

LAWYER LENDING: COSTS AND CONSEQUENCES

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The “lawyer lending” industry—comprised of lenders who extend capital to plaintiffs’ lawyers to finance personal injury litigation—has blossomed. This industry has taken off, at least in part, because attorneys are permitted to deduct interest on these loans from client recoveries as an additional “expense” of litigation. The cost of the burgeoning lawyer lending industry is thus, in large measure, borne by clients. This Article asks whether personal injury attorneys who choose to take out loans to cover case costs and litigation expenses ought to be allowed to offload associated interest charges. The Article shows this question is important in its own right—with profound implications for the quantity and intensity of tort litigation. And the question is also an ideal point of entrée to identify, and begin to remedy, broader deficiencies in three strands of current legal analysis. Examining the propriety of interest pass-throughs first highlights the importance of litigation costs—and the interconnectivity of costs and contingency fees—a topic that has suffered from too little investment in research. Second, by separately considering just lawyer lending (rather than all third-party funding mechanisms simultaneously) and by studying a mechanism’s on-the-ground operation (rather than just its bird’s-eye view impact), the Article attempts to lead by example to reorient future alternative litigation finance (ALF) scholarship. Third, the Article underscores the need to push past bare formalism, and it sketches an alternative theoretical framework that can be employed when confronting certain ethical issues going forward.

INTRODUCTION

Representing some 9,400 individuals injured in the wake of the 9/11 attacks and saddled with millions of dollars in litigation expenses, law-

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yers from Worby Groner Edelman and Napoli Bern LLP took out a \$35 million loan from lender Counsel Financial.¹ The lawyers took out the loan because, Paul Napoli later explained, “[f]inancing . . . is part of what you have to do.”² Years went by, and the sprawling litigation ultimately came to a successful conclusion. After its resolution, Judge Alvin Hellerstein of the Southern District of New York was confronted with the question of whether the firms could pass a \$6.128 million charge, which represented just a portion of the accrued interest on that \$35 million loan, along to their clients.³ Defending the charge, Napoli Bern’s ethics expert pointed to a long and unbroken line of authority permitting these pass-throughs. He further assured Judge Hellerstein that “[c]ustomary billing practices include charging clients interest on funds borrowed to finance the cost of specific litigation.”⁴ Still, Judge Hellerstein wasn’t convinced. Making national news, he broke ranks with other courts and commentators and ultimately disallowed the proposed deduction.⁵ In so doing, Judge Hellerstein could not cite a single Model Rule, *Restatement* section, ethics opinion, or court precedent in his favor. Instead he reasoned: “Beyond legality and beyond ethics, there’s also a sense of balance and what’s appropriate, particularly in this field, particularly in relationship to clients who sign . . . retainer agreements without thinking too much about what they mean.”⁶

1. The case did not seek damages for those injured or killed on 9/11 itself, as those individuals were mostly compensated through the congressionally created 9/11 Victim Compensation Fund. It instead sought damages for the many who were hurt (mostly by dust-borne toxins) while engaged in an intense rescue, recovery, and debris-removal effort in and around Ground Zero in the days and months following the attack. For more on this litigation, see generally Alvin K. Hellerstein et al., *Managerial Judging: The 9/11 Responders’ Tort Litigation*, 98 CORNELL L. REV. 127 (2012). For more on the loan itself, see Plaintiffs’ Memorandum Responding to the Court’s Sua Sponte Order of August 4, 2010 at 2, 8, *In re World Trade Ctr. Disaster Site Litig.*, No. 21 MC 100 (AKH) (S.D.N.Y. Aug. 24, 2010) [hereinafter WTC Pls.’ Memo].

2. Transcript of Oral Argument at 7, *In re World Trade Ctr. Disaster Site Litig.*, Nos. 21 MC 100 (AKH), 21 MC 102 (AKH), 21 MC 103 (AKH) (S.D.N.Y. Aug. 27, 2010) [hereinafter WTC Hearing Transcript].

3. In fact, \$11 million in interest accrued on the \$35 million loan, but some of the \$11 million went not to reimbursable expenses of litigation but, rather, to office overhead. See WTC Pls.’ Memo, *supra* note 1, at 5–6.

4. Affidavit of W. Bradley Wendel, in WTC Pls.’ Memo, *supra* note 1, ¶ 11 [hereinafter Wendel Aff.].

5. See Mireya Navarro, *Judge Rejects \$6.1 Million in 9/11 Legal Fees*, N.Y. TIMES, Aug. 28, 2010, at A17.

6. WTC Hearing Transcript, *supra* note 2, at 21; see also *id.* at 44–45 (outlining the court’s rationale). Following the hearing, the lawyers withdrew their claim for reimbursement. Letter from Denise A. Rubin, General Counsel, Worby Groner Edelman & Napoli Bern LLP, to Alvin K. Hellerstein, Dist. Judge, U.S. Dist. Court for the S.D.N.Y. (Sept. 22, 2010), available at <http://www.nysd.uscourts.gov/cases/show.php?db=911&id=582>.

This Article asks: Was Judge Hellerstein right to forbid those deductions? Or, abstracting slightly: Should personal injury (PI) lawyers who choose to take out loans from third-party “lawyer lenders” to cover case costs and litigation expenditures be permitted to pass associated financing charges along to their clients?⁷

This seemingly narrow or technical question is of profound practical importance. For starters, whether to allow—or disallow—interest pass-throughs will have a significant effect on the cost of tort litigation. Studies suggest that plaintiffs’ out-of-pocket expenditures (excluding legal fees) average on the order of 3%–5% of plaintiffs’ gross compensation.⁸ In a tort system that delivers to plaintiffs roughly \$172 billion in gross compensation each year,⁹ a conservative (though admittedly back-of-the-envelope) estimate is that plaintiffs’ litigation

7. Three notes on terminology are warranted. First, in order to simplify the analysis, the piece assumes a rough equivalency between social welfare and client welfare. Others may attempt to disaggregate more carefully social and client welfare effects in the lawyer lending context. Second, going forward, I will sometimes refer to financing charges as “interest.” I use this term for simplicity and ease of exposition, not because I intend to suggest that lenders’ financing charges are governed by state usury laws. Third, I will use the terms “costs” and “expenses” interchangeably. Technically, “costs” refer to only those charges that one party has incurred and is permitted to have reimbursed by the opposing party via, for example, Federal Rule of Civil Procedure 54(d), while expenses “include all the expenditures actually made by a litigant in connection with the action.” 10 CHARLES ALAN WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* § 2666 (2d ed. 1998).

8. See JAMES S. KAKALIK & NICHOLAS M. PACE, *COSTS AND COMPENSATION PAID IN TORT LITIGATION* 39, 111 tbl.A.40 (1986) (suggesting that expenses equal roughly 3% of clients’ gross compensation); see also JAMES S. KAKALIK ET AL., *VARIATION IN ASBESTOS LITIGATION COMPENSATION AND EXPENSES* 82–84 (1984) (finding that costs averaged approximately 5% of gross compensation on settled or dismissed asbestos claims and 6% of gross compensation on tried claims); David A. Hyman et al., *The Economics of Plaintiff-Side Personal Injury Practice* 17 (Univ. of Ill., Law, Behavior, and Social Sciences Research Paper No. LBSS13-28, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1441487 (reporting that litigation expenses equaled a mean of roughly 5% of the plaintiffs’ recovery at three studied PI firms); Telephone Interview with Michael Swanson, President & CEO, Advocate Capital (Apr. 24, 2013) [hereinafter Swanson Interview I] (“Our experience is that 10% of plaintiffs’ gross compensation goes to costs and expenses. If the plaintiff recovers \$100,000, our experience is that costs and expenses will be on the order of \$10,000.”).

9. I derive the \$172 billion figure by taking \$264.6 billion (estimated to be the total “cost” of the tort system in 2010) and subtracting the portions allotted to defense costs and insurance company administration, as neither would be transferred to plaintiffs as gross compensation. For the breakdown, see Tillinghast-Towers Perrin, *U.S. Tort Costs: 2003 Update, Trends and Findings on the Costs of the U.S. Tort System* 17 (2003), https://www.towersperrin.com/tillinghast/publications/reports/2003_Tort_Costs_Update/Tort_Costs_Trends_2003_Update.pdf. For the \$264.6 billion figure, see Towers Watson, *U.S. Tort Cost Trends, 2011 Update* 3 (2011), <http://www.towerswatson.com/en/Insights/IC-Types/Survey-Research-Results/2012/01/2011-Update-on-US-Tort-Cost-Trends>. To be sure, the estimate is rough, and the underlying data is susceptible to criticism. For more on the underlying data, see KENNETH S. ABRAHAM, *THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11*, at 241 n.3 (2008).

expenditures equal \$5 billion.¹⁰ Increasing that sum, even marginally, would be nontrivial. And notably, increases that could occur, were lawyer loans with interest deductions to become widespread, might not be “marginal.” To the contrary, interest on these loans often tops 15% per year, while rates of even 100% are not unprecedented.¹¹ This means that, if lawyers borrow funds and then deduct interest on those funds, they stand to significantly increase the litigation costs their clients incur. It also means that to permit the deduction of interest is possibly to authorize a multi-billion-dollar annual reduction in tort plaintiffs’ recoveries.

Further, allowing—or disallowing—interest deductions will affect not only the cost of tort litigation in the United States, but also its quantity. Most notably, the treatment of interest on the costs of litigation will affect PI lawyers’ profits: If financing charges are offloaded to clients, whereas previously lawyers themselves bore the burden of financing, litigation will, for PI lawyers, become more lucrative.¹² If tort litigation becomes more lucrative, we will likely see more of it, for better or worse.¹³

Finally, the permissibility of pass-throughs will affect the structure of plaintiff-side practice. Over the past half-century, plaintiffs’ lawyers have increasingly joined together in order to finance big-ticket litigation. They have also developed sophisticated referral networks to channel complex cases to other more experienced, better financed practitioners. Yet, by enabling more lawyers to finance big lawsuits individually (in an essentially costless way, assuming interest can be passed to clients), lawyer lending might disrupt referral networks and deter the creation of interfirm partnerships. In this new world, we might expect more lawyers to cling to complex cases, instead of refer-

10. I derive the \$5 billion figure by multiplying \$172 billion (the estimated gross transfer to tort plaintiffs) by 3% (which equals \$5.16 billion). By contrast, Bill Tilley of lender Amicus Capital estimates that “there is approximately \$12.375 [b]illion in case costs advanced to clients at any point in time.” Bill Tilley, Amicus Capital Servs., Overview of Developments and Issues in Loans and Lines of Credit for Law Firms 4 (2010), available at <http://amicuscapital.files.wordpress.com/2010/05/rand-2010-conference-amicuscapitalservices.pdf> [hereinafter Tilley Presentation].

11. See *infra* notes 68, 78–80 and accompanying text.

12. This is true, of course, only if contingency fee percentages don’t drop. For reasons explained below at Part IV.B.3, it is unlikely that the utilization of lawyer loans will exert downward pressure on contingency fee percentages.

13. Litigation’s intensity may also be affected. If financing charges for litigation costs are offloaded to clients, whereas previously lawyers bore the burden of financing, lawyers might be tempted to spend more preparing their cases for trial. For more on how lawyer lending may alter the cost, quantity, and intensity of tort litigation, see generally Nora Freeman Engstrom, *Re-Re-Financing Civil Litigation: How Lawyer Lending Might Remake the American Litigation Landscape, Again*, 61 UCLA L. REV. DISC. 110 (2013).

ring these cases to their more experienced and better financed counterparts. And we might expect more lawyers to go it alone, instead of forging co-counsel relationships with fellow practitioners, carrying consequences for both access to justice and the evolution of substantive law.¹⁴

Stepping back, the question of interest deductions does not just matter in its own right. It is also an ideal point of entrée through which to identify, and begin to rectify, broader deficiencies in three strands of current legal scholarship at the intersection of litigation finance and legal ethics. First, the deduction-of-interest inquiry belatedly brings litigation costs to the fore. Over the past half-century, barrels of ink have been spilled analyzing and debating nearly every aspect of contingency fee financing.¹⁵ Yet, notwithstanding all the attention paid to the contingency fee and all the controversy the contingency fee has engendered, the out-of-pocket *costs* of litigation—the other, inextricably interconnected, side of the case-expense coin—have been surprisingly neglected.¹⁶ Given costs’ practical significance—in determining which cases are brought, which cases succeed, and the vigor with which cases are litigated—this neglect is both surprising and troubling. By offering the most detailed description to date of how personal injury litigation is (and was historically) financed, this Article highlights, and begins to bridge, this gap in contemporary legal scholarship.

Second, in separately considering *just* lawyer lending (rather than other third-party funding mechanisms), this Article makes a dent in remedying what I view as a deficiency in most current alternative litigation finance (ALF) analysis. To be sure, in recent years, ALF has not suffered from a lack of interest or inquiry. It has been the subject of a flurry of newspaper stories, ethics opinions, academic articles, symposia, white papers, and commentaries. In the course of all this discussion, many aspects of ALF have been explored. Some, for ex-

14. See *id.* at 123–24.

15. See ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 94-389 (1994) (discussing the “intense public policy debate” surrounding the contingency fee and nodding to the debate’s “inflammatory and divisive” character).

