and differences between payday lending and consumer litigation funding. Part IV takes stock of the types of policies that have been implemented to regulate payday loans and explores whether similar policies would make sense for nonrecourse advances. Specifically, it examines bans, restrictions on loan characteristics, and disclosure regulations. From an economics perspective, policymakers should ban funding only when the credit product on net harms consumers. Empirical studies are critical to understanding how the product will affect borrowers. Because the legal finance industry is still developing and little empirical research on how funding affects consumer welfare is available at this time, states should not pursue bans. States should also not enact restrictions on loan characteristics for three reasons: it is difficult to find the optimal parameters for such restrictions; such restrictions would likely negatively impact low-income borrowers; and financiers may strategically act to render these restrictions ineffective. Part IV concludes by arguing for a disclosure policy, coupled with attorney acknowledgment, to help customers understand the true costs of funding.

A. Bans

Prohibition of a financial service is not justified unless it is on net detrimental to consumers. Table 2 depicts the state policies that currently govern payday lending. Fourteen states have expressly banned payday loans.⁸¹ Existing empirical literature does not come to a consensus regarding the effect of payday loans on borrowers. There is as much research showing that payday loans help consumers as there is demonstrating that these loans harm them.⁸²

Payday loans may raise the probability of borrowers experiencing negative financial consequences: Melzer found that payday loan access increased financial

79. See *id.* at 21–23 (summarizing the results of studies on financial literacy and economic outcomes).

80. White & Mansfield, *supra* note 77, at 240.

81. Skiba, *supra* note 17, at 1043.

82. See generally John P. Caskey, *Payday Lending: New Research and the Big Question*, in THE OXFORD HANDBOOK OF THE ECONOMICS OF POVERTY 681 (Philip N. Jefferson ed., 2012). Economists treat the issue of whether payday lending increases or decreases social welfare as an empirical question. Thus, this article does not focus on nonempirical studies. For a source that makes the case for why households should be protected from payday lending from a nonempirical perspective, see generally Creola Johnson, *Congress Protected the Troops: Can the New CFPB Protect Civilians from Payday Lending?*, 69 WASH. & LEE L. REV. 649 (2012).

hardship with respect to paying bills,⁸³ Skiba and Tobacman demonstrated that having a payday loan raised the likelihood of a personal bankruptcy filing,⁸⁴ and Campbell et al. showed that access to payday lending resulted in a hike in involuntary bank account closures.⁸⁵ Further, Carrell and Zinman discovered that the presence of payday lending increased the likelihood of adverse work outcomes among Air Force employees.⁸⁶

However, others have shown that payday lending has positive effects as an alternative credit source. Morgan and Strain demonstrated that banning payday loans led to a rise in check bouncing (a more costly alternative to taking out a payday loan), complaints to the Federal Trade Commission (a proxy for the level of informal bankruptcy), and Chapter 7 bankruptcies.⁸⁷ Zinman found that after a restrictive payday lending law passed in Oregon, check bouncing and the likelihood of adverse events, such as job loss, increased.⁸⁸ Morse provided evidence that payday loans aided people in financial distress after natural disasters.⁸⁹ Hynes showed that personal bankruptcy filings did not rise after states legalized payday lending and, in fact, fell in areas with large military communities.⁹⁰ Dobbie and Skiba demonstrated that greater payday loan principals decrease default rates, suggesting that the money is used to help customers manage their budget.⁹¹ These studies cast doubt on the assertion that payday lending is generally bad for borrowers. Bans are not necessarily the best policy because they take away a credit source that may assist in times of need and that may deter consumers from engaging in more costly financial behaviors, such as writing a check when there are insufficient bank account funds.

Most states have not yet passed legislation to address legal finance; nor have most state supreme courts addressed a challenge to these cash advances. There are currently no express prohibitions on funding. The Ohio Supreme Court previously banned funding in 2003, but the Ohio legislature overturned this policy in 2008.⁹² Table 3 reports the state policies that currently govern nonrecourse advances.

83. See Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Q.J. ECON. 517, 519 (2011).

84. Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* 1 (Vanderbilt Law & Econ., Research Paper No. 11-13, 2011).

85. Dennis Campbell et al., *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*, 36 J. BANKING & FIN. 1224, 1224–25 (2012).

