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How third-party funders change the chemistry of settlements

HOW THE ADDITION OF A THIRD-PARTY LITIGATION FUNDER AFFECTS BOTH PARTIES' DECISION-MAKING AT MEDIATION

A plaintiff, plaintiff's attorney, a defendant, defendant's attorney and a mediator walk into a mediation room. There is uncertainty, anxiety, stress and anticipation. Decisions must be made under conditions of uncertainty. What will happen at trial? Will we do better settling in mediation or at trial? What shapes our decision-making under conditions of uncertainty? And how are our decisions impacted by the elephant that is not in the room, the plaintiff's third-party funder?

Decision-making in mediation

Economists teach us to use rational-choice theory to maximize utility, based upon dollars and probabilities. The rational economic person will evaluate a case by calculating their likely damages weighted by likelihood of success. Psychologists remind us that people are not always rational economic beings, and our decisions are influenced by a range of psychological drivers that influence people's behavior.

Behavioral psychology uses a decision theory called "prospect theory" when explaining people's decision-making. Developed by cognitive psychologists Daniel Kahneman and Amos Tversky, prospect theory is an empirical theory that describes how people actually make decisions. Kahneman and Tversky formally introduced their theory in an article in 1979, and it has been the topic of scholarly comment since then. Prospect theory assumes that people try to maximize outcomes, but recognizes that people are influenced by psychological biases, optimism, fears and other emotions, and do not decide based strictly on economics and logic.

Prospect theory identifies the following types of behavior when people make risky or uncertain decisions:

- They evaluate decision options relative to some reference point, generally the status quo (if my net worth is $20,000, I evaluate an option to gain $10,000 differently than if my net worth is $200,000.);
- When choosing between options that appear to be gains relative to that reference point, people tend to make risk-averse choices; when choosing between options that appear to be losses, people tend to make risk-seeking choices (people will generally choose a definite $1,000 prize over a 50 percent chance at receiving a $2,000 prize but will opt for a 50 percent chance at having to pay a $2,000 fine or nothing over having to pay a definite $1,000 fine);
- Individuals' risk preferences tend to reverse when they are faced with low-probability gains and losses. For example, when choosing between a definite $50 and a 5 percent chance at winning a $1,000 prize, individuals tend to make the risk-seeking choice and opt for the gamble. And when choosing between paying a definite $50 fine and facing a 5 percent chance at having to pay a $1,000 fine, individuals tend to make the risk-averse choice and opt to make the sure payment.
- Individuals tend to value losses more heavily than gains of the same magnitude. The unhappiness one experiences in losing a sum of money appears to be greater than the pleasure associated with gaining the same amount, and in fact, that losses generally loom at least twice as large as equivalent gains.
- Individuals tend to overvalue certainty. For example, most individuals prefer a definite award of $1,000 over a 50 percent chance at winning $3,000.

One can test these predictions on oneself by, for example, considering some examples. Which would you choose?

- Get $900 for sure or a 90 percent chance to get $1,000?
- Lose $900 for sure or a 90 percent chance to lose $1,000?
- Toss a coin, and if heads, you win $100; if tails, you lose $100; or a definite $40?
- Toss a coin, and if heads, you win $150; if tails, you lose $100. Would you take this gamble?
- Would a person with a net worth of $5 million evaluate these options any differently than a person with a net worth of $20,000?

The crowded mediation room

At the most basic level, the mediation room contains two sides: a plaintiff and a defendant. Examined more closely, there are five players: a plaintiff, a plaintiff's attorney, a defendant, a defendant's attorney and a mediator. Each individual has different risk tolerances, and starts from his or her own and different reference point.

In mediation, the attorneys and the mediator recognize that the clients generally make risk-averse choices when selecting between options framed as gains and risk-seeking choices when selecting between options framed as losses. If a party views a settlement as a gain, he is more likely to accept it; if he views it as a loss, he is more likely to opt for trial. Thus mediators (and the attorneys if they are interested in bringing about a settlement) emphasize the benefits of receiving a fixed amount of money now, without the risk, delay and stress of continuing to litigate through a long trial. For whatever reason, people are wired to be willing to take risks to avoid losses but are unwilling to take risks to accumulate gains. When faced with a definite loss versus a risk of an even greater loss, we prefer to roll the dice (in the hope of being lucky) and avoiding the loss.

The third-party funder

Add in a third-party funder, and the mediation room becomes much more crowded in terms of different economic and psychological interests, even though, and maybe even because, the third-party funder is not in the room. Lawyers are skilled at analyzing their clients' prospects and risk sensitivity and guiding them through mediation. The focus of this article is how a third-party funder's involvement in the case alters that assessment.