16. For the interconnectivity between fees and costs, see Part IV.B.3. See also W. William Hodes, *Cheating Clients with the Percentage-of-the-Gross Contingent Fee Scam*, 30 HOEFLER L. REV. 767, 773 (2002) (recognizing that “from the client’s point of view, there is no clear divide between ‘fees’ that will go into the lawyer’s bank account and ‘expenses’ that go into the bank accounts of various third parties”). As noted in the text, very few have seriously analyzed the out-of-pocket costs of litigation from the plaintiffs’ perspective. Two exceptions are Vincent Robert Johnson, *Ethical Limitations on Creative Financing of Mass Tort Class Actions*, 54 BROOK. L. REV. 539 (1988), and Morris A. Ratner & William B. Rubenstein, *Profit for Costs*, 63 DEPAUL L. REV. 587 (2014).

ample, have debated ALF's utility, considering whether ALF expands access to justice and levels the playing field or, alternatively, corrupts the adversarial process and facilitates frivolous claims.¹⁷ Others have considered ALF's legality, grappling with how ALF arrangements might violate, or be made to conform to, existing laws governing litigation and lending.¹⁸ Still others have analyzed issues of ethics, assessing whether funding arrangements will tempt lawyers to preference lenders' interests above the interests of clients and puzzling over how arrangements ought to be structured in order to avoid inadvertently waiving the attorney-client privilege, breaching lawyers' duty of confidentiality, or running afoul of Model Rule 5.4's prohibition on the splitting of fees.¹⁹

Yet most commentary to date suffers from a glaring limitation. Most, that is, considers all three types of financing said to fall under the ALF umbrella simultaneously.²⁰ This undifferentiated analysis is

17. For those making positive claims about ALF, see, for example, Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 *FORDHAM J. CORP. & FIN. L.* 55, 74–75 (2004) (arguing that ALF can level the playing field); Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 *GEO. L.J.* 65, 68 (2010) (contending that ALF can promote accuracy in adjudication). For those making negative claims, see, for example, JOHN BEISNER ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, *SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES* 5 (2009), available at <http://ilr.iwssites.com/uploads/sites/1/thirdparty litigation financing.pdf> (“[T]hird-party financing particularly increases the volume of questionable claims.”); Tiger Joyce, *Shining a Light on the Lawsuit Loan Industry*, METROPOLITAN CORP. COUNS., July 2011, at 5, available at <http://www.metrocorp counsel.com/pdf/2011/July/05.pdf> (contending that “ALF undermines the adversarial system” and “encourages unnecessary litigation”); Paul H. Rubin, *Third-Party Financing of Litigation*, 38 *N. KY. L. REV.* 673, 685 (2011) (contending that ALF will lead to the “creation of inefficient precedents”). See also, e.g., Stuart L. Pardau, *Alternative Litigation Financing: Perils and Opportunities*, 12 *U.C. DAVIS BUS. L.J.* 65, 79–82 (2011) (considering whether ALF (broadly defined) “promote[s] access to justice” or “encourage[s] frivolous lawsuits”).

18. In this vein, academics have considered whether ALF runs afoul of ancient restrictions on maintenance, champerty, and barratry, as well as statutory laws against usury. See, e.g., Martin, *supra* note 17, at 57–63; Douglas R. Richmond, *Litigation Funding: Investing, Lending, or Loan Sharking?*, *PROF. LAW., Symp. Issue*, 2005, at 17, 18–33; Jason Lyon, Comment, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 *UCLA L. REV.* 571, 579–90 (2010).

19. E.g., Grace M. Giesel, *Alternative Litigation Finance and the Work-Product Doctrine*, 47 *WAKE FOREST L. REV.* 1083, 1094–96 (2012); Richmond, *supra* note 18, at 33–40; Lyon, *supra* note 18, at 604–06.

20. Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 *MINN. L. REV.* 1268, 1302 (2011) (“The current discourse on litigation funding . . . debates the merits and demerits of litigation funding en masse, as if there is only one type of funding in question.”). I am not the first to call for targeted analysis. See, e.g., Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns* 9 (2010), available at http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf (“It is crucial to distinguish these segments, because activities in the different segments raise different ethical and economic issues, despite some prominent recent suggestions to the contrary.”). Further, in critiquing existing ALF scholarship, I do not intend to underestimate the strides that have been

problematic because, as this Article makes plain, ALF comprises three quite distinct kinds of financing: (1) consumer legal funding (nonrecourse loans to individual personal injury plaintiffs, typically for living expenses while awaiting case resolution); (2) investments in commercial lawsuits (business versus business), such as loans typically provided by Juridica Investments and Burford Capital; and (3) loans to plaintiffs' personal injury lawyers and law firms to finance case preparation (i.e., "lawyer lending").²¹ Though they may logically fall under the same umbrella, these three mechanisms are directed toward different entities, by (often) different lenders, in different dollar amounts, for different purposes, to fund (often) different kinds of cases. They are, at bottom, more different than alike. By honing in on one narrow question concerning the operation of just one particular segment of the ALF marketplace, this Article tries to show that it helps to *separately* analyze the three ALF mechanisms, and even when analyzing a single mechanism, *small details matter*. Before we can possibly tackle big normative questions, we need additional empirically grounded, granular accounts.²²

Finally, the Article attempts to expand legal ethicists' method of inquiry when confronted with litigation finance questions going forward. Whether interest on lawyer loans can be deducted from client recoveries as an additional "expense" of litigation is, as we will see, a question that is neither new nor particularly controversial. Indeed, it's a question that's been addressed by more than a dozen state ethics committees—and every single committee has given these interest deductions their blessing.²³ And, in so doing, these committees are in fine company, joined by the ABA Working Group on Alternative Litigation Finance,²⁴ the Louisiana Supreme Court,²⁵ the *Restatement*

made in certain areas. Indeed, there are some issues (from champerty restrictions to usury laws, and from privilege issues to fee-splitting prohibitions) that logically and legitimately cut across the ALF orbit.

21. See Garber, *supra* note 20, at 1 (providing these classifications).

22. See *id.* at 9 n.9 (observing that a number of prominent commentators have called "for banning or limiting ALF without distinguishing among types of ALF"); see also *supra* note 17 (collecting examples of those making sweeping and undifferentiated claims about ALF's utility).

23. See *infra* note 96 and accompanying text.

24. ABA COMM'N ON ETHICS 20/20, INFORMATIONAL REPORT TO THE HOUSE OF DELEGATES 37–38 (2012) [hereinafter ABA INFORMATIONAL REPORT], available at http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf.

25. *Chittenden v. State Farm Mut. Auto. Ins. Co.*, 788 So. 2d 1140 (La. 2001). The opinion was less than a resounding victory for plaintiffs' counsel, however, because the court reduced the interest deducted. *Id.* at 1151–53. The parties' contract had failed to specify an exact interest rate, and the court ruled that, in the absence of client consent to more generous terms, interest

(Third) of the Law Governing Lawyers,²⁶ and most academic commentators.²⁷

What unites these various accounts, beyond their concurrence that interest pass-throughs ought to be permissible, are two core deficiencies. The first is a tendency to engage in a purely formalist analysis. Thus, though many state ethics committees, the ABA White Paper, the Louisiana Supreme Court, the *Restatement*, and various academics have all given interest deductions their blessing, *none* have scratched the surface in terms of contemplating their impact. The second is a tendency to rely on client consent, the workhorse of contemporary legal ethics, for nearly the whole of client protection. I view both as serious shortcomings. In this area, where rules are vague and offer little guidance, where research from the fields of behavioral economics and cognitive psychology suggests clients are apt to offer consent without anything approaching adequate understanding, and where decisions will have significant and predictable social welfare effects, a more utilitarian consideration of those effects is warranted. This Article thus offers an alternative theoretical framework that pushes past mere formalism to take fuller account of the structural features and on-the-ground realities of modern tort litigation. Admittedly, a functionalist approach is messier—disagreements will be plenty and easy answers few. But weighing a decision's likely impact is critically important, for only by mapping how a given decision will affect client welfare can we even begin to fashion an adequate policy response.²⁸

The Article unfolds as follows. Part II sets the stage by tracing the evolution of plaintiff-side case funding from the 1950s to the present day. In so doing, I offer the most detailed description to date of both the development of plaintiff-side financing and the contemporary lawyer lending industry.²⁹ Having laid that factual foundation, Parts III

charges should not exceed the "conventional rate of interest" of 12% per year. *Id.* at 1143, 1150–51.

26. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 36 cmt. c (1998).

27. See, e.g., Wendel Aff., *supra* note 4, ¶ 6 (stating that interest deductions are "entirely appropriate"); Jennifer Anglim Kreder & Benjamin A. Bauer, *Litigation Finance Ethics: Paying Interest*, 2013 J. PROF. LAW. 1, 35 (declaring that "if done properly, [borrowing funds and passing the interest through to clients] can make the difference in leveling the playing field to achieve a fair and full legal victory"); Lazar Emanuel, *Recognizing Interest on Loans as a Litigation Expense*, N.Y. PROF. RESP. REP., Oct. 2010, at 10, 10, https://www.nypr.org/newsletter/pdfs/2010/NYPRR10_10.pdf (arguing that it is anomalous to "exclude a reasonable rate of interest on borrowings" when a litigation's sprawling nature necessitates some borrowing activity).

28. For a helpful discussion on the meaning of, and difference between, formalism and functionalism (sometimes called legalism and pragmatism, respectively), see RICHARD A. POSNER, *HOW JUDGES THINK* 40–43, 238–43 (2008).

29. To this point, the scholarly literature's depiction of the lawyer lending industry is incomplete and somewhat contradictory. Compare Elizabeth Chamblee Burch, *Financiers as Monitors*

and IV turn to the propriety of interest pass-throughs. Specifically, Part III canvasses the discussion so far, corralling the many state ethics opinions that have, without exception, given interest deductions their blessing, while Part IV begins the critical inquiry—asking whether these state ethics opinions are correct. It does so by analyzing interest deductions first from a formalist and then a functionalist perspective. Parsing relevant authority, Part IV.A concedes that, from a straight formalist perspective, pass-throughs pass muster, but I contend this should not be the end of the inquiry. Part IV.B thus looks beyond mere technical compliance to evaluate pass-throughs' propriety from a functionalist perspective and, in so doing, finds the question far more difficult. On the one hand, interest deductions raise a number of tricky ethical questions that defy easy resolution, and deductions also threaten to significantly increase the cost of legal services. On the other hand, deductions offer some important benefits: The deduction of interest may, in some instances, reduce principal-agent problems and may also encourage the litigation of certain meritorious but resource-intensive claims. Given this mixed picture, Part V puzzles over how interest deductions ought to be regulated to harness their advantages while reducing the likelihood of abuse. To do that, Part V arrays five possible policy alternatives on a continuum from least to most restrictive, develops a vocabulary to describe these options, weighs each option's costs and benefits, and offers a proposal for how the interest-deduction inquiry might be equitably resolved.

in Aggregate Litigation, 87 N.Y.U. L. REV. 1273, 1302–03 (2012) (“When financiers lend money to law firms . . . plaintiffs’ firms must repay the money regardless of whether they win or lose a particular case.”), and Sheri P. Adler, Note, *Alternative Litigation Finance and the Usury Challenge: A Multi-Factor Approach*, 34 CARDOZO L. REV. 329, 332 (2012) (“[S]ome ALF companies provide funding directly to plaintiffs’ law firms; these advances, however, are typically made on a recourse basis.”), with Pardau, *supra* note 17, at 78–79 (declaring that “ALF providers structure . . . loans to lawyers as ‘non-recourse,’ secured only by any recovery that may be obtained in the case”), and Douglas R. Richmond, *Other People’s Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649, 650 (2005) (“All such loans or advances, whether to plaintiffs or attorneys, are nonrecourse.”). It should also be emphasized that this Article marks only a first step toward understanding the lawyer lending industry. Thus, though we now know that the industry offers both recourse and nonrecourse loans, and even the relative size of these market segments (the former is much larger and more robust than the latter), many other questions remain. Some include: Which lawyers are utilizing these loans? How carefully are lenders evaluating cases and counsel before investing in litigation? As lenders evaluate cases, is confidential information revealed? And, are lenders really (as they insist) resisting the impulse to influence lawyer decision making?

II. BACKGROUND

A. *Four Phases of Financing*

As the Napoli Bern and Worby Groner Edelman lawyers who shepherded the World Trade Center Disaster Site litigation to a successful conclusion well learned, big cases cost big bucks. Money is needed to pay for routine things like court filing fees, medical exams, photocopying, travel, postage, investigators, stenographers, and videographers. And, as cases get bigger and more complex, expenses grow—and expense categories seem to multiply. The World Trade Center lawyers, for example, had to shoulder more than \$27 million in case disbursements, which went to everything from filing fees, to the compensation of an array of medical, economic, and scientific experts, to payments to consultants and lobbyists, to Special Masters' bills, to payments for the creation and maintenance of the court's database system.³⁰

Nor was that sum unprecedented. Over nine years spent working to obtain compensation for plaintiffs in the polybutylene pipe litigation, Texas lawyer George Fleming racked up out-of-pocket expenses of over \$22 million.³¹ Simply sending a single standard letter to each of his clients set his firm back low five-figures.³² The lead lawyers who represented the victims of the 1986 New Year's Eve fire at the San Juan Dupont Plaza Hotel advanced litigation expenses of nearly \$10 million.³³ Dallas attorney Kip Petroff spent upwards of \$25 million while representing those alleging injuries caused by the diet drug fenphen.³⁴ Famed plaintiffs' attorney Mark Lanier reportedly spent

30. See WTC Pls.' Memo, *supra* note 1, at 2, 8, 10; see also Worby Groner Edelman & Napoli Bern LLP, *Statement to Our Clients About Litigation Interest Charges*, <http://www.877wtchero.com/wtcverdict/STATEMENT-TO-OUR-CLIENTS-ABOUT-LITIGATION-INTEREST-CHARGES.pdf> (last visited Feb. 4, 2014) [hereinafter Napoli Bern, *Statement to Our Clients*].

31. Indeed, Fleming reportedly faced financial ruin, and "representatives of at least one defendant had specifically threatened to bankrupt him if he persisted with the litigation." Task Force on Contingent Fees, Am. Bar Ass'n Tort Trial & Ins. Practice Section, *Contingent Fees in Mass Tort Litigation*, 42 TORT TRIAL & INS. PRAC. L.J. 105, 117 (2006) [hereinafter ABA Task Force, *CFs in Mass Torts*]. Fleming racked up these eye-popping expenses while conducting 8,000 depositions, preparing nearly 50,000 sets of answers to interrogatories, staffing a phone answering center with ten receptionists able to field calls in three languages, and establishing an IT system rivaling the system utilized by Southwest Airlines. *Id.* at 112–13, 116–17; Minutes of ABA Task Force on Contingent Fees, May 5, 2006, Austin, Texas, *reprinted in* 42 TORT TRIAL & INS. PRAC. L.J. 105 app. at 149–52 (2006) (statement of George Fleming) [hereinafter Fleming Statement]; *In re Polybutylene Plumbing Litig.*, 23 S.W.3d 428, 433 (Tex. App. 2000).