86. Scott Carrell & Jonathan Zinman, *In Harm's Way? Payday Loan Access and Military Personnel Performance*, 27 REV. FIN. STUD. 2805, 2808 (2014).

87. MORGAN & STRAIN, *supra* note 29, at 1, 3.

88. See Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap*, 34 J. BANKING & FIN. 546, 546–47 (2010).

89. Adair Morse, *Payday Lenders: Heroes or Villains?*, 102 J. FIN. ECON. 28, 28 (2011).

90. Richard Hynes, *Payday Lending, Bankruptcy, and Insolvency*, 69 WASH. & LEE L. REV. 607, 607 (2012).

91. Will Dobbie & Paige Marta Skiba, *Information Asymmetries in Consumer Credit Markets: Evidence from Payday Lending*, AM. ECON. J.: APPLIED ECON., Oct. 2013, at 256, 256.

92. Xiao, *supra* note 36, at 274.

Prohibitions should be instituted only if nonrecourse advances are on net bad for consumers. Because funding is a recent phenomenon, little empirical work exists that evaluates the effect of these advances on consumer welfare. In a working paper, Xiao examines the effect of access to funding on personal bankruptcy and finds that access reduces the Chapter 7 and 13 filing rates.⁹³ As more researchers conduct empirical studies, it is plausible that, as in the case of payday loans, research on the consequences of using funding will not come to a consensus on its net effects on borrowers. Further, unlike the situation in the payday loan industry, legal finance rates likely have not fully stabilized and equilibrated because the funding industry is still growing. More firms will continue to enter and drive the rates down, potentially shifting the consequences for plaintiffs. Thus, at this time, states should not ban nonrecourse loans.

Instead, states should engage in data collection efforts and partner with financiers to systematically evaluate long-term consumer outcomes. Maine, Nebraska, and Vermont all mandate that financiers report aggregate data on their businesses including the total number of nonrecourse loans made, the aggregate dollar amount of such fundings, and the total amount charged to customers including interest and one-time fees.⁹⁴ However, these reporting requirements do not go far enough. States should instead seek data on individual transactions and partner with financiers to conduct telephone surveys to obtain consumer outcome data on how many consumers ended up in bankruptcy, whether the financing carried plaintiffs over to their next paycheck, and similar inquiries.

B. Restrictions On Loan Characteristics

In terms of regulating payday loan characteristics, thirty states have capped interest rates, thirty-three have capped loan sizes, thirty-five have restricted loan lengths, and thirty-three have limited rollovers.⁹⁵ Colorado, New Hampshire, Ohio, and Montana have interest rate caps so low that it is unprofitable for most financiers to operate in these states.⁹⁶ Thus, these states have effectively banned payday lending without certain empirical evidence that payday loans are on net bad for borrowers.⁹⁷ Economic research on consumer behavior suggests that the second and third measures—capping loan sizes and restricting loan lengths—may be ineffective, but the fourth—limiting rollovers—may yield positive results. Dobbie and Skiba found that a larger loan size led to a lower likelihood of

93. See Jean Xiao, *The Effect of Consumer Litigation Funding on Bankruptcy* (Working Paper, 2017).

94. ME. STAT. tit. 9-A, § 12-107 (2016); NEB. REV. STAT. § 25-3309 (2016); VT. STAT. ANN. tit. 8, § 2260 (2016).

95. See *infra* Table 2.

96. See *infra* Table 2; see also *Legal Status of Payday Loans by State*, PAYDAY LOAN CONSUMER INFO., <http://www.paydayloaninfo.org/state-information> [<https://perma.cc/NK76-SPZG>] (last visited Oct. 17, 2016).

97. See *supra* Part IV.A.

default,⁹⁸ and Carter et al. demonstrated that longer loan lengths had very little effect on the likelihood of repayment and renewal of payday loans.⁹⁹ However, Skiba and Tobacman showed that borrowers tend to miscalculate their ability to repay payday loans;¹⁰⁰ this contributes to customers rolling over their loans multiple times only to end up in debt traps. Thus, the fourth measure of restricting the number of renewals may improve consumer welfare, but monitoring compliance with such regulations has proven difficult.¹⁰¹