This article takes as a given that prospect theory, or something like it, influences decision-making by litigants and their counsel when deciding whether to accept a settlement or proceed to trial. The question is, does the addition of a third-party funder affect any party's decision-making, and how? Does a third-party funder's involvement alter a party's evaluation of an option that is seen as a gain or as a loss; might it lead to a party not accepting an offer that is a fair or rational settlement? The author has only recently begun to evaluate these theories against the empirical evidence of what happens during mediations she conducts, and is continuing to explore this issue. This article summarizes the author's

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early observations and solicits comments and input from the reader.

Third-party litigation funding: What is it?

First, a brief summary of third-party funding, also referred to as third-party finance or alternative litigation funding. Traditionally, litigation has been funded by a variety of sources: plaintiffs themselves, plaintiffs' attorneys, defendants, defendants' attorneys and insurance companies.

In the past decade, third-party litigation funding has gained public attention, most notably from the news articles surrounding the Hulk Hogan/Gawker litigation, financed by Silicon Valley venture capitalist Peter Thiel. Scholarly articles have been written about efforts to regulate third-party funding, ethical issues for lawyers handling cases funded by third parties and judicial responses to third-party litigation funding.

There are many variations in third-party litigation funding. The industry includes funders that fund individual plaintiffs in consumer litigation and those that fund plaintiffs in larger commercial litigation, as well as entities that provide funding to plaintiffs' law firms for an entire book of business. The contractual arrangements for litigation funding transactions also vary considerably. Some third-party funding companies provide funding of a client's litigation costs in exchange for an agreed share of any recovered proceeds. Some funding agreements may require the client to pay monthly fees to the funder. Some contracts may provide that the money may only be used for litigation expenses, others permit the money to also be used for personal matters such as to void foreclosure, eviction or bankruptcy, as well as for medical procedures.

The industry refers to the transactions as investments, advances, financing or funding, and not as loans, to avoid issues regulating loans, especially consumer loans. If the claim is successful, either in litigation or settlement, the funder receives a portion or percentage of the recovery. If the case proceeds to trial and the litigant loses, the third-party funding company receives nothing, the litigant does not have to repay the money, and the funder loses the money they have invested in the case.

Third-party funding and mediation: ALF and ADR

So what does all this alternative litigation financing have to do with mediation and settlement? (Or what does ALF have to do with ADR?) Answer: the interests in the mediation room just became more complicated.

Objectively, the fact that a plaintiff has been financed by a third-party funder should not change his evaluation of his case, or his judgment as to whether to accept a settlement, assuming an economically rational plaintiff. In other words, if I have a 50 percent chance of prevailing on a claim, I can value my claim and why should it matter whether I am being financed by my credit card, my bank account, or a third-party funder? I want to maximize my recovery, my counsel wants the same, but also has an interest in receiving attorney fees for his work; the defendant wants to eliminate risk at minimum cost, defense counsel wants to protect her client while also keeping an eye on attorney fees; and the mediator wants a settlement.

The author's observations to date disclose that the involvement of a third-party funder has at least the following impacts upon the mediation room:

- The impact of the third-party funder's "endorsement" on the client's already overly optimistic evaluation of his case may cause the client to raise his or her settlement value;
- The "framing" impact of the funder's terms upon the client's reference point may cause an otherwise reasonable settlement to be viewed as a loss rather than as a gain when the funder's fees and compensation are considered;
- The fact that the third-party funder's reference point is different from the client's reference point may cause both the plaintiff and plaintiff's counsel to reconsider their own reference points;
- The presence of a third-party funder may level the playing field in terms of resources between a plaintiff and defendant, if disclosed, making it clear to the defendant that a war of attrition will not work because the plaintiff has more staying power, thus causing the defendant to raise its reference point for settlement.

The interaction of these influences leads to a shifting, or reframing, of the parties' reference points in a way that can inhibit or encourage settlement. If the mediator is brought into the discussion and informed of the funding arrangement, and if the funder is allowed to "hear" the mediator, the empirical evidence seems to support the proposition that the mediator can work with all the parties to better reach a settlement.

Framing around different reference points

Framing refers to the process we go through to determine whether something appears to be a gain or a loss. If I expect a $1,000 raise and I receive a $2,000 raise, I perceive it as a gain. If I expect a $3,000 raise and I receive a $2,000 raise, I perceive it as a loss. How I view a settlement depends upon whether I am primed to view it as a gain or a loss.

When parties choose between a certain settlement outcome and an uncertain trial outcome, they likewise evaluate the options as a gain or a loss relative to a reference point. A plaintiff and a defendant come to mediation with their own reference points: the terms at which they each hope the case will settle, their aspirational settlement, and the terms they will accept if they have to, their bottom line settlement. Somewhere among those numbers the mediator tries to find a settlement.