32. See Fleming Statement, *supra* note 31, at 150.

33. *In re San Juan Dupont Plaza Hotel Fire Litig.*, 111 F.3d 220, 222 (1st Cir. 1997).

34. Telephone Interview with Kip Petroff, Founder & Senior Partner, Petroff & Assocs. (Jan. 30, 2013) [hereinafter Petroff Interview].

more than \$4 million on just his first two Vioxx trials.³⁵ And Vioxx's Common Benefit Counsel spent a whopping \$34.4 million while litigating the difficult case.³⁶

Further, though these mass torts are concededly outliers, even the ordinary tort case's cost is substantial—and, it appears, climbing.³⁷ According to the Federal Judicial Center, pursuing an action in federal court costs plaintiffs a median of \$15,000, including attorneys' fees.³⁸ Cases involving scientific evidence, such as suits alleging product defects or medical malpractice, cost more, frequently resulting in out-of-pocket expenditures in the low six figures.³⁹

35. SNIGDHA PRAKASH, *ALL THE JUSTICE MONEY CAN BUY: CORPORATE GREED ON TRIAL* 33 (2011).

36. See Affidavit of Herbert M. Kritzer ¶ 65, in *The Vioxx Litigation Consortium's Supplemental Submission with Affidavits to its Motion for Reconsideration of Capping Order*, *In re Vioxx Prods. Liab. Litig.*, No. 2:05-MD-01657-EEF-DEK (E.D. La. Mar. 31, 2009) [hereinafter Kritzer Aff.]; see also Plaintiffs' Liaison Counsel's Memorandum in Support of Motion for Award of Plaintiffs' Common Benefit Counsel Fees and Reimbursement of Expenses at 69, *In re Vioxx Prods. Liab. Litig.*, No. MDL 1657 (E.D. La. Jan. 20, 2009).

37. See Stephen Daniels & Joanne Martin, *It Was the Best of Times, It Was the Worst of Times: The Precarious Nature of Plaintiffs' Practice in Texas*, 80 TEX. L. REV. 1781, 1808 (2002) (reporting on a survey of plaintiffs' lawyers in Texas, which found that, of the lowest echelon lawyers, 82.3% believed that the cost of a typical case had increased from 1995 through 2000; of the highest echelon lawyers, a full 92.2% shared the belief); Swanson Interview I, *supra* note 8 ("The costs of litigation have gone way up in recent years."); see also, e.g., Bernard Black et al., *Defense Costs and Insurer Reserves in Medical Malpractice and Other Personal Injury Cases: Evidence from Texas, 1988–2004*, 10 AM. L. & ECON. REV. 185, 187, 204 fig.1 (2008) (showing that medical malpractice defense costs are on the rise); Aaron E. Carroll et al., *The Impact of Defense Expenses in Medical Malpractice Claims*, 40 J.L. MED. & ETHICS 135, 137, 139 fig.3 (2012) (same).

38. Unfortunately, as far as I can tell, no recent study has considered case expenditures, without also considering legal fees. See Mary Nell Trautner, *Personal Responsibility v. Corporate Liability: How Personal Injury Lawyers Screen Cases in an Era of Tort Reform*, in 12 SOCIOLOGY OF CRIME, LAW & DEVIANCE: ACCESS TO JUSTICE 203, 207 (Rebecca L. Sandefur ed., 2009) ("There are no systematic, verifiable data on the use of or expenses associated with civil cases . . ."). For the best recent study combining both fees and costs, see EMERY G. LEE III & THOMAS E. WILLGING, FED. JUDICIAL CTR., NATIONAL, CASE-BASED CIVIL RULES SURVEY: PRELIMINARY REPORT TO THE JUDICIAL CONFERENCE ADVISORY COMMITTEE ON CIVIL RULES 35–36 (2009), available at [http://www.fjc.gov/public/pdf.nsf/lookup/dissurv1.pdf/\\$file/dissurv1.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/dissurv1.pdf/$file/dissurv1.pdf).

39. See Stephen Daniels & Joanne Martin, "The Juice Simply Isn't Worth the Squeeze in Those Cases Anymore:" *Damage Caps, 'Hidden Victims,' and the Declining Interest in Medical Malpractice Cases* 28 (Am. Bar Found., Research Paper Series No. 09-01, 2009), available at <http://ssrn.com/abstract=1357092> ("The expenses to appropriately prepare a medical malpractice case can approach \$100,000 or more if the case is especially complex."); Joanna Shepherd, *Uncovering the Silent Victims of the American Medical Liability System*, 67 VAND. L. REV. (forthcoming 2014) (manuscript at 33–34) (reporting on a survey of plaintiffs' attorneys wherein attorneys indicated that the average cost of taking a medical malpractice claim to trial was \$97,000); Trautner, *supra* note 38, at 207 ("Lawyers in my interviews reported that they routinely spent \$50,000–\$100,000 on expert witnesses in products liability and medical malpractice cases . . ."); see also, e.g., STUART M. SPEISER, *LAWSUIT* 560 (1980) ("Today, with the rapidly escalating costs of tort litigation, it is not unusual for plaintiff's lawyers to lay out six-figure sums for processing a single case."); Andrew L. Payne, *Building, Structuring & Financing Tomorrow's Products Liability*

Tort victims rarely have enough cash on hand to begin to cover these amounts, so personal injury attorneys have long fronted these litigation expenses on behalf of their clients.⁴⁰ Clients then repay the debt with the proceeds of their recovery; if the case is lost, the lawyer typically absorbs the out-of-pocket investment.⁴¹ Even attorneys can be cash strapped, however—and from the lawyer's perspective these advances are subject to unfavorable tax treatment, as they are categorized not as business expenses, deductible in the year the money is advanced, but rather as loans, deductible by the lawyer if and only if the advance is not repaid.⁴² So, over the years, PI lawyers have developed different (and increasingly aggressive) modes of financing. Below, though the periodization is fairly crude, I attempt to break methods of PI financing into four overlapping phases.

1. Phase 1: Going It Alone

Traditionally, in what can be called the first phase of attorney financing, PI lawyers individually bore the cost of case preparation.

Practice 3 (Apr. 28, 2005) (unpublished paper presented at the Arkansas Trial Lawyers Association 2005 Annual Convention), available at <http://www.paynemitchell.com/objectfiles/PMLG.Web.Data.Publication/22/Building%20Successful%20Liability%20Practice.pdf> (“In my experience, an average [product liability] case with fair complexity and no need for testing and research, costs between \$100,000 and \$200,000.”).

40. Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1, 17 tbl.7 (1996) (showing that, out of a sample of personal injury plaintiffs involved in trials in 1990–1991, litigation costs were advanced by attorneys 91% of the time, borne by clients 5% of the time, and shared 4% of the time); see also Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 270 (1998) (“Very often, lawyers . . . defer the collection of expenses until the close of a case.”).

41. Even in the absence of a recovery, the initial Canons, and then the Model Code, obligated the client to repay the debt to the lawyer, in full. CANONS OF PROF'L ETHICS Canon 42 (1928); MODEL CODE OF PROF'L RESPONSIBILITY DR 5-103(B) (1980). Relaxing that restriction, Model Rule 1.8(e) permits a lawyer to relieve the client of his obligation to repay if no recovery is obtained. MODEL RULES OF PROF'L CONDUCT R. 1.8(e) (2013). The Model Code's repayment provision was apparently scrapped after lawyers and bar associations came to terms with the futility and inhumanity of seeking reimbursements from injured, defeated, and typically impecunious clients—and it also came to be known that the requirement was frequently disobeyed. See, e.g., F.B. MACKINNON, *CONTINGENT FEES FOR LEGAL SERVICES: A STUDY OF PROFESSIONAL ECONOMICS AND RESPONSIBILITIES* 69 (1964) (“Most standard fee contracts call for the lawyer to advance [court] costs for his client subject to reimbursement whatever the outcome of the claim. As a practical matter, the lawyer typically does not press for this reimbursement if no recovery is obtained.”). Still, though, a minority of states continue to require even losing clients to remain “ultimately liable for such expenses.” WASH. RULES OF PROF'L CONDUCT R. 1.8(e)(1) (2012); accord, e.g., VA. RULES OF PROF'L CONDUCT R. 1.8(e)(1) (2010).

42. This tax treatment increases costs from the lawyer's perspective. For more on the IRS's treatment of litigation expenses, see generally Joseph W. Blackburn & Kelly Thrasher, *Deduction of Litigation Expenses: Trial Lawyers v. I.R.S.*, 28 N. KY. L. REV. 1 (2001); Edward A. Morse, *Taxing Plaintiffs: A Look at Tax Accounting for Attorney's Fees and Litigation Costs*, 107 DICK. L. REV. 405, 493–95 (2003).

Back in 1980, then, noted plaintiffs' lawyer Stuart Speiser bemoaned the fact that, though case costs could be enormous, tort lawyers had to "finance everything themselves."⁴³ Likewise, Dallas lawyer Kip Petroff recalls: "When I went out on my own in 1993, I sought funding from several bankers. I even went to bankers I knew who knew I was successful. No bank would hear of it."⁴⁴ Denied outside financing, plaintiffs' lawyers would accept a diverse portfolio of cases and use last month's settlements and trial victories to fund this month's office overhead and case costs—while sometimes relying on personal or law firm credit cards to bridge inevitable shortfalls.⁴⁵ Yet, this method of financing was far from ideal; lawyers might hit a dry patch where cases wouldn't settle, experience a string of bad luck where the other side unexpectedly prevailed, or take on a case that met stiffer resistance and required more expensive inputs than they had reasonably anticipated.⁴⁶

2. *Phase 2: Reliance on Fellow PI Lawyers and/or Loans from Traditional Banks*

Given the instability and inherent risk of individual attorney financing, in time a second phase of financing developed. In this second phase, PI lawyers relied on fellow attorneys and/or borrowed from traditional lending institutions.⁴⁷

In regards to reliance on fellow PI lawyers, over the past thirty years, a number of PI lawyers engaged in high-profile litigation efforts have sought and accepted funds from other, better financed law firms, which invested in the litigation in exchange for a cut of the ultimate contingent fee.⁴⁸

The Agent Orange litigation of the 1980s offers a case in point. A massive undertaking, the litigation involved 600 separate actions on behalf of some 2.4 million Vietnam veterans and their offspring seeking damages from two dozen defendants.⁴⁹ Not surprisingly, such an undertaking was not cheap, and the lawyers prosecuting the case ulti-

43. SPEISER, *supra* note 39, at 560–61.

44. Petroff Interview, *supra* note 34.

45. Engstrom, *supra* note 13, at 113–14. For more on the portfolio approach to case management, see HERBERT M. KRITZER, RISKS, REPUTATIONS, AND REWARDS: CONTINGENCY FEE LEGAL PRACTICE IN THE UNITED STATES 10–16 (2004). For more on lawyers' utilization of credit cards, see MICHAEL J. SWANSON, HOW DAVID BEATS GOLIATH: ACCESS TO CAPITAL FOR CONTINGENT-FEE LAW FIRMS 85–88 (2011).

46. Engstrom, *supra* note 13, at 114.

47. *Id.*

48. *Id.*

49. Ultimately the two dozen defendants were pared down to seven. *Id.* at 114 n.11.

mately ran short on funds. Indeed, after investing significant sums, members of the Plaintiffs' Management Committee (PMC) became so depleted that they "lacked the financial capacity to continue the litigation."⁵⁰ After certain members of the PMC resigned, a newly constituted PMC reached an agreement on financing. The agreement provided that six of the nine PMC members would advance money for general litigation expenses (\$200,000 apiece), and for each dollar advanced, these "investor-attorneys" would be repaid threefold.⁵¹ Thus, if the plaintiff class ultimately prevailed, the investor-attorneys would garner a treble return on their cash investment. Although the arrangement was subsequently amended, then invalidated, the takeaway for our present purposes is that, in the 1980s, when certain mass tort attorneys ran short on cash, they sought assistance from their better financed counterparts.⁵²

Another example comes from the water contamination litigation against Pacific Gas & Electric Co., immortalized by the 2000 blockbuster *Erin Brockovich*. In the real case, before securing a \$333 million settlement for residents of Hinkley, California, small-time plaintiffs' lawyer Edward Masry ran short of funds. As litigation expenses skyrocketed, Masry initially took out a second mortgage on his home. Then, when that wasn't sufficient, he sold property near Palm Springs, where he and his wife planned to retire. When that still wasn't sufficient, Masry brought in two more experienced and better financed Los Angeles plaintiffs' lawyers, Walter Lack and Thomas Girardi. Lack and Girardi ultimately contributed roughly \$12 million in funding in exchange for a portion of Masry's fee.⁵³ "My law firm had literally run out of money," Masry later recalled. "I had 30 to 60 days of operating capital left when Lack and Girardi stepped into the fight."⁵⁴

50. W. John Moore, *Fee-Splitting Agreement Draws Attention of Agent Orange Judge*, LEGAL TIMES, Nov. 5, 1984, at 1 (quoting attorney Phillip B. Allen).

51. *Id.*

52. For further information on the funding arrangement, see *In re "Agent Orange" Prod. Liab. Litig.*, 611 F. Supp. 1452 (E.D.N.Y. 1985), *rev'd*, 818 F.2d 216 (2d Cir. 1987); Johnson, *supra* note 16, at 545-53.

53. See Jonathan D. Epstein, *An Unusual Financial Niche: Lending Money to Lawyers*, BUFFALO NEWS, Sept. 30, 2007, at C1; Douglas Martin, *Edward L. Masry, 73, Pugnacious Lawyer*, N.Y. TIMES, Dec. 8, 2005, at B11; *Profiles of the 50 Best-Compensated Lawyers in L.A.*, L.A. BUS. J., Jan. 6, 2009; Ben Winograd, *Specialized Lenders Help Fill Financing Void for Law Firms*, AM. BANKER, Nov. 2, 2006, at 3. Girardi's contribution was facilitated by a \$6-plus million loan by Comerica Bank. *Rumblings*, CRAIN'S DETROIT BUS., May 8, 2000, at 54.