With little empirical work on funding, it is difficult to know whether limiting some aspects of funding will be beneficial. However, restrictions on various characteristics of nonrecourse loans are inadvisable for three reasons. First, finding the optimal parameters for such restrictions is difficult. Financiers and consumers are heterogeneous: financiers have distinct costs of capital, and consumers likely have different opinions on whether maximizing the size of their cash advance or their share of lawsuit proceeds most benefits them. Second, limiting different aspects of funding will hurt low-income borrowers. Arkansas, Colorado, Indiana, and Tennessee have interest rate caps that make it unprofitable for most funders to operate in these states.¹⁰² Policymakers may have good intentions in limiting interest rates; they may see funding as a valuable alternative credit source for those in need and want to lower the price to make it less costly for low-income consumers. However, in setting extremely low rates, these policymakers cause the supply of funding to dry up as financiers pull away. Plaintiffs who take up nonrecourse advances are likely liquidity-constrained and have low incomes. Some funding consumers are likely to be among the payday borrowing population. As legal financiers leave states with very low interest rate caps,¹⁰³ these consumers may resort to payday lending or other forms of more costly capital, through which they may end up in debt traps while waiting for lawsuit proceeds. Thus, the unavailability of nonrecourse loans mostly hurts those who have the greatest need and have very few, if any, financial options.

Finally, financiers may engage in strategic actions to render funding restrictions ineffective. It is common for companies to adjust their behavior to get around regulations. For example, Delaware limits the number of loans per year that payday loan consumers can take out.¹⁰⁴ To evade this policy, payday lenders in Delaware have reclassified themselves as installment lenders, allowing

98. Dobbie & Skiba, *supra* note 91, at 256.

99. See Susan Payne Carter et al., *The Effect of Having More Time to Repay a Payday Loan: Implications for Understanding Borrower Myopia 2* (Working Paper, 2017).

100. See Skiba & Tobacman, *supra* note 60, at 2–3.

101. See Skiba, *supra* note 17, at 1045.

102. See *infra* Table 3.

103. See Andrew G. Simpson, *Litigation Financing Firm Exits Tennessee as New Law Goes into Effect*, INS. J. (July 3, 2014), <http://www.insurancejournal.com/news/southeast/2014/07/03/333772.htm> [<https://perma.cc/7WTZ-9XS9>].

104. SUSANNA MONTEZEMOLO, CTR. FOR RESPONSIBLE LENDING, PAYDAY LENDING ABUSES AND PREDATORY PRACTICES 4 n.11 (2013), <http://www.responsiblelending.org/state-of-lending/reports/10-Payday-Loans.pdf> [<https://perma.cc/SX65-FUPH>].

them to offer an unrestricted number of loans.¹⁰⁵ Similarly, payday lenders in Ohio have reclassified themselves as mortgage lenders to avoid payday loan laws.¹⁰⁶ In regard to consumer litigation funding, Maine prohibits financiers from assessing fees forty-two months after the contract date; Nebraska and Tennessee prohibit funders from accruing fees thirty-six months after the contract date.¹⁰⁷ There are a number of actions that funders can take in response to such laws. Financiers may stop funding lawsuits with long repayment horizons (for example, medical malpractice cases¹⁰⁸) or may fund cases only in the latter stages of litigation, which have less uncertainty about their settlement prospects. Some firms may shift their capital to higher value claims to maximize revenues. Others in Maine and Nebraska may choose to hike up prices for the months during which fees can be charged; financiers cannot do this in Tennessee because Tennessee also caps interest and fees. Any of these financier actions would render the original duration restrictions ineffective.

C. Disclosure Regulations

Payday loans are subject to the Truth in Lending Act (TILA).¹⁰⁹ TILA requires lenders to reveal the cost of the loan, including finance charges and APR, in a clear and conspicuous manner.¹¹⁰ Some states have additional disclosure provisions in their consumer credit statutes.¹¹¹ Two recurring types of provisions are payday loan purpose statements and state consumer finance authority information clauses.¹¹² Nine states require financiers to tell their customers that payday loans are intended to address short-term needs and are not long-term solutions.¹¹³ Twelve states mandate that lenders provide information to borrowers about the state financial department that is in charge of regulating payday loans so that borrowers can contact the department with any concerns.¹¹⁴

105. *Id.*

106. *Payday Lenders Adept at Evading State Law, Democratic Committee Staff Report Finds*, U.S. HOUSE COMM. ON FIN. SERVS. DEMOCRATS (June 16, 2016), <http://democrats.financialservices.house.gov> [<https://perma.cc/48JZ-CF2A>].