By way of background, Kahneman and Tversky provide the following example. A village of 600 people is affected by a deadly disease. Physicians were asked to choose between two treatments: Vaccine A was 100 percent effective, but there were only 200 doses of the vaccine. Vaccine A would save 200 lives. There were 600 doses of the B vaccine, but it was only one-third effective. Framed that way, 72 percent of physicians preferred the vaccine A treatment. A second group of physicians were told that vaccine A was predicted to result in 400 deaths, whereas vaccine B had a 33 percent chance that no one would die but a 66 percent chance that everyone would die. Framed in this way (400 people will die), only 22 percent of physicians preferred the vaccine A treatment.

Why did the two groups of physicians react so differently to the same set of facts? The answer is in the framing. When faced with the prospect of a definite gain (save 200 lives) the physicians opted for that.

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When framed in terms of a loss (400 people will die) the physicians preferred to roll the dice with the uncertain option.

In a mediation, a party's reference point for viewing a settlement as a gain or loss depends upon the party's current financial position, its past financial situation, its current view of the righteousness of its case, and its expectations about the case as it has developed. A third-party funder can influence a party's reference point in several ways, and these influences can cause a party to change his or her view of a settlement from a gain to a loss, or vice versa.

First, the third-party funder has probably impacted the party's case evaluation through an endorsement effect. The third-party funder endorsed my claim by investing in the case, so it must be valuable! My settlement reference point just increased.

Optimistic overconfidence is an impediment to mediation success. This is not difficult to understand. If the parties (and the parties' counsel) have similar evaluations about their likelihood of success, the maximum sum that the defendant is willing to pay in settlement and the minimum that the plaintiff is willing to accept to settle out of court will usually produce a bargaining range within which the case can be settled. This is true even when the parties are, as most humans are, overconfident in their prediction of future events.

However, if one or both parties substantially overestimate their likelihood of prevailing in the litigation, the bargaining range narrows or disappears as each party views litigation more desirable than settlement. A case will not settle if the plaintiff so greatly overestimates the expected value of trial, and/or the defendant so greatly underestimates the expected value of trial, that they eliminate any viable bargaining range.

Second, the third-party funder has its own sunk costs and expectations, and may convey those to the plaintiff or plaintiff's attorney. The third-party funder invested a certain amount with a specific expectation of receiving a good rate of return, and may try to persuade the plaintiff and plaintiff's attorney why the case is worth more than the amount they have as their original reference point. From the third-party funder's point of view, it has already sunk money into the case and a settlement offer that is less than it had anticipated recovering may cause it to prefer to gamble on the trial outcome.

Third, the third-party funder has a claim on the proceeds such that the plaintiff now evaluates a settlement offer as net of not only his attorney fees but also of the amount that the funder will take. If the plaintiff had potential damages of $1 million, and a 50 percent chance of prevailing, he valued the case at $500,000, then allowed for attorney fees and costs. Now the funder is entitled to a percentage of the recovery or a flat amount, whether the plaintiff goes to trial or settles. Is that amount in addition to any attorney fees? If the plaintiff has a number such as $500,000 in mind, minus costs, the funder's payment must be subtracted out and that may bring the amount to the plaintiff below the number he would otherwise have been willing to accept. Suppose the plaintiff decides he will settle for nothing less than $480,000 ($500,000 - $20,000 costs). However, the funder has made advances that now must be added in to the calculation, such that the amount that the plaintiff will accept now must equal his reference point ($480,000) plus the amount due to the funder. Assume the amount due to the funder is its advances in the amount of $100,000 plus a specified profit or percentage. (Is that amount more or less than a contingency fee would have been?) As such, the plaintiff views an offer of $480,000, or even $500,000 as a loss, given his original reference point and the impact of the amount owed to the third-party funder.

Fourth, the funder is generally an entity with a larger net worth than the plaintiff, and thus likely to view settlement offers from a different perspective. A plaintiff that has a net worth of $100,000 views a $500,000 settlement differently than a third-party funder with a net worth of tens of millions of dollars.

On the other hand, the presence of a third-party funder may level the playing field as regards the parties' relative resources, and cause the opposing party defendant to raise its reference point for a settlement. The question is whether any increase in the defendant's reference point will be sufficient to create a bargaining range in light of the plaintiff's increased reference point.

Two mediation examples

In conducting research for this article I asked colleagues to provide examples of mediations they had conducted in which they knew or suspected that there was a third-party funder involved, without names or other identifying information so as to preserve confidentiality. I've selected two that illustrate several issues in which psychological biases that parties possess and that are obstacles to settlement appear to have been exacerbated in one case and lessened in another, by the actions of a third-party funder.

(1.) A wrongful death/product liability case

Plaintiffs were the wife and children of a 35-year-old construction worker who was killed when a wall fell on him on a construction site. He was employed by the construction company and his family initially was told they would receive only a Workers' Compensation recovery. For that reason, the widow initially had no luck in finding a lawyer to take the case. The widow thought there was something more there. She had heard her husband's co-worker complain that the wall supports were defective. Through a friend, the widow was connected to a plaintiff's firm that had a relationship with a litigation funding company. With the support of the third-party litigation funder, the widow and her attorney were able to afford to investigate and determine that there were viable claims against parties other than the contractor/employer, and brought suit against the manufacturer of the defective component and other sued defendants.