54. Robert W. Welkos, *Digging for the Truth*, L.A. TIMES, Mar. 12, 2000, at 8. Masry elaborated: "The PG&E case would have been lost without the law firms of Tom and Walter coming on board, because PG&E exhausted me. I'd been in it for approximately two years. I couldn't go no more." Shelly Garcia, *Beyond Erin Brockovich*, L.A. BUS. J., Sept. 18, 2000, at 49.

Yet another prominent example comes from the litigation against American Home Products (now Wyeth) involving the diet drug fen-phen. In the midst of representing thousands of claimants, attorney Kip Petroff became financially depleted while waiting for funds from already-settled cases to start rolling in.⁵⁵ In order to overcome the shortfall, he partnered up with veteran plaintiffs' attorney and "mass torts guru" Vance Andrus.⁵⁶ Becoming Petroff's "advisor and strategist," Andrus contributed roughly \$2 million to help fund the litigation in exchange for a 7.5% share of Petroff's portion of the recovery.⁵⁷

Nor has interfirm coordination been confined to marquee cases. Even in routine litigation, a practice has developed whereby, when PI law firms become overextended, they forge co-counsel relationships with better financed and more experienced PI lawyers, together shepherding difficult cases to trial. Indeed, in 2003 it was reported: "The most common way for plaintiff trial lawyers to obtain outside funding is by 'joint venturing,' that is, by sharing cases—and fees—with other law firms."⁵⁸

At the same time, starting perhaps thirty years ago, some old-style banks that had long been reluctant to engage in this kind of investment started to extend limited financing to plaintiff-side firms.⁵⁹ Most commonly, these traditional banks opened up lines of credit upon which attorneys could draw. So, for example, in 1989, legendary PI lawyer Philip Corboy reported that his firm had access to a \$1 million bank line of credit that could be repaid every ten to eleven months.⁶⁰ Or, readers of *A Civil Action* will recall that, in the 1980s, "Uncle Pete" (George Kennedy Briggs II) of the Bank of Boston's Private Banking Group extended \$1 million in financing to Jan Schlichtmann

55. Engstrom, *supra* note 13, at 115.

56. *Id.*

57. *Id.*; see also KIP PETROFF WITH SUZI ZIMMERMAN PETROFF, *BATTLING GOLIATH: INSIDE A \$22 BILLION LEGAL SCANDAL* 105 (2011); Petroff Interview, *supra* note 34. The "third-wave" tobacco litigation involves another prominent example. For more on plaintiff lawyers' coordination while battling cigarette manufacturers, see Engstrom, *supra* note 13, at 114–15.

58. Tom Vesper & Ben A. Goff, *Manage Costs Strategically to Escape Case Cost Crunch: Outpouring of Cash Can Become a Serious Handicap—for a Litigation and for the Firm as a Whole*, N.J. L.J., Sept. 15, 2003, at 27; see also RICK FRIEDMAN, *ON BECOMING A TRIAL LAWYER* 185 (2008) ("More and more often, sole practitioners and small law firms band together to handle cases. This trend is borne of necessity, as cases become more complex and expensive.").

59. Engstrom, *supra* note 13, at 115–16. Estimating these loans' prevalence is difficult. Compare Richmond, *supra* note 29, at 651 (stating that, as of 2004, while "some" banks were lending to plaintiffs' law firms, "many" were unwilling to do so), with Marc Galanter, *Anyone Can Fall Down a Manhole: The Contingency Fee and its Discontents*, 47 DEPAUL L. REV. 457, 476 (1998) (stating that, as of 1998, "plaintiffs' firms are typically dependent" on "bank credit").

60. Andrew Blum, *Big Bucks, But . . . Five Prominent 'PI' Lawyers Talk About Money*, NAT'L L.J., Apr. 3, 1989, at 1, 46.

and his law partners as they represented families in Woburn, Massachusetts battling W.R. Grace & Co. and Beatrice Foods.⁶¹

Crucially, this bank financing was secured not by the PI lawyer's case inventory, but rather by his personal assets. As one bank president who extended loans to PI lawyers explained in 2002: "We're not looking at the contingency fee as a primary source of repayment. We're looking at their real estate."⁶² Following that template, then, the \$1 million from Uncle Pete to fund the Woburn litigation was secured not by a lien on the case's possible proceeds, but rather by (among other things) the deeds to two partners' houses.⁶³ This collateral requirement had two critical consequences. First, it constrained a lawyer's ability to borrow, as a lawyer's ability to borrow maxed out at the value of her personal assets. Second, it upped the ante in terms of risk; with a bank loan, losing lawyers had their personal property on the chopping block.

3. Phase 3: Specialized Recourse Lenders

In the late 1990s, a third phase of lawyer lending dawned: Free-standing lawyer lenders (a few examples include Counsel Financial, Advocate Capital, and Amicus Capital Services) opened their doors.⁶⁴ These third-phase lenders are more streamlined, specialized, and equipped—for the first time—to allocate interest on loans to expenditures to particular cases. By so doing, they facilitate the transfer of a loan's cost from the lawyer (who traditionally bore the burden of financing) to the client. "It's that tracking case-by-case," Advocate

61. JONATHAN HARR, A CIVIL ACTION 212, 215, 275, 277, 348 (1995).

62. Katie Kuehner-Hebert, *A Few Banks Betting on Lawyers' Winning Ways*, AM. BANKER, Jan. 3, 2002, at 6A (quoting Richard E. Herrington, President of Franklin Financial Corp.) (internal quotation marks omitted); see also SPEISER, *supra* note 39, at 568 (stating, as of 1980, that "[n]o bank will lend money to a tort lawyer beyond the personal assets that the lawyer can put up as security"); Epstein, *supra* note 53 ("Banks don't consider legal cases to be assets and won't lend based on the value of 'contingent fees' So the only way to get a bank loan is for the partners to borrow money personally or use their credit cards."); Winograd, *supra* note 53, at 3 ("No matter how large the potential verdict, banks generally will not make loans beyond the existing assets of a firm or its attorneys.").

63. HARR, *supra* note 61, at 212, 215, 275, 277, 348. Even with these loans, expenditures mounted to the point where the financial position of Schlichtmann's team became "precarious in the extreme." *Id.* at 405.

64. Engstrom, *supra* note 13, at 116. This third phase appears to date back to 1996, when (now defunct) Themis Capital Services of Dallas created the first legal finance company to work exclusively with plaintiffs' law firms. See Tilley Presentation, *supra* note 10, at 3. LawFinance Group began operation even earlier (in 1994), though in the early days, LawFinance's loans were all nonrecourse loans, tied to jury verdicts under appeal. See Alison Frankel, *Helping Underfunded Plaintiffs Lawyers—at a Price*, AM. LAW., Feb. 13, 2006, available at <http://www.law.com/jsp/article.jsp?id=1139565913200>. For a list of additional third-phase funders in operation as of early 2010, see Garber, *supra* note 20, at 14 tbl.2.

Capital's CEO explains, "that converts borrowing costs into case expenses that can then be reimbursed to the law firm."⁶⁵

Beyond the ability to track interest, loans offered by these third-phase lenders have four main characteristics. First, the loans are *re-course* (i.e., noncontingent), so the obligation to repay is untethered to case success.⁶⁶ Second, these loans are broadly secured, sometimes by all of the law firm's assets, including future fees and real property, and sometimes (like second-phase loans from traditional banks) by the lawyer's personal assets.⁶⁷ Third, interest—on the order of 15%–20% per year—is higher than traditional bank loans but lower than the nonrecourse loans described below.⁶⁸ And fourth, these lenders appear to offer significantly larger sums than banks would previously provide. For example, Amicus Capital Services reports that it can make available "four to five times the amount of money that a tradi-

65. Interview by Dan Goldstein with Michael J. Swanson, President & CEO, Advocate Capital, in Denver, Colo. (pt.1) (May 3, 2012), *available at* <http://www.page1solutions.com/page-1-blog/interview-mike-swanson-ceo-advocate-capital.html>; *see also* *Legal Lending Program*, AMICUS CAPITAL SERVICES, LLC, <http://www.amicuscapitalservices.com/overview-lending-program/> (last visited Feb. 4, 2014) [hereinafter AMICUS, *Legal Lending*] ("At the time of resolution, Amicus will provide an accounting of the advances made to the firm and the amount of interest paid on that specific case. Traditional banks do not provide this service . . ."). It is not clear that *all* third-phase lenders have the ability to track interest accurately on a case-by-case basis. *See* Swanson Interview I, *supra* note 8 (suggesting that many of Advocate Capital's competitors advertise that law firms can pass through interest though they do not actually "have the technology to track expenses, and interest on expenses, for every client").

66. This does not mean that payments are totally dissociated from case outcomes. *See, e.g.*, Alexa Hyland, *Firms Make Case for Legal Loans*, L.A. BUS. J., Apr. 21, 2008, at 1, 59 ("At Amicus Capital, lawyers pay the monthly interest charge and make principal payments on their loan. The principal payments are a negotiated percentage of the total money borrowed, and are tied to when a lawyer receives income from a case.").

67. Tilley Presentation, *supra* note 10, at 8 (explaining that the "vast majority of lenders require blanket liens on the firm's entire docket of cases and assets"); *see also, e.g.*, Epstein, *supra* note 53 ("Counsel Financial makes loans based on the estimated value of a firm's total portfolio of cases Partners in the client law firm also must provide personal guarantees and get term life insurance for 100 percent of the loan amount."); Hyland, *supra* note 66, at 59 ("Amicus Capital lets lawyers borrow money without using their personal assets as collateral.").

68. *See* Binyamin Appelbaum & Ben Hallman, *Betting on Justice: Borrowing to Sue*, CTR. FOR PUB. INTEGRITY (Nov. 15, 2010), <http://www.publicintegrity.org/2010/11/15/2320/betting-justice-borrowing-sue> (quoting Counsel Financial's president, Paul R. Cody, as stating that it would not "be competitive" with interest rates charged by traditional banks); *see also, e.g.*, Winograd, *supra* note 53, at 3 (quoting Counsel Financial's CEO, Michael Callahan, as stating that "the standard lending rate is 18%"); Telephone Interview with Michael Swanson, President & CEO, Advocate Capital (Apr. 30, 2013) [hereinafter Swanson Interview II] ("The overall effective annual rate for Advocate Capital's Case Expense Product is between 13.5% and 15%."); AMICUS, *Legal Lending*, *supra* note 65 ("Interest accrues on each case at a competitive rate of interest that has varied between 17% and 20% per annum since the inception of the program."). Presumably because firm partners offered personal assets as collateral, the interest on the loans in the World Trade Center Disaster Site Litigation were lower—ranging from 6%–18%. *See* Napoli Bern, *Statement to Our Clients*, *supra* note 30.

tional bank will offer,” with typical loans on the order of \$2 million to \$3 million.⁶⁹ Likewise, Counsel Financial explains that its “average line of credit is \$1.5 million, but can be as little as \$50,000 and as much as \$25 million.”⁷⁰

4. Phase 4: Specialized Nonrecourse Lenders

Completing the evolution, the fourth phase of lawyer lending has emerged. This latest breed of lender (Augusta Capital⁷¹ and Excalibur Funding Programs⁷² are two apparent examples) extends *nonrecourse* loans to plaintiffs’ lawyers or law firms to fund *particular* cases. For these lenders, loans are case specific (*x* loan will fund *y* case), and repayment is contingent on case success (if *y* case is not successful, *x* loan need not be repaid). In Augusta’s words: “The funding that Augusta Capital provides is entirely contingent If, as to a particular case, no recovery is obtained, then the lawyer is not obligated to repay any portion of the funding provided by Augusta Capital for that particular case or any fee to Augusta.”⁷³

So far, the growth of these fourth-phase lenders has been limited—as some have fled the market after booking significant losses, while others have shifted their focus to other, more profitable segments of the industry.⁷⁴ Furthermore, fourth-phase funding is not available everywhere, as some state ethics committees have found that loans

69. Press Release, Amicus Capital Services, LLC, Amicus Capital Services Continues to Help Trial Lawyers Fight for Justice with Law Firm Loans (Aug. 10, 2010), *available at* <http://www.prlog.org/10850815-amicus-capital-services-continues-to-help-trial-lawyers-fight-for-justice-with-law-firm-loans.html> (providing “four to five times” figure); Hyland, *supra* note 66, at 59 (providing \$2 million to \$3 million figure).

70. Epstein, *supra* note 53; *see also* Hyland, *supra* note 66 (quoting a practitioner stating that he could get “20 times more” money from Counsel Financial than he could obtain from a bank).

71. Letter from Lucian T. Pera & Brian S. Faughnan, Augusta Capital LLC, to ABA Comm’n on Ethics 20/20 (Feb. 7, 2011) [hereinafter *Augusta Letter*], in ABA COMM’N ON ETHICS 20/20, COMMENTS: ALTERNATIVE LITIGATION FINANCING WORKING GROUP ISSUES PAPER 19, 19 (2011), *available at* http://www.americanbar.org/content/dam/aba/migrated/2011_build/ethics_2020/comments_on_alternative_litigation_financing_issues_paper.authcheckdam.pdf (stating that Augusta Capital LLC is “a business engaged in providing litigation funding on a contingently-repayable basis directly to lawyers”).

72. *Attorney Funding*, EXCALIBUR FUNDING PROGRAMS, <http://www.excaliburlegal.com/AttorneyPricing.html> (last visited Feb. 4, 2014) [hereinafter *EXCALIBUR, Funding*] (“Funding is non-recourse . . .”).

73. *Augusta Letter*, *supra* note 71, at 20.