107. *See infra* Table 3.

108. A medical malpractice lawsuit can take, on average, five years from injury to case resolution. David M. Studdert et al., *Claims, Errors, and Compensation Payments in Medical Malpractice Litigation*, 354 *NEW ENG. J. MED.* 2024, 2027 (2006).

109. *Truth in Lending*, OFF. OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, <https://www.occ.gov/topics/consumer-protection/truth-in-lending/index-truth-in-lending.html> [<https://perma.cc/H67R-WG92>] (last visited Mar. 16, 2017).

110. Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 *FORDHAM J. CORP. & FIN. L.* 55, 69 (2004).

111. *See infra* Table 2.

112. *See infra* Table 2.

113. *See infra* Table 2.

114. *See infra* Table 2.

TILA does not automatically cover legal finance because funders arguably do not qualify as “creditors” under the Act.¹¹⁵ However, a state’s usury statute may incorporate TILA obligations, and if a court finds a nonrecourse advance to be a loan in that state, then funding will be subject to TILA requirements. Colorado is the only state that has decided at the supreme court level that funding is a loan.¹¹⁶ To date, states that regulate legal finance by statute have set their own disclosure provisions including (1) a minimum font size, (2) itemization of one-time fees, (3) provision of a schedule of repayments, and (4) disclosure of the APR. These state laws are similar to TILA requirements because both mandate that the same information—finance charges and APRs—be disclosed.

Though normal disclosure regulations involving APR and fees may be effective for payday lending, different disclosures may be needed for litigation finance because funding’s relationship to litigation hides its effect on the consumer’s cash flow and complicates the repayment calculus. Instead of giving the plaintiff a very complicated contract with an itemization of various fees, a repayment schedule, and the APR, the funder should give the plaintiff an estimate of how much he will owe and when the amount owed will be due. Refer back to the example in part III and assume that the financier predicts the case will settle twenty-four months after the contract date. Under this proposal, the financier should directly disclose that the plaintiff will owe the financier \$3,400—\$1,000 for the principal and \$2,400 in fees—on X date, which is twenty-four months after the date of the funding agreement. Such a disclosure would focus the consumer’s attention on the cost of the advance and obviate the consumer’s need to do any additional calculations.

Although funders will likely require a few years of experience (and thus a phase-in period) prior to being able to generate precise estimates of repayment amount and due date, such approximations are feasible. The workings of the insurance industry demonstrate clearly how data analysis can help with profit and loss predictions. Insurance companies possess software to analyze case characteristics and eventual payment outcomes.¹¹⁷ After they gather enough data points, these companies use the software to generate estimates of what different cases are worth, and they are also able to predict their profits and losses.¹¹⁸ Likewise, financiers can invest in software to analyze case characteristics and repayment outcomes. They can use the software to predict funding durations, as well as profits and losses.

One counterargument to this proposal may be that the plaintiff can get a case duration estimate from his attorney and then figure out what he will owe and

115. Martin, *supra* note 110, at 69.

116. Oasis Legal Fin. Grp., L.L.C. v. Coffman, 361 P.3d 400, 401 (Colo. 2015).

117. See, e.g., MARK ROMANO & J. ROBERT HUNTER, CONSUMER FED’N OF AM., LOW BALL: AN INSIDER’S LOOK AT HOW SOME INSURERS CAN MANIPULATE COMPUTERIZED SYSTEMS TO BROADLY UNDERPAY INJURY CLAIMS 1 (2012), <http://www.consumerfed.org/pdfs/Studies.ComputerClaims06-04-12.pdf> [<https://perma.cc/L7XB-8XG8>].

118. *Id.* at 2–3.

when he must pay. Experienced attorneys may be able to generate case duration predictions, but financiers should do so instead for several reasons. First, funders can generate more precise estimates. Though attorneys can predict when cases will settle from their filing dates, plaintiffs obtain nonrecourse advances at different stages of litigation. Financiers can better assess repayment dates by conducting data analysis with the filing, funding, and repayment dates from previous cases. Next, attorneys' estimates center on case characteristics, whereas funders' estimates take into consideration statutory liens and other debts because funders are not first in priority to get the case proceeds. Also, attorneys' estimates are generally derived from their own funded and unfunded cases. Financiers' estimates are from only funded cases, across various attorneys. In a working paper, Xiao shows that access to funding increases claim payment and duration of medical malpractice claims.¹¹⁹ This provides evidence that the litigation outcomes of funded cases differ from unfunded ones. Thus, financiers have more relevant samples. Additionally, financiers' samples have more predictive power because they include data across attorneys and are likely larger. In sum, funders' rather than attorneys' estimates may be more precise and appropriate for consumers to get a sense of when and how much the repayment will be.