The defendants and their attorneys showed up for mediation, and their bench strength outnumbered plaintiff's. However, she authorized her attorney to disclose to the mediator that they had a third-party funder who had committed enough funding to take the case through all the discovery and motion practice that the defendants could throw at them.

The mediator used that information to move the defendants' settlement reference point to a considerably higher number than they had previously offered, and the matter resolved at a number that provided a fair economic compensation to the widow and her children, as much as economic compensation can be said to compensate for the loss of a husband and father.

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(2) An employment discrimination/ whistleblower case

This was a case in which the plaintiff, an engineer, had been terminated from employment after complaining that the products the company was manufacturing did not meet mandated safety standards and posed a serious health hazard to consumers. The company sold products to the government through government contracts, in addition to selling to the general public. The plaintiff, a female, also alleged that after she learned that she had been paid fifteen percent less than her male counterparts, she complained and was retaliated against.

Plaintiff brought a qui tam action, and a claim for wrongful termination. The government declined to join the qui tam action.

Potential damages, measured by the amounts of the government contracts, exceeded $100 million, and were subject to trebling. However, the plaintiff had only one other witness in addition to herself to support her qui tam case, her expert whose qualifications and credibility had been so badly shredded in deposition that there was a strong likelihood that the judge would exclude the expert. The defendant had a long list of witnesses, including government witnesses, testifying that the products were safe and in compliance with the mandated standards.

In sum, this was a case with high potential damages, but also a high risk of failure.

The defense recognized the financial risk it was facing, and made significant settlement offers, moving from $5 million to $15 million. (The defendant was also willing to allocate most of the settlement to the employment claims, as it was in both parties' interest to avoid making a significant payment to the government.) This settlement would have taken care of the plaintiff quite comfortably for the rest of her life, even after accounting for covering attorney fees and costs.

Plaintiff's initial demands were in the very high eight figures, starting at $90 million and gradually dropping to $70 million. Upon receiving substantial offers from the defendant, plaintiff and plaintiff's counsel at first seemed receptive. Then plaintiff's counsel stated: "I have to check with my people." Following a lengthy break, plaintiff's counsel's next statement was that unless the defendant put at least $30 million on the table as a beginning point, plaintiff would not negotiate further. What had happened? To whom did the plaintiff's counsel talk? At first the mediator assumed that there was another law firm partnering with plaintiff's counsel who had an interest in any settlement proceeds. The mediator explored this hypothesis with the parties in an effort to see what was feasible.

Plaintiff's counsel eventually disclosed to the mediator:

1) Plaintiff had signed a litigation funding agreement with a third-party funder.

2) The litigation funder was quite enthusiastic about the case, and had personally told plaintiff that a jury would love the case and they anticipated a nine-figure verdict if the case went to trial.

3) The litigation funding agreement was structured such that the funder would receive a larger percentage of any recovery (settlement or verdict) below $30 million than of a settlement or verdict greater than or equal to $30 million. (Counsel did not share the specific recovery percentages.) The higher percentage payout below a $30 million recovery made the plaintiff feel as if she would "lose"– lose face, lose value – and thus rather than viewing a settlement of $15, $20 or $25 million as a gain, she viewed $30 million as a "must have" amount.

4) Plaintiff's reference point, and plaintiff's counsel's reference point, thus moved to $30 million, and any offer less than that amount was viewed as a loss. Plaintiff's mindset became that the defendant had to offer at least $30 million or else she was willing to roll the dice, rather than accept what she viewed as a "loss." Accordingly, the parties went to trial.

After a week of trial, the jury rendered a defense verdict.

Conclusion

Third-party funders bring additional economic and psychological interests and influences to the mediation room. Because they are not present, the mediator may be unaware of their existence and may not be assessing their impact upon what appears to be a rational bargaining range. The mediator is also not in a position to discuss settlement with an absent third-party funder, and thus while the parties in the mediation room may reevaluate their case during the mediation session, the third-party funder's evaluation may remain unchanged.

As the above examples illustrate, informing the mediator of the third-party funder early in the process, and, if possible involving the third-party funder in understanding the progression of the mediation, may be determinative of whether a reasonable settlement can be reached. Third-party funders play valuable roles in providing plaintiffs access to justice that they might otherwise not be able to afford, but they bring their own interests with them and their presence can alter the chemistry in the mediation room by impacting the parties' settlement reference points. A skilled mediator can understand the impact of a third-party funder and can factor that impact into the settlement negotiations – if the mediator is fully informed.

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