74. *See* Swanson Interview I, *supra* note 8 (“There are very few people doing nonrecourse lending anymore. A few have tried it, but there were some folks who took big, big losses. . . . The folks who came into the industry didn’t stay in the industry long.”); Telephone Interview with Harvey R. Hirschfeld, President and Director, LawCash (May 16, 2013) [hereinafter *Hirschfeld Interview*] (stating that LawCash “no longer provide[s] nonrecourse funding for lawyers” and, more broadly, observing that participants in the nonrecourse lawyer lending market “are few and far between”).

secured by a specific client's settlement or judgment violate Model Rule 5.4(a)'s prohibition on the splitting of fees.⁷⁵ But, where available and permitted, fourth-phase funding has three notable characteristics. First, like recourse loans above, these arrangements tend to provide a larger pool of funds compared to what traditional banks would provide.⁷⁶ Second, because of their nonrecourse nature, they shift from lawyers to lenders substantial case risk; they allow, in one commentator's words, the attorney to "'take some chips off of the table' earlier in the case."⁷⁷ The third, and related, characteristic is cost. Because these lenders bear the risk of nonrecovery, charges on nonrecourse loans can be substantial, far exceeding the cost of recourse loans from third-phase lenders. Nonrecourse lender Augusta Capital, for example, reports: "Typically, in a case involving complex litigation that resolves successfully three years after Augusta began providing funding, Augusta's fee equals approximately \$1 for every \$1 of funding to be repaid"⁷⁸ Likewise, LawCash, which for a time engaged in this type of lending, reported that it charged a "monthly usage fee[] of about 2 to 3.25 percent per month for pre-settlement lawsuit financing."⁷⁹ And, on its website, Excalibur helpfully provides

75. See, e.g., Me. Prof'l Ethics Comm'n of the Bd. of Overseers of the Bar, Op. No. 193 (2007) (concluding that a PI lawyer may not secure funding for individual cases on a nonrecourse basis because "[i]rrespective of how the finance company may characterize its agreement, the nature and structure of such an arrangement involves the sharing of legal fees with a non-lawyer"); Nev. Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. No. 36, at 1 (2007) ("Repayment of the loan may not be contingent on the success of the litigation for which the loan is obtained."); Utah State Bar Ethics Advisory Op. Comm., Op. No. 02-01, ¶ 5 (2002) ("An attorney's grant of a security interest in a contingent fee from a particular case to secure a loan constitutes the sharing of fees with a non-lawyer in violation of Utah Rules of Professional Conduct 5.4(a).") (quoting Utah State Bar Ethics Advisory Op. Comm., Op. No. 97-11 (1997)); cf. Mo. Bar, Informal Op. 20030022 (2003) (suggesting that a lawyer may not take out a nonrecourse loan to fund litigation because "[a]n attorney cannot engage in conduct that would amount to champerty or maintenance"); Prof'l Ethics Comm. for the State Bar of Tex., Op. 576 (2006) (rejecting a proposed agreement where the loan's repayment would be not only contingent on some recovery but also "tied directly to the *amount* of the recovery in the underlying litigation" (emphasis added)). Other state and local ethics committees have expressly permitted such financing arrangements. See, e.g., N.C. State Bar, Formal Ethics Op. 12 (2006); Phila. Bar Ass'n, Prof'l Guidance Comm. Op. 2003-15 (2003); Bd. of Prof'l Responsibility of the Sup. Ct. of Tenn., Advisory Op. 2001-A-744 (2001). For an argument that these agreements do not violate Model Rule 5.4(a), see Richmond, *supra* note 29, at 676-77.

76. SWANSON, *supra* note 45, at 64 ("[T]here can be a relatively large potential line of credit compared to what a traditional lender would provide.").

77. *Id.*

78. Augusta Letter, *supra* note 71, at 20; see also Augusta Capital, LLC v. Reich & Binstock, LLP, No. 3:09-CV-0103, 2009 WL 2065555, at *1 (M.D. Tenn. July 10, 2009) ("In a successful case, R & B agreed to pay back not only the funded litigation expenses, but also a stipulated funding fee which ranged from 75% to 125% of the funded amount.").

79. *Frequently Asked Attorney Lawsuit Financing Questions*, LAW CASH, <http://www.lawcash.net/html/attorney-faqs.html> (last visited Feb. 10, 2014). As of February 10, 2014, LawCash ad-

the following table of how “attorney funding pricing may be calculated on a \$100,000 attorney cash advance.”

TABLE 1: EXCALIBUR FUNDING PROGRAMS, REPORTED CHARGES FOR \$100,000 IN FUNDS⁸⁰

Term	Multiplier	Investment Recovery
0 to 6 months	1.4	\$140,000
7 to 12 months	1.6	\$160,000
12 to 18 months	2.4	\$240,000
12 to 28 months	2.6	\$260,000

B. The Current Situation

The above discussion traces the four phases of plaintiff-lawyer financing, though, to be sure, the evolution has been neither linear nor complete. Still today, most PI lawyers continue to go it alone.⁸¹ Many lawyers continue to join forces and pool resources.⁸² And some lawyers continue to rely on lines of credit from traditional banks.⁸³ The crucial point is that *alongside* these more traditional options, a new option—third- and fourth-phase financing—is now available, and it is being utilized.⁸⁴

vertised that it “provides non-recourse case cost funding and litigation cost funding for attorneys, at no cost to attorneys. If you do not win or settle the case, no repayment is due to LawCash.” *Id.* Curiously, however, when asked about this funding, LawCash’s President, Harvey Hirschfeld, clarified that “we don’t provide nonrecourse funding” and, in fact, stated that LawCash stopped providing nonrecourse attorney funding in 2003 or 2004. Hirschfeld Interview, *supra* note 74.

80. EXCALIBUR, *Funding*, *supra* note 72.

81. SWANSON, *supra* note 45, at 89 (“Covering case expenses and general overhead with partners’ cash is by far the most common way contingent-fee lawyers finance their practices.”).

82. See Telephone Interview with Rick Friedman, Partner, Friedman Rubin (July 6, 2012) (noting that, in his experience still today, when a law firm is over-extended, the law firm will seek to co-counsel with another better financed or more experienced law firm).

83. SWANSON, *supra* note 45, at 101 (“Outside of partners’ cash, a bank line of credit is surely the second-most common method law firms use to fund case expenses.”).

84. Notably, too, there are subspecies and variants on the arrangements above. Two noteworthy ones are appeal funding and settlement funding. Appeal funding describes an arrangement whereby a funding company will purchase a portion of the firm’s expected fee while the case is under appeal. If the appeal is not won, the funder will not be repaid. For more on appeal funding, see *id.* at 67–69. Meanwhile, settlement funding—sometimes dubbed “fee acceleration”—describes an arrangement whereby a lender fronts proceeds from a settled case while the firm awaits actual payment. Most of these funding arrangements are short lived (with durations measured in weeks or months), and these loans are typically contingent, so the law firm will not have to repay the lender if, for some reason, proceeds are not forthcoming. *Id.* at 71–76. For more on a funder that specializes in this type of funding, see *Our Story*, LAW FINANCE GROUP, <http://www.lawfinance.com/story.html> (last visited Feb. 4, 2014).

Just how significant is this third- and fourth-phase lending activity? It is impossible to say with any precision because there is no central repository of data, and information only rarely comes to light. But based on the fragmentary information available, it appears that both recourse and (to a much lesser extent) nonrecourse lawyer lending, while not ubiquitous, is making a significant mark. Lenders operate nearly everywhere. Advocate Capital, for example, claims it funds law firms in roughly forty states,⁸⁵ while public records from just one state, New York, show that between 2000 and 2010, more than 250 law firms borrowed on pending cases, sometimes repeatedly.⁸⁶ Via lawyer lending, hundreds of millions of dollars have changed hands. Counsel Financial, for example, apparently had “more than \$200 million” in loans outstanding as of 2010,⁸⁷ while Amicus Capital Services reports on its website that its founders have “participated in” generating over \$200 million “in loans to law firms that focus on plaintiff’s litigation.”⁸⁸ Lawyer lending has helped to fund tens of thousands of cases, and the cases that are being funded are themselves consequential.⁸⁹ Indeed, these loans have helped to finance some of the most important tort cases initiated over the past two decades—from asbestos, to Vioxx, to fen-phen.⁹⁰ And, notwithstanding the market’s current size, some within the industry seem to believe that lawyer lending is still in its infancy, with remarkable potential for future growth.⁹¹

85. Interview by Dan Goldstein with Michael J. Swanson, CEO, Advocate Capital, in Denver, Colo. (pt. 2) (July 18, 2012), *available at* <http://www.advocatecapital.com/2012/07/18/dan-goldstein-interview-of-michael-j-swanson-part-two/> (stating “we have clients in about forty states now”).

86. Binyamin Appelbaum, *Putting Money on Lawsuits, Investors Share in the Payouts*, N.Y. TIMES, Nov. 15, 2010, at A1.

87. *Id.*

88. AMICUS, *Legal Lending*, *supra* note 65; *see also* Frankel, *supra* note 64 (“At least three companies claim they’ve invested more than \$100 million in litigation.”).

89. Getahn Ward, *Loans Help Lawyers Fund Cases*, TENNESSEAN, Mar. 8, 2001, at 1E (reporting that Themis had funded 60,000 cases); *see also* Swanson Interview I, *supra* note 8 (reporting that, as of April 2013, Advocate Capital had funded 149,272 cases).

90. *See* Winograd, *supra* note 53, at 3 (reporting that Counsel Financial helped fund asbestos litigation); *see also* Frankel, *supra* note 64 (observing that “asbestos, Fen-Phen and Vioxx have a hidden layer of investors”); Petroff Interview, *supra* note 34 (noting that fen-phen litigation was funded, in small part, with financing from Themis Capital).

91. *See* Tilley Presentation, *supra* note 10, at 12 (“Law Firm Lending has . . . amazing growth potential.”); *see also id.* (“There are currently 165,000 . . . plaintiff-focused law firms in the United States that create a-more-than \$12 Billion law firm finance market . . .”). *But see* Swanson Interview I, *supra* note 8 (suggesting that the industry is not growing but is, in fact, “stagnant”). Some have discussed *why* lawyer lending has grown. Explanations include the increased cost of tort litigation, *see generally supra* note 37, the fact that tort reform efforts have both increased litigation risk and depleted some lawyers’ cash reserves, the tightening of traditional credit markets in the wake of the “great recession,” investors’ increased taste for counter-cyclical investment opportunities and increased comfort with subprime investments, and international

III. DEDUCTING INTEREST CHARGES FROM CLIENT RECOVERIES: THE DISCUSSION SO FAR

As noted, lawyer lending is a big—and apparently burgeoning—field. An important factor driving this growth is that, unlike second-phase lenders (fellow plaintiffs’ lawyers and traditional banks), some lawyer lenders facilitate the passing of financing charges from lawyers onto lawyers’ clients. And, indeed, many lenders make the ability to pass—or “deduct”—interest a prime selling point. Advocate Capital, for example, repeatedly boasts on its website that it provides “Case Expense Financing at a Net Cost of Less Than 1%*.”⁹² The asterisk, of course, notes that 1% is what a law firm would *itself* pay after transferring “borrowing costs” along to firm clients.⁹³ Amicus Capital Services similarly advertises: “Financing under the Amicus program is INTEREST FREE to participating law firms when a case is won. As provided in many state ethics codes, interest expense incurred under the Amicus program is reimbursable to the firm as a cost of litigation.”⁹⁴ And, another lawyer lender, ViaLegal Funding, goes further still, declaring (somewhat dubiously) that it permits lawyers to “Transform Costs Into Money.”⁹⁵

This leads to an important question: whether these touted interest pass-throughs ought to be permissible. More precisely, if the lawyer incurs financing charges while advancing reasonable litigation “expenses,” are those financing charges also reasonable litigation “expenses” that can be subtracted from a client’s recovery?

In something of a stampede, every state ethics committee to address the issue has said yes. More than a dozen state ethics committees have weighed in, and they have all concluded that interest deductions are acceptable, often with the following safeguards: (1) the interest

developments, as third-party litigation finance has become big business in the United Kingdom and Australia.

92. ADVOCATE CAPITAL, INC., <http://www.advocatecapital.com> (last visited Feb. 4, 2014).

93. *Id.* Or, in a promotional video, Advocate Capital explains:

[O]ur service team uses our proprietary AdvoTrac software to track our law firm clients’ lines of credit on a case-by-case basis. It’s this case-by-case tracking that turns the borrowing costs into case expenses that can then be recouped from the cases themselves. So, the cost of borrowing for our law firm clients is zero for the cases they win. Of course, no law firm wins every case. That’s why, on average, there is some net borrowing costs to the law firm, but that is usually well under 1%!

AdvocateCapital, *Case Expense Financing Advocate Capital, Inc.*, YouTube (Nov. 15, 2011), <http://www.youtube.com/watch?v=n4htfDbvFoc>.