The second reason that financiers should have the burden of generating estimates is that producing precise approximations is costly due to the technology required. If the obligation of providing these approximations rested on attorneys, attorneys may start charging fees, making such predictions available only to plaintiffs with more resources. Third, there may be legal reasons why attorneys should not give these predictions. For example, questions may arise concerning whether attorneys are agents of financiers for liability purposes. Finally, even if attorneys could easily give consumers precise case-duration estimates, many consumers may lack the financial and contractual literacy, as well as the impetus, to put the lawsuit information from their attorneys together with information from the funding agreements in order to generate accurate repayment amounts and dates.

The proposed disclosure policy not only obviates the need for financially and contractually unsophisticated consumers to make complex judgments related to litigation and connect these assessments to repayment of nonrecourse advances, but it also mitigates the problem of potentially waiving attorney-client privilege and work-product doctrine protection.¹²⁰ By placing the legal burden on financiers to make precise predictions, financiers hopefully will cease attempting to extract case value and duration estimates from plaintiffs' attorneys in order to figure out the profitability of these advances. If plaintiffs' attorneys provide these

119. See Jean Xiao, *The Effect of Consumer Litigation Funding on Medical Malpractice Litigation* (Working Paper, 2017).

120. For how funding relates to attorney-client privilege, see generally Grace M. Giesel, *Alternative Litigation Finance and the Attorney-Client Privilege*, 92 DENV. U. L. REV. 95 (2014). For how funding relates to the work product doctrine, see generally Grace M. Giesel, *Alternative Litigation Finance and the Work-Product Doctrine*, 47 WAKE FOREST L. REV. 1083 (2012).

estimates, then the predictions and any accompanying information may lose attorney-client privilege and work-product protection. Currently, the laws surrounding funding, the attorney-client privilege, and the work-product doctrine are unsettled and vary in different jurisdictions.¹²¹ This article's proposal encourages financiers to collect their own data in order to generate estimates of repayment amounts and dates and to calculate their own profits and losses. Under the proposal, financiers will need only case information that would be disclosed to defendants anyway in order for defendants to make settlement offers; that is, financiers will require only non-confidential information.

Though some literature documents the failure of disclosure laws,¹²² these laws may work for funding if they are coupled with attorney acknowledgments. One of the main reasons why disclosure laws do not work is because firms intentionally hide disclosures or prevent consumers from reading them.¹²³ With funding, borrowers have access to the attorney that is representing them in their underlying case. Currently, five states—Indiana, Maine, Nebraska, Ohio, and Tennessee—have provisions in their funding statutes that require a written acknowledgment by the plaintiff's attorney that verifies that the attorney has reviewed the contract and all disclosures related to the cost of the nonrecourse loan have been made.¹²⁴ This way, the attorney can confirm that the financier has actually revealed the necessary information in an understandable way. Such acknowledgments can stop financiers from burying the costs deep in the contract or attempting to pressure plaintiffs into signing before reviewing the disclosures.

V

CONCLUSION

Consumer litigation funding is not just another form of payday lending. Funding has similarities with payday lending because they are both alternative financial services, involve high interest rates, and cater to customers who need money for living expenses. However, they differ in ways that regulators should recognize. Many justify bans on payday lending by pointing to the fact that millions of borrowers every year are getting stuck in an inescapable cycle of interest payments. While legal finance has real costs, funding's nonrecourse nature prevents consumers from getting stuck in a cyclical repayment of debt. Moreover, prohibitions may not be appropriate at this time because there is little empirical evidence on how funding affects consumer welfare and there is room for interest rates to fall as the industry continues to expand and competition

121. See LISA BENCH NIEUWVELD & VICTORIA SHANNON, *THIRD-PARTY FUNDING IN INTERNATIONAL ARBITRATION* § 6.09(B)(5)(a)–(b), at 140–42 (2012) (discussing the attorney-client privilege and work-product doctrine in relation to disclosing information to a funder).

122. See, e.g., Lauren E. Willis, *Performance-Based Consumer Law*, 82 U. CHI. L. REV. 1309, 1321–26 (2015); see also Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647 (2011).

123. Willis, *supra* note 122, at 1322–24.

124. IND. CODE § 24-12-2-1 (2016); ME. STAT. tit. 9-A, § 12-104 (2016); NEB. REV. STAT. § 25-3303 (2016); OHIO REV. CODE ANN. § 1349.55 (West 2016); TENN. CODE § 47-16-104 (2016).

increases among funders. States should take the initiative to partner with financiers to study the effect of this new form of credit on borrowers.

Both payday loans and funding can help consumers who are in financial distress. Appropriate regulation is necessary to make sure cash-constrained consumers are making informed choices. Though funding's nonrecourse nature makes it less dangerous for customers, its tie to litigation makes it more difficult for customers to truly understand its price. It is cognitively cumbersome for consumers to link how lawsuit proceeds relate to income. They experience almost no pain of paying to help them assess the costs. To address consumer understanding, some states have implemented disclosure regulations that mandate that funders itemize the fees, present a repayment schedule, and relay the APR. However, customers do not have the legal expertise or financial sophistication to estimate case duration and to put this information together with funding contract terms to get an accurate sense of where they may end up on a repayment schedule. Thus, financiers should disclose a reasonable approximate repayment amount and date to improve borrowers' understanding of the costs of nonrecourse advances.

Table 2. Payday Lending State Policies as of Year 2016¹²⁵

| State | Express Bans and Caps on Interest Rate/Fees | Restrictions on Loan Characteristics | Disclosure Regulations in Addition to TILA Requirements |
|-------------|--|---|---|
| Alabama | *456.25% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: 10–31 days *max # rollovers: 1 | |
| Alaska | *520% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: min 14 days *max # rollovers: 2 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| Arizona | *Express ban | | |
| Arkansas | *Express ban | | |
| California | *459% APR for 14-day \$100 loan | *\$300 max loan amount *loan term: max 31 days *max # rollovers: 0 | |
| Colorado | *20% interest for first \$0–300 and then additional 7.5% for \$301–500 | *\$500 max loan amount *loan term: min 6 months *max # rollovers: 1 rollover at 45% interest | |
| Connecticut | *Express ban | | |
| D.C. | *Express ban | | |
| Delaware | | *\$500 max loan amount *loan term: max 60 days *max # rollovers: 4 | *payday loans meant to address short-term needs |
| Florida | *419% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: 7–31 days *max # rollovers: 0 | |
| Georgia | *Express ban | | |

125. In addition to our own research using Westlaw and LexisNexis, we also obtained information from paydayloaninfo.org.

| | | | |
|---------------|---------------------------------|---|---|
| Hawaii | *459% APR for 14-day \$100 loan | *\$600 max loan amount *loan term: 32 days *max # rollovers: 0 | *state agency's contact information for customer's concerns and complaints |
| Idaho | | *\$1000 max loan amount *max # rollovers: 3 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| Illinois | *403% APR for 14-day \$100 loan | *max loan amount: the minimum of \$1000 or 25% gross monthly income *loan term: 13–45 days *max # rollovers: 0 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| Indiana | *390% APR for 14-day \$100 loan | * max loan amount: the minimum of \$550 or 20% gross monthly income *loan term: min 14 days *max # rollovers: 0 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| Iowa | *433% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: max 31 days *max # rollovers: 0 | |
| Kansas | *390% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: 7–30 days | |
| Kentucky | *459% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: 14–60 days *max # rollovers: 0 | |
| Louisiana | *780% APR for 14-day \$100 loan | *\$350 max loan amount *loan term: max 60 days *max # rollovers: 0 | |
| Maine | *Express ban | | |
| Maryland | *Express ban | | |
| Massachusetts | *Express ban | | |