94. AMICUS CAPITAL SERVICES, LLC, <http://www.amicuscapital.com> (last visited Feb. 4, 2014).

95. VIALEGAL FUNDING, <http://vialegalfinance.com/> (last visited Feb. 4, 2014). Under this provocative header, ViaLegal Funding explains: “In most states, the financing charges incurred for case disbursements can be charged back to the client as a case expense.” *Id.*

deducted must itself be reasonable (some opinions use the term “non-usurious”); (2) the interest can only be charged on loans that themselves were utilized to fund legitimate case expenses (not office overhead or the like); (3) the client must provide informed consent; and (4) the statement given to the client upon the matter’s conclusion must reflect the interest charged on expenses advanced.⁹⁶

Moreover, some ethics committees seem to believe the question is quite easily answered. Exemplifying this approach, Ohio’s Board of Commissioners on Grievances and Discipline has declared: “Interest fees and costs of a loan obtained by a law firm are a client’s ‘expenses of litigation.’”⁹⁷ Though reaching the same result, other opinions are

96. See WTC Hearing Transcript, *supra* note 2, at 28 (statement of Professor W. Bradley Wendel: “[U]niformly nationwide, applying the same legal standard, the ethics opinions say that along with photocopying, and travel, and filing fees, and expert witnesses, and things like that, lawyers may borrow and pass along borrowing costs as an ordinary incidental expense of litigation.”); Kreder & Bauer, *supra* note 27, at 29 (describing the “virtually unanimous consensus among state legal ethics committees and courts”); *see also, e.g.*, Ala. State Bar Disciplinary Comm’n, Op. RO-88-88 (1988), *discussed in Opinions of the General Counsel*, 50 ALA. LAW. 344 (1989); State Bar of Ariz. Comm. on the Rules of Prof’l Conduct, Formal Op. 01-07 (2001) (providing, additionally, that “[t]o the extent the lawyer has a past or on-going business relationship with the lender, the lawyer . . . must be satisfied that his or her representation of the client will not be ‘materially limited’ by the lawyer’s responsibilities to the lender”); Conn. Bar Ass’n Comm. on Prof’l Ethics, Informal Op. 02-03 (2002); Prof’l Ethics Comm. of the Fla. Bar, Op. 86-2 (1986); State Bar of Ga., Formal Advisory Op. No. 05-5 (2007) (noting, additionally, that “the lawyer must be careful to make sure that the bank understands that its contractual arrangement can in no way affect or compromise the lawyer’s obligations to his or her individual clients”); Ill. State Bar Ass’n, Advisory Op. on Prof’l Conduct No. 94-06 (1994); Ill. State Bar Ass’n, Advisory Op. on Prof’l Conduct No. 87-10 (1988); Ky. Bar Ass’n Comm. on Ethics and Unauthorized Practice of Law, Legal Ethics Op. E-420 (2002) (providing, additionally, that an agreement that the client will bear interest charges “takes on the characteristics of a business transaction”); Me. Prof’l Ethics Comm’n of the Bd. of Overseers, Op. No. 177 (2001) (cautioning, additionally, that “the lawyer may not disclose any client confidences . . . without the informed written consent of the client”); Md. State Bar Ass’n Comm’n on Ethics, Ethics Docket 98-23 (1998); State Bar of Mich. Standing Comm. on Prof’l Ethics, Op. RI-336 (2005) (cautioning, additionally, that the law firm must maintain client confidences and that the contingent fee agreement must disclose the maximum rate of interest); Mo. Bar, Informal Advisory Op. 970066 (1997); State Bar of Nev. Standing Comm. on Ethics & Prof’l Responsibility, Formal Op. No. 36 (2007) (including a number of additional restrictions); N.J. Advisory Comm. on Prof’l Ethics, Op. 603 (1987), *reprinted in* 120 N.J. L.J. 252 (1987); N.Y. State Bar Ass’n Comm. on Prof’l Ethics, Op. No. 754 (2002) (adding that the lawyer must not have an interest in the lender, the lawyer must preserve “client confidences and secrets,” and the client must have the opportunity to “avoid the interest charge by paying the disbursements”); N.C. State Bar, Formal Ethics Op. 12 (2006); Ohio Bd. of Comm’rs on Grievances & Discipline, Op. 2001-3 (2001); Pa. Bar Ass’n, Advisory Comm. on Legal Ethics & Prof’l Responsibility, Op. 2003-018 (2003) (requiring, additionally, that the lawyer safeguard client confidences); Tex. Comm. on Prof’l Ethics, Op. 465 (1991); Utah State Bar Ethics Advisory Comm. Op. No. 02-01 (2002). Other ethics opinions have reached the same result. L.A. Cnty. Bar Ass’n Prof’l Responsibility & Ethics Comm., Formal Op. 499 (1999); Ass’n of the Bar of the City of N.Y. Comm. on Prof’l and Judicial Ethics, Formal Op. 1997-1 (1997).

97. Ohio Bd. of Comm’rs on Grievances & Discipline, Op. 2001-03 (2001).

more detailed. For instance, in 2006, the North Carolina State Bar addressed the following inquiry:

ABC Litigation Funding (hereinafter “ABC”) is a company that offers non-recourse loans to personal injury lawyers who need to borrow funds for expenses advanced in contingency cases. Lawyer is interested in obtaining financing for a large personal injury case for which he has already advanced some of the expenses. Lawyer will be unable to complete the matter unless he receives help with the costs.

. . . .

Assume ABC’s financing agreement requires the lawyer to repay the amount borrowed plus a fee equivalent to 100% of the amount of funding ABC provided. So, for every dollar the lawyer borrows, he will have to repay two dollars if the case is successfully tried. If the lawyer is unsuccessful and there is no recovery, he will owe nothing to ABC Financial. ABC suggests that Lawyer can pass along the 100% financing charge to the client as an expense of litigation.

May Lawyer pass along the expense of obtaining litigation financing to the client?⁹⁸

The North Carolina Bar ruled that, with a few caveats, the lawyer could.⁹⁹

Nor are the state ethics committees alone. In the case most directly on point, *Chittenden v. State Farm Mutual Automobile Insurance Co.*, the Louisiana Supreme Court approved the deduction of interest from a client’s recovery.¹⁰⁰ Respected ethics scholar W. Bradley Wendel has studied the issue and concluded that interest deductions are “entirely appropriate.”¹⁰¹ And, the recently published, eagerly awaited ABA Informational Report on Alternative Litigation Finance likewise provides: “If clear, understandable written disclosure had been made . . . there is no reason in principle why these expenses [interest charges] could not be charged to clients.”¹⁰²

Yet, the unanimity might obscure uneasiness. As noted above, in the World Trade Center Disaster Site Litigation, when faced with an *actual* loan and an imminent deduction of over \$6 million from injured

98. N.C. State Bar, Formal Ethics Op. 12 (2006).

99. Additional restrictions required the lawyer to: obtain written informed consent prior to entering into the funding agreement, ensure that the expense was “not clearly excessive under the circumstances,” and ensure that borrowed funds would “be used only to pay expenses incurred on behalf of the client.” *Id.* The opinion further cautioned that, in order “[f]or consent to be fully informed, . . . a lawyer must discuss other financing arrangements, their availability, and the risks and advantages of each.” *Id.*

100. *Chittenden v. State Farm Mut. Auto. Ins. Co.*, 788 So. 2d 1140 (La. 2001). For more on the opinion, see *supra* note 25.

101. Wendel Aff., *supra* note 4, ¶ 6.

102. ABA INFORMATIONAL REPORT, *supra* note 24, at 38.

individuals' recoveries, Judge Hellerstein broke ranks.¹⁰³ Some practicing lawyers have likewise expressed skepticism.¹⁰⁴ And, at least one lender has remained cautious—even requiring, as a condition of extending financing, that the lawyer not pass financing charges along to clients.¹⁰⁵

IV. A MORE COMPLICATED QUESTION

Are state ethics committees, the Louisiana Supreme Court, the ABA Informational Report on Alternative Litigation Finance, and respected commentators right to bless the deduction of interest? The answer, it turns out, depends on one's mode of analysis.

A. Formalist Perspective: Easy to Acquiesce

If one seeks to determine whether financing charges can be deducted from a client's recovery merely by parsing the ABA Model Rules of Professional Conduct, the *Restatement (Third) of the Law Governing Lawyers*, and relevant ABA Formal Opinions, there is reason for acquiescence. The Model Rules only include Rule 1.5(a)'s general admonition that both fees and expenses must be "reasonable."¹⁰⁶ Assuming the financing charge is "reasonable," then, the Model Rules provide no impediment. Section 36 of the *Restatement* clearly implies that contingency fee lawyers can deduct interest, as long as they comply with rules governing business transactions.¹⁰⁷ And, ABA Formal Opinion 93-379, which offers detailed guidance on how to handle the "costs" of litigation, also suggests that lawyers can charge clients for *lots* of things, including, for example, the cost of

103. See *supra* note 6 and accompanying text.

104. See, e.g., *Billing Clients Interest Fees on Lawyer Loans Legal, but Uncommon*, CTR. FOR PUB. INTEGRITY, <http://www.publicintegrity.org/2010/12/13/2258/billing-clients-interest-fees-lawyer-loans-legal-uncommon> (last visited Feb. 4, 2014) (quoting New York lawyer Stephen Fearon as stating: "It seems to me that if you are being billed \$50,000 or \$100,000 for an expert witness, that's what you should pass along on to the client. . . . Not interest charges."); Petroff Interview, *supra* note 34 ("Based on my experience dating to the '80's, I'd be surprised if top-notch lawyers charged their clients interest.").

105. Augusta Letter, *supra* note 71, at 20–21 (reporting that Augusta requires that any lawyer who receives financing must promise that "any fee that becomes owed . . . will not be passed on to the lawyer's client").

106. MODEL RULES OF PROF'L CONDUCT R. 1.5(a) (2013).

107. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 36 cmt. c (1998) (permitting a lawyer to advance the expenses of litigation, with the client to repay the advance from case proceeds, while cautioning that any greater obligation on the part of the client, such as the payment of interest, subjects the arrangement to § 126, which governs attorney-client business transactions); cf. *id.* § 38 cmt. e (vesting lawyers with wide latitude to bill clients for nontraditional expenses, provided the "client was told of the billing practice at the outset of the representation").

maintaining a law library, as long as the lawyer discloses the proposed charges “to the client in advance of the engagement,” and the client agrees thereto.¹⁰⁸ Thus, from a formalist perspective, interest pass-throughs ought to be permissible, at least if they are accompanied by the four protections and safeguards set forth above.¹⁰⁹

B. Functionalist Perspective: Three Problems

Yet, even while deductions technically pass muster, there are serious practical problems with interest pass-throughs that a formalistic reading obscures. Accordingly, in the remainder of Part IV, I evaluate interest deductions from a functionalist perspective. Initially, in subpart B, I highlight three practical problems with permitting these deductions. Then, in subpart C, I switch gears to highlight possible benefits.

1. An Ethical Minefield

The first reason to disallow interest deductions is that permitting them is bound to mire lawyers, judges, and policymakers in a thicket of heretofore unexamined and under-theorized ethical dilemmas in the loans’ negotiation and administration. These questions include: (1) the timing of client consent; (2) whether the lawyer is obligated to secure a loan for her client at the lowest possible cost; (3) what interest charge is “reasonable”; (4) whether interest deductions, if generally permissible, shall be permitted in quasi-class actions; and (5) whether lawyers can lend to one another and charge interest to one another’s clients. The discussion below fleshes out these neglected but important ethical issues to show that when one digs beyond the surface and considers how interest deductions will actually operate, the interest deduction inquiry becomes really quite complicated.

a. When should the client consent?

The first ethical issue posed by interest deductions involves the timing of client consent. Quite simply, the issue is: *When* should client consent be obtained?

108. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 93-379 (1993) (“*In the absence of disclosure to the client in advance of the engagement to the contrary*, the client should reasonably expect that the lawyer’s cost in maintaining a library, securing malpractice insurance, renting of office space, purchasing utilities and the like would be subsumed within the charges the lawyer is making for professional services.” (emphasis added)); *see also id.* (“*[I]n the absence of an agreement to the contrary*, it is impermissible for a lawyer to create an additional source of profit for the law firm beyond that which is contained in the provision of professional services themselves.” (emphasis added)).

109. *See supra* note 96 and accompanying text.

Interest deductions are most defensible when the client consents at the outset of the representation in a retainer agreement that specifies that outside financing will be secured, the precise terms of that financing, and what the client's obligation for that financing will be.¹¹⁰ And indeed, many states permit interest deductions *only with* such advanced consent. The Ohio Board of Commissioners on Grievances and Discipline, for example, cautions: "The terms of the loan must be disclosed to the client and must be agreed upon by the client in the contingent fee agreement."¹¹¹ Likewise, Kentucky's ethics committee explains that "the contingent fee agreement must be in writing and must explain how the interest will be calculated, and that the interest and other loan related expenses will be deducted from the settlement or judgment as an expense of litigation."¹¹² Similarly, the Missouri Bar has ruled that interest can be passed to clients only if the client agrees to the deduction "in general terms, at the outset of the representation."¹¹³ For ease of analysis, I call this the "*ex ante* approach."

At the same time, other states appear to take what may be dubbed an "*ex post* approach." In these states, while it is clear that the attorney must obtain the client's consent prior to deducting interest from the client's recovery, beyond "prior to recovery," the timing of client consent is left unspecified. For example, Arizona's State Bar explains: "[B]efore passing on any interest charges to the client, the arrangement must be explained clearly to the client in writing and be agreed upon by the client in writing."¹¹⁴ So, too, Nevada's Standing Committee on Ethics and Professional Responsibility declares: "After having been advised of counsel's intention to borrow funds, the client must

110. See MODEL RULES OF PROF'L CONDUCT R. 1.5(c) ("The [retainer] agreement must clearly notify the client of any expenses for which the client will be liable . . ."); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 38 cmt. e; see also Attorney Grievance Comm'n v. Kreamer, 946 A.2d 500, 534 (Md. 2008) ("Should a lawyer wish to charge clients for overhead costs and expenses, such a charge, including its method of calculation, ought to be explained to the client prior to the start of representation, and expressly stated in the written retainer agreement."); La. State Bar Ass'n v. Edwins, 540 So. 2d 294, 303 (La. 1989) ("A client who has retained a lawyer on a contingent fee basis may be billed for computer-aided research only when the fee agreement explicitly provides such costs will be billed, the agreement includes a detailed and complete explanation of the nature of the computerized research, and the client consents.").

111. Ohio Bd. of Comm'rs on Grievances & Discipline, Op. 2001-3 (2001).

112. Ky. Bar Ass'n Comm. on Ethics and Unauthorized Practice of Law, Legal Ethics Op. E-420 (2002).

113. Mo. Bar, Informal Advisory Op. 970066 (1997); accord Conn. Bar Ass'n Comm. on Prof'l Ethics, Informal Op. 02-03 (2002); State Bar of Ga., Formal Advisory Op. No. 05-5 (2007); Pa. Bar Ass'n, Advisory Comm. on Legal Ethics & Prof'l Responsibility, Op. 2003-018 (2003).

114. State Bar of Ariz. Comm. on the Rules of Prof'l Conduct, Formal Op. 01-07 (2001).

give written consent prior to the attorney's taking of the loan."¹¹⁵ And, the North Carolina opinion, quoted at length above, seems to anticipate a situation where the need for financing only becomes clear—and consent for the financing is only secured—once the representation is well underway.¹¹⁶

Now, the *ex post* approach seems eminently practical; many attorneys may not know whether a loan will be necessary until they understand a case's intricacies or, in some cases, a defendant's intransigence. The *ex ante* approach, by contrast, imposes a real obstacle for the attorney who only seeks outside financing when absolutely necessary—in rare instances when case costs mount and cash reserves run low.

But while undeniably practical, the *ex post* approach is ethically problematic. For starters, the *ex post* approach is hard, if not downright impossible, to reconcile with Model Rule 1.5(c), which requires that the attorney "notify the client of any expenses for which the client will be liable" up front in a retention agreement "signed by the client."¹¹⁷

Then, even assuming the incompatibility with Model Rule 1.5(c) is not disqualifying, there are also practical problems. Namely, the *ex post* approach appears to permit a lawyer to demand that the client consent to the deduction of interest partway through a representation. This demand closely resembles a lawyer's demand that the client consent to a contingency fee bump partway through a representation. Both, in essence, funnel more money to the lawyer at the client's expense.¹¹⁸ Yet, contingency fee bumps are viewed with great suspicion. Even if the case takes an unanticipated turn that increases the risk the lawyer must face or effort he must exert, authorities generally caution that a lawyer cannot "demand a new, more generous fee arrangement" once a contingency fee representation has commenced.¹¹⁹ Why

115. State Bar of Nev. Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. No. 36 (2007).

116. N.C. State Bar, Formal Ethics Op. 12 (2006). The opinion permits the deduction of interest as long as, *inter alia*, the client's consent is obtained "before Lawyer enters into the agreement with ABC." At the same time, though, the opinion cautions that, in order to be "fully informed" consent should be obtained in the retainer agreement.

117. MODEL RULES OF PROF'L CONDUCT R. 1.5(c) (2013); *see also supra* note 110 (collecting additional authority).

118. For why these loans enrich lawyers, see *infra* Part IV.B.3.

119. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 94-389 (1994); *accord* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 11-458 (2011) ("Modifications sought by a lawyer that change the basic nature of a fee arrangement or significantly increase the lawyer's compensation absent an unanticipated change in circumstances ordinarily will be unreasonable."); 7A C.J.S. *Attorney & Client* § 383 (2004) ("An attorney who has contracted with his or

should ethicists tolerate midcourse bumps in reimbursement while disallowing midcourse bumps in payment?

Finally—and perhaps worst of all—there is the issue of nonconsent. If midstream consent can be obtained, what happens if the lawyer seeks consent to the interest deduction and the client withholds it? Putting a finer point on it: Does a client’s refusal to consent to an interest charge constitute grounds for attorney withdrawal, pursuant to Model Rule 1.16(a)? That seems dubious.¹²⁰ And, if a client’s decision to withhold consent does not create a permissible ground for withdrawal, why would any sensible client agree to bear what is, in effect, a gratuitous interest penalty?¹²¹

b. Must the lawyer secure a loan with the lowest terms possible?

A second dilemma arises from the fact that, even if the client formally consents to the interest deduction at the time of retention, litigation financing is sometimes not actually *secured* until the case is well

her client as to the amount of compensation for a specified service is not allowed to contract for greater compensation for such service while the service is being rendered.”); Lynn A. Baker & Charles Silver, *Fiduciaries and Fees: Preliminary Thoughts*, 79 *FORDHAM L. REV.* 1833, 1839 (2011) (“Because a lawyer becomes a fiduciary once representation begins, post-retention fee negotiations are suspect, and contracts entered into with clients post-retention are presumptively unreasonable.” (footnote omitted)); cf. E. ALLAN FARNSWORTH, *CONTRACTS* § 4.21 (4th ed. 2004) (explaining that, in contract law generally, the preexisting duty rule forbids certain contract modifications; one party to a contract simply cannot “threaten[] to walk off the job” unless he is paid “an additional sum”).

120. The most likely candidate would be Model Rule 1.16(a)(6), which permits withdrawal if “the representation will result in an unreasonable financial burden on the lawyer.” *MODEL RULES OF PROF’L CONDUCT* R. 1.16(a)(6). Still, it is doubtful that a lawyer would be within her rights to withdraw in such a circumstance. See *RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS* § 32 cmt. m (1998) (“The burdens of uncertainty should . . . ordinarily fall on lawyers That a representation will require more work than the lawyer contemplated when the fee was fixed is not ground for withdrawal.”); ABA Comm. on Ethics & Prof’l Responsibility, Formal Op. 11-458 (2011) (cautioning that a lawyer may not “threaten to withdraw if the client does not agree to increase the fee”); see also, e.g., Comm. on Prof’l Ethics & Conduct of the Iowa State Bar Ass’n v. Chipokas, 493 N.W.2d 414, 417–18 (Iowa 1992) (disciplining a lawyer for, *inter alia*, attempting to renegotiate a contingency fee agreement and threatening to withdraw if the client did not consent to the agreement’s new, more lucrative, terms); Haines v. Liggett Grp., 814 F. Supp. 414, 427 (D.N.J. 1993) (refusing to permit withdrawal even where “costs of litigating . . . are far greater than anyone could have reasonably expected at the time the contingency contract was signed” and noting that “accepting high fees when the risk of litigation pays off and claiming unilateral mistake when the decision and investment go bad are unacceptable”). But cf. Richmond, *supra* note 29, at 664 (“If the attorney cannot competently represent the client absent the desired funding, or if he is unwilling to do so, the attorney must terminate the representation.”).

121. Or, must an attorney advise a client that the client could compel counsel to perform under the original contract? See 8 *IA. PRAC. CIVIL LITIG. HANDBOOK* § 1:19 (2012) (cautioning counsel not to renegotiate a fee agreement for the performance of essentially the same services without advising the client that he “could compel counsel to perform under the original contract”).

underway, at which time the lawyer and client undeniably stand in a fiduciary relationship.¹²² This timing matters because, as noted above, there are two types of lawyer loans, recourse and nonrecourse, and the former, especially when secured by a lawyer's personal assets, are less expensive than the latter. "Fiduciary law ordinarily requires a lawyer to place the interests of his client above the attorney's own interests,"¹²³ and a comment to the Model Rules specifically advises that "[t]he lawyer's own interests should not be permitted to have an adverse effect on representation of a client."¹²⁴ Does it follow, then, that a lawyer has an obligation to obtain a recourse rather than nonrecourse loan to secure more advantageous terms, before deducting interest charges from a client's recovery? Going further, must a lawyer personally guarantee the recourse loan, pledging personal assets as collateral to get (and give clients) the best possible deal?¹²⁵ Adding yet another layer of complexity, if a lawyer opts not to personally secure the loan, does Rule 1.4, which generally compels candid conversation between lawyer and client, require the lawyer to notify the client that a more advantageous funding arrangement was, in fact, available?¹²⁶

122. By contrast, most (though not all) agree that the lawyer and client do not stand in a fiduciary relationship at the time the retention agreement is first executed. Compare *Setzer v. Robinson*, 368 P.2d 124, 126 (Cal. 1962) ("[I]n agreeing upon [the retainer agreement's] terms, the parties deal at arm's length." (internal quotation marks omitted)), and *Baker & Silver*, *supra* note 119, at 1838 (contending that, at the time the retainer agreement is signed, "the parties stand at arm's length"), with *Nolan v. Foreman*, 665 F.2d 738, 739 n.3 (5th Cir. 1982) ("The fiduciary relationship between an attorney and his client extends even to preliminary consultations between the client and the attorney regarding the attorney's possible retention."), and Stephen D. Annand & Roberta F. Green, *Legislative and Judicial Controls of Contingency Fees in Tort Cases*, 99 W. VA. L. REV. 81, 89 n.21 (1996) ("In fact, it seems clear that attorneys do have a responsibility (i.e., fiduciary duty) to 'prospective clients.'" (quoting *Nolan*, 665 F.2d at 739 n.3)).

123. Fred C. Zacharias, *The Preemployment Ethical Role of Lawyers: Are Lawyers Really Fiduciaries?*, 49 WM. & MARY L. REV. 569, 607 (2007).

124. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 10.

125. Compare WTC Hearing Transcript, *supra* note 2, at 11–12 (statement of Paul Napoli) (discussing the lawyer's "obligation" to ensure that "the interest that's charged on cost are at the lowest available rates possible" and asserting that he and his colleagues fulfilled that obligation by "personally guaranteeing the credit lines that are used to finance the litigation costs"), with State Bar of Nev. Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. No. 36 (2007) (suggesting that the lawyer need not pledge personal assets in order to secure a loan for a client).

126. See MODEL RULES OF PROF'L CONDUCT R. 1.4(b) ("A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."); accord N.C. State Bar, Formal Ethics Op. 12 (2006) (cautioning that, "prior to asking the client to sign the fee agreement, a lawyer must discuss other financing arrangements, their availability, and the risks and advantages of each").

c. What qualifies as “reasonable”?

Litigation funding companies charge a lot for their services. Recall, for example, that Augusta Capital often charges approximately \$1 for every \$1 advanced—the equivalent of 100% interest—while Excalibur appears to charge a good deal more. These charges far exceed interest rates permitted under the usury laws of most states.¹²⁷ Can attorneys really deduct the equivalent of 100% interest on costs from client recoveries without running afoul of usury laws’ terms? Or, even if usury laws do not apply—because the client’s obligation to repay the lawyer, and by extension the lender, hinges on case success, and usury laws do not apply to contingent obligations—does an interest rate of 100% comply with Model Rule 1.5’s catchall requirement that deducted expenses be “reasonable”?¹²⁸ If 100% isn’t reasonable, what *would* qualify as “reasonable” in this sphere?

d. Should deductions be permissible in class and quasi-class actions?

The next constellation of ethical concerns involves class and quasi-class actions. Mass torts, where costs run high, sometimes involve cases at least conceivably amenable to class certification pursuant to Federal Rule of Civil Procedure 23. It follows that a number of the highest cost cases will involve instances where Rule 23 class certification motions are at least filed.¹²⁹ It further follows that, under current law, the permissibility of interest pass-throughs will sometimes hinge on whether these filed Rule 23 motions are granted. If a Rule 23 certification motion is filed and granted, that is, scholars seem to agree that interest deductions are impermissible, either because of limits imposed by Rule 23(h) or because some class members won’t have signed agreements with class counsel consenting to such charges.¹³⁰

127. “‘Usury’ is defined as the illegal profit received by a lender on a sum of money loaned to a borrower” Ann K. Wooster, Annotation, *Construction and Application of Usury Provisions in State Constitutions*, 73 A.L.R. 6th 571, 571 (2012). All but a few states have enacted usury laws capping permissible rates of interest. *Id.*

128. MODEL RULES OF PROF’L CONDUCT R. 1.5(a). Most states define a usurious transaction as one where there is “an absolute obligation to repay the principal.” Wooster, *supra* note 127, § 2; *see also, e.g.*, *MoneyForLawsuits V LP v. Rowe*, No. 10-CV-11537, 2012 WL 1068760 (E.D. Mich. Mar. 29, 2012) (finding that the contract did not violate state usury law because there was a contingency).

129. *See, e.g., In re Vioxx Prods. Liab. Litig.*, 239 F.R.D. 450 (E.D. La. 2006) (denying plaintiffs’ motion for class certification).

130. Federal Rule of Civil Procedure 23(h) gives the trial court the power to award fees and expenses in a certified class action. *See* FED. R. CIV. P. 23(h); *see also* WTC Hearing Transcript, *supra* note 2, at 19 (statement of Professor Anthony Sebok) (“I will say as a matter of my experi-

Yet, if the Rule 23 motion is filed and *denied*, lawyers will be free to charge extra for interest provided their clients consent.

These facts raise a pair of important ethical challenges. First, is it justifiable to treat financing charges differently based on the Rule 23 certification decision? Second, even if *that* line drawing is justifiable, as Judge Jack Weinstein's quasi-class action framework is more widely adopted, and judges exert ever-greater control over attorney compensation in mass consolidations—on what side of the increasingly blurred line should interest deductions fall?¹³¹ In other words, if interest deductions are impermissible in class actions, should they also be banned in large consolidated cases imbued with quasi-class action characteristics?

e. Why don't lawyers lend to one another?

Finally, if interest deductions *are* widely permitted, still another potentially troubling scenario might arise. As noted above, during the second phase of lawyer financing, lawyers sometimes joined forces. Well-heeled lawyers would contribute capital in exchange for a portion of the contingency fee; cash-strapped lawyers would forego a portion of their contingency fee in exchange for help with financing. The Agent Orange litigation was a prominent example. There, as noted, the lawyers who had invested the most *effort* into the case were willing to forego some portion of their fee to induce other lawyers to contribute capital. The fen-phen and Hinkley, California water contamination litigations involved similar agreements.¹³²

In the brave new world of lawyer lending, however, will those co-counsel relationships continue to be forged? Or, instead, might well-heeled lawyers who contribute capital be compensated for that capital, not by taking a portion of the cash-strapped lawyers' contingency fee, but instead by taking a sizable chunk of the clients' ultimate recovery?¹³³ Furthermore, even in the absence of budget shortfalls,

ence, it is not done in class actions . . . because there is no client signing a retainer agreement in a class action.”).

131. The quasi-class action rubric originated in a 1977 case, *In re Air Crash Disaster at Florida Everglades* on Dec. 29, 1972, 549 F.2d 1006 (5th Cir. 1977), and then came to prominence in Judge Jack B. Weinstein's influential article, *Ethical Dilemmas in Mass Tort Litigation*, 88 NW. U. L. REV. 469, 480–81 (1994). For more on the quasi-class action model, which is characterized by “judicial appointment of lead attorneys, judicial control of lead attorneys' compensation, forced fee transfers, and fee cuts,” see Charles Silver & Geoffrey P. Miller, *The Quasi-Class Action Method of Managing Multi-District Litigations: Problems and a Proposal*, 63 VAND. L. REV. 107, 110 (2010).