| | | | |
|------------------|--|--|---|
| Michigan | *390% APR for 14-day \$100 loan | *\$600 max loan amount *loan term: max 31 days *max # rollovers: 0 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| Minnesota | *390% APR for 14-day \$100 loan | *\$350 max loan amount *loan term: max 30 days *max # rollovers: 0 | |
| Mississippi | *520% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: under \$250, max 30 days; \$250–500, 28–30 days *max # rollovers: 0 | |
| Missouri | *1950% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: 14–31 days *max # rollovers: 6 | |
| Montana | *36% APR for 14-day \$100 loan | *\$300 max loan amount *loan term: max 31 days | *state agency's contact information for customer's concerns and complaints |
| Nebraska | *459% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: max 34 days *max # rollovers: 0 | |
| Nevada | | * max loan amount: 25% gross monthly income *loan term: max 35 days | |
| New Hampshire | *36% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: 7–30 days *max # rollovers: 0 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| New Jersey | *Express ban | | |
| New Mexico | *416% APR for 14-day \$100 loan | *\$2500 max loan amount *loan term: 14–35 days *max # rollovers: 0 | |

| | | | |
|----------------|---------------------------------|--|---|
| New York | *Express ban | | |
| North Carolina | *Express ban | | |
| North Dakota | *520% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: max 60 days *max # rollovers: 1 | |
| Ohio | *28% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: min 31 days *max # rollovers: 0 | *state agency's contact information for customer's concerns and complaints |
| Oklahoma | *390% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: 12–45 days *max # rollovers: 0 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| Oregon | *156% APR for 31-day loan | *loan term: min 31 days *max # rollovers: 2 | |
| Pennsylvania | *Express ban | | |
| Rhode Island | *260% APR for 14-day \$100 loan | *\$500 max loan amount *loan term: min 13 days *max # rollovers: 1 | |
| South Carolina | *390% APR for 14-day \$100 loan | *\$550 max loan amount *loan term: max 31 days *max # rollovers: 0 | |
| South Dakota | | *\$500 max loan amount *max # rollovers: 4 | |
| Tennessee | *459% APR for 14-day \$100 loan | *\$425 max loan amount for \$500 check *loan term: max 31 days *max # rollovers: 0 | |

| | | | |
|---------------|---|---|---|
| Texas | *309.47% APR for 14- day \$100 loan | *loan term: 7–31 days *max # rollovers: 0 | *payday loans meant to address short-term needs *state agency's contact information for customer's concerns and complaints |
| Utah | | *loan term: less than 70 days | *state agency's contact information for customer's concerns and complaints |
| Vermont | *Express ban | | |
| Virginia | *687.76% APR for 14- day \$100 loan | *\$500 max loan amount *loan term: min 2 pay periods *max # rollovers: 0 | |
| Washington | *390% APR for 14-day \$100 loan | * max loan amount: the minimum of \$700 or 30% gross monthly income *loan term: max 45 days *max # rollovers: 0 | |
| West Virginia | *Express ban | | |
| Wisconsin | | * max loan amount: the minimum of \$1500 or 35% gross monthly income *loan term: max 90 days *max # rollovers: 1 | |
| Wyoming | *780% APR for 14-day \$100 loan | *loan term: 1 month *max # rollovers: 0 | |

Table 3. Consumer Litigation Funding State Policies as of Year 2016¹²⁶

| State | Caps on Interest Rate/Fees | Restrictions on Loan Characteristics | Disclosure Regulations |
|----------|---|--|---|
| Arkansas | *17% per year | | *Minimum font size *APR disclosure |
| Colorado | *Depends on amount charged; highest potential cap is 36% per year | | *Truth in Lending Act requirements |
| Indiana | *36% per year | | *Minimum font size *Itemization of one-time fees *Schedule of repayments |
| Maine | | *Shall not assess fees exceeding 42 months after contract date | *Minimum font size *Itemization of one-time fees *Schedule of repayments *APR disclosure |
| Nebraska | | *Shall not assess fees exceeding 36 months after contract date | *Minimum font size *Itemization of one-time fees *Schedule of repayments *APR disclosure |
| Ohio | | | *Minimum font size *Itemization of one-time fees *Schedule of repayments *APR disclosure |
| Oklahoma | | | *Minimum font size *Itemization of one-time fees *Schedule of repayments |

126. This table includes information from state statutes and state supreme court cases.

| | | | |
|-----------|------------------------------|---|--|
| Tennessee | *Effectively 46% per year | *Shall not assess fees exceeding 36 months after contract date | *Minimum font size *APR disclosure |
| Vermont | | | *Minimum font size *Itemization of one- time fees *Schedule of repayments *APR disclosure |