132. See *supra* notes 53–57 and accompanying text.

133. See *Fausone v. U.S. Claims, Inc.*, 915 So. 2d 626, 630 n.6 (Fla. Dist. Ct. App. 2005) (noting, in an aside, that “if lawyers establish litigation loan companies to ‘service’ one another’s

might lawyer *A* loan money for case preparation to lawyer *B*, while lawyer *B* loans money for case preparation to lawyer *A*, as both charge (and deduct) interest?

2. *An Increase in Underlying Costs*

Above, we saw that the first reason to disallow—or at least tread very cautiously when permitting—interest deductions is that they are bound to tangle lawyers, judges, and policymakers in an ethical bramble bush. A second reason to question interest deductions is that, given moral hazard considerations—the idea that parties act differently when they are insulated from the consequences of their actions—permitting interest deductions may increase not just the financing charges borne by clients, but also the underlying costs clients incur.¹³⁴

To understand why, it is helpful to go back in time. The 1990s witnessed a series of minor scandals involving corporate law firm spending—with flaps over \$77.50 faxes, \$22 document deliveries, and nearly \$9 danishes, all charged to clients.¹³⁵ These scandalous charges were, in part, fueled by greed—by firms' desires to *make* money. The temptation to pad costs and pocket payments exists in the PI realm too and, crucially, exists irrespective of the deduction of interest. What is relevant for current purposes is the fact the corporate law firm scandals were driven not *solely* by greed; they were also the product of inattention born of moral hazard. "When costs are passed on, there's no incentive to do things prudently or cheaply," journalists reporting on a scandal observed at the time.¹³⁶ Skadden, they elaborated, cared little "that one associate . . . regularly treated himself to \$30 and \$40 dinners at D.C.'s Old Ebbitt Grill" because, with expenses passed through, "the client picked up the tab."¹³⁷

This experience is relevant because (especially) nonrecourse loans plus interest deductions permit PI attorneys to offload the *entire* out-

clients, these high interest loans may actually be a method to increase the lawyers' contingency fees").

134. For more on moral hazard, see generally Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996). To be sure, some increased spending on case preparation could be beneficial, a point considered below in subpart C.2.

135. See generally Susan Beck & Michael Orey, *Skaddenomics*, AM. LAW., Nov. 1991, at 3, available at amlawdaily.typepad.com/files/skaddenomics.pdf (detailing corporate law firms' profligate spending); Karen Dillon, *Dumb and Dumber*, AM. LAW., Oct. 1995, at 5; Linda Himmelstein, *The Verdict: Guilty of Overcharging*, BUS. WEEK, Sept. 6, 1993, at 62. Of course, the problem of gouging is not yet vanquished. See Peter Lattman, *E-Mail Points to Overbilling by Law Firm*, N.Y. TIMES, Mar. 26, 2013, at A1.

136. Beck & Orey, *supra* note 135, at 94.

137. *Id.*

of-pocket cost of case preparation onto others. By contrast, in the absence of loans and interest deductions, cash-flow constraints, tax liability, financing charges, and the specter of personal liability in the event of defeat gave PI lawyers some incentive to scrutinize bills and limit expenditures. Given moral hazard, interest deductions are thus apt to reduce PI lawyers' incentive to bargain shop. (Why spend time searching for a discount provider when you aren't paying anyway?) And, deductions are simultaneously apt to increase lawyers' temptation to fly first class, dine at fine restaurants, and sleep at luxury hotels.¹³⁸ Indeed, the corporate law firm experience of the 1990s indicates that some lawyers displayed a tendency toward profligacy even when powerful repeat players with sophisticated general counsel and specially trained auditors were monitoring,¹³⁹ and even after some abuses were (most unflatteringly) revealed.¹⁴⁰ Might problems be *exacerbated* in the PI realm, when unsophisticated individual accident victims are the ones "scrutinizing" invoices, especially when the case has concluded and the chance of future interaction is slim?

Analogizing to the corporate experience also raises a basic fairness concern. Over the past decade, corporate clients have, according to a number of sources, cracked down on costs. Fed up with past gouging, many now refuse to reimburse law firms for everything from first-class travel, to online legal research, to overtime meals.¹⁴¹ At the very moment when corporate clients are effectively limiting their expense ob-

138. In addition, the ability to offload the entire out-of-pocket cost of case preparation could encourage nonattorney litigation inputs, relative to attorney inputs. As Judge Walker explained in the Oracle litigation:

To varying degrees non-attorney litigation inputs are substitutes for attorney effort (e.g., computerized legal research, non-attorney factual investigation). If the costs of attorney substitutes are reimbursable one hundred cents on the dollar, a law firm paid by a percentage of recovery will find it in its interest to substitute non-attorney inputs for attorney effort. . . . Reimbursement, thus, gives percentage fee lawyers an economic incentive to chose [sic] a combination of attorney and non-attorney litigation inputs which discourages attorney effort relative to other inputs, dubious stuff for canons of lawyer ethics.

In re Oracle Sec. Litig., 136 F.R.D. 639, 644 (N.D. Cal. 1991).

139. Amy Stevens, *Ten Ways (Some) Lawyers (Sometimes) Fudge Bills*, WALL ST. J., Jan. 13, 1995, at B1 (reporting that "one of the fastest growth industries in the legal business is made up of entrepreneurs claiming they can find the fat in law-firm invoices").

140. Dillon, *supra* note 135, at 5 (expressing astonishment that some corporate law firms were still overcharging clients for disbursements four years after the publication of the original "Skaddenomics" story, which prompted client "[o]utrage").

141. Douglas R. Richmond, *For a Few Dollars More: The Perplexing Problem of Unethical Billing Practices by Lawyers*, 60 S.C. L. REV. 63, 93 (2008) (reporting that corporate clients "commonly" "specify expenses that they will not reimburse, such as facsimile or electronic legal research charges" and also "employ specialists to audit legal bills").

ligations, should the legal profession offload to individual clients responsibility for a new cost category?

3. *A Backdoor Way to Increase Lawyers' Profits*

A third and related practical problem posed by interest deductions is that these deductions are likely a backdoor way to increase PI lawyers' profits, at unwitting clients' expense. As noted above, PI lawyers traditionally used their own capital to finance case preparation. In so doing, they were subjected to harsh tax treatment, took on extra risk in the event of defeat, and incurred an opportunity cost; by sinking funds into ongoing cases, instead of investing those monies elsewhere, they sacrificed the interest they would have otherwise earned. Moreover, PI lawyers did all this at no extra charge to their clients. Though a small minority of lawyers did charge their clients interest on expenditures, the vast majority did not.¹⁴² The custom was (and still is) to extend to clients what was, on the face of it, an interest-free loan.

Of course, though, while ostensibly "interest-free," these advances were never really gratuitous. Lawyers *were* compensated, but their compensation was simply embedded in the contingency fee. That is, the contingency fee has always been understood to compensate plaintiffs' lawyers for a trio of services: (1) professional services (actual lawyering), (2) banking services (advancing to clients the value of the lawyer's professional services and out-of-pocket expenses), and (3) insurance services (insuring the value of the lawyers' professional services and out-of-pocket expenses against the risk of non- or inadequate payment).¹⁴³ And, it has also always been understood that contingency fee lawyers do—and should—earn higher effective hourly rates than their defense-side counterparts precisely because of the extra services they provide. To quote one of the forefathers of the plaintiffs' bar, Stuart Speiser:

[Personal injury lawyers] are deprived of the opportunity to make equity and real estate investments, which other lawyers are free to

142. Johnson, *supra* note 16, at 569 ("For whatever reason . . . most firms do not separately bill interest."); *see also id.* at 567. Whether law firms *could* charge extra for interest, even while self-funding the litigation, is a bit unclear. Some states clearly permit (and, indeed, have long permitted) the practice. *See, e.g.,* Conn. Bar Ass'n Comm. on Prof'l Ethics, Informal Op. 02-03 (2002); Prof'l Ethics Comm. of the Fla. Bar, Op. 86-2 (1986); Ill. State Bar Ass'n Advisory Op. on Prof'l Conduct No. 94-06 (1994); N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. No. 729 (2000). *But see* SWANSON, *supra* note 45, at 39–40 (asserting, without citation: "In most states, law firms cannot charge interest to their clients for case expenses. To do so would make the law firm a consumer lender and could make them subject to the host of regulations regarding lending to consumers.").

143. *See* KRITZER, *supra* note 45, at 15–16 ("[C]ontingency fee lawyers provide more than legal services to their clients; they also function as financier and insurer.").

engage in without fear of tying up funds needed for law firm capital. This heavy financial penalty is never discussed publicly, but it is one of the reasons why the profits of a successful tort practice must be higher than those of lawyers paid by the hour.¹⁴⁴

Lawyer lending could change things. If lawyer lending, fueled by interest deductions, permits some lawyers to offload the cost of capital onto their clients, PI lawyers will effectively shed some of these banking and (if nonrecourse loans are utilized) insurance services.¹⁴⁵ As these services are shed, the “heavy financial penalty” Speiser describes will be lifted, or at least lightened. And, if the shedding is unaccompanied by a drop in contingency fees, PI lawyers will start reaping higher effective rewards.

This all means that, while addressing the propriety of interest deductions, an important question becomes: How likely is it that the shedding of some banking and insurance services will be accompanied by a reduction in contingency fee percentages? After all, if contingency fee percentages *do* drop as services are shed, our view of interest deductions might be quite favorable. Interest deductions could be a catalyst, creating a new unbundled, differentiated marketplace with new choices, possibilities, and opportunities for clients. On the other hand, if contingency fees *aren't* reduced as services are shed, our view might be quite negative; deductions might be seen as merely an opaque way to enrich attorneys at client expense.

So which is more likely? If the market for personal injury legal services is competitive, then the former outcome will prevail. The nominal increase in costs to the client from the pass-through will be offset by changes to other implicit or explicit contract terms—and the interest deduction, whatever its size, will not disadvantage clients.¹⁴⁶ Yet, there is reason to doubt that the market for personal injury legal services is an efficient market. For one, it is well established that “[a] foundation for an efficient market is the ability of market participants

144. SPEISER, *supra* note 39, at 569; *see also In re “Agent Orange” Prod. Liab. Litig.*, 611 F. Supp. 1296, 1310 (E.D.N.Y. 1985) (“Contingent fees take into account not only the risk of nonrecovery, but the fact that the lawyer must wait for years before collecting a fee to cover long-paid out-of-pocket expenses, overhead costs and living costs.”), *rev'd*, 818 F.2d 216 (2d Cir. 1987).

145. Notice, the word “some” is used above. This important qualifier reflects the fact that, even if nonrecourse loans fund case expenses, lawyers will continue to provide *some* banking and insurance services, as they will continue to advance the value of their professional services and insure those services against the risk of non- or inadequate payment.

146. *See* Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, in *HANDBOOK OF LAW AND ECONOMICS* § 2.3.3, at 39 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (recognizing that “competitive markets can be expected to maximize welfare in the absence of externalities”).

to consider and compare the alternatives available in the marketplace.”¹⁴⁷ When selecting a PI lawyer, however, meaningful quality comparisons are next to impossible. While lawyer quality varies—and also matters (better lawyers do, in general, achieve better results for their clients)—the PI marketplace is marked by a near-total absence of objective, verifiable information bearing on the quality question.¹⁴⁸ This means that a precondition to an efficient market is lacking.

Moreover, the contingency fee market does not appear to *behave* like an efficient market. Contingency fees, on a percentage basis, appear to have fluctuated little over time, even as the risk of defeat and size of award have changed considerably.¹⁴⁹ And lawyers these days of varying quality, who litigate very different types of cases, who have different levels of experience, and who obtain clients using different client-origination mechanisms, appear to charge nearly the same percentage.¹⁵⁰ Moreover, as explained below, (1) in the past, when law-

147. Christopher Avery, Christine Jolls, Richard A. Posner & Alvin E. Roth, *The Market for Federal Judicial Law Clerks*, 68 U. CHI. L. REV. 793, 799 (2001); see ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 625 (8th ed. 2013) (explaining that “the market system will not operate efficiently” if consumers lack sufficient information about product quality).

148. See Nora Freeman Engstrom, *Sunlight and Settlement Mills*, 86 N.Y.U. L. REV. 805, 860 (2011) (“Credible information about lawyer performance is difficult (more often, impossible) to find, no matter one’s resources or resolve.”). In fact, most clients have great difficulty judging the quality of legal services, even after the services have been rendered. See Winand Emons, *Expertise, Contingent Fees, and Insufficient Attorney Effort*, 20 INT’L REV. L. & ECON. 21, 25 (2000) (“The attorney’s services thus constitute ‘credence’ goods, as distinct from search and experience goods—from *ex post* observations, the client can never be certain of the quality of the services he has obtained.” (citation omitted)).

149. Compare Kritzer, *supra* note 40, at 284–86 (reporting on the results of a 1995–1996 survey of Wisconsin lawyers which found that most lawyers charged a fee of 33%), with MACKINNON, *supra* note 41, at 116 (suggesting, on the basis of a review of then-available data that, in 1964, the average contingency fee in the United States was roughly 33%).

150. See Nora Freeman Engstrom, *Attorney Advertising and the Contingency Fee Cost Paradox*, 65 STAN. L. REV. 633, 667–69, 676–77, 681 (2013); see also, e.g., John Fabian Witt, *Bureaucratic Legalism, American Style: Private Bureaucratic Legalism and the Governance of the Tort System*, 56 DEPAUL L. REV. 261, 279 (2007) (“[D]espite some limited evidence of price competition in the plaintiffs’ market, the price term in plaintiffs’-side personal injury retainers is remarkably sticky . . .”). See generally Lester Brickman, *The Market for Contingent Fee-Financed Tort Litigation: Is It Price Competitive?*, 25 CARDOZO L. REV. 65 (2003).

This raises the question, of course: *Why* might contingency fees be sticky? Part of the answer is no doubt tied to the informational problems identified above. The absence of objective quality information likely discourages lawyers from competing on the basis of price, for fear that litigants—without objective information to consult—might interpret a discount contingency fee as an indicator of inferior quality. See Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697, 738 (2005).

Part of the answer, too, likely stems from the fact that contingency fees themselves are not particularly salient to consumers of legal services. After all, contingency fees are uncertain (since fees are only paid if a case is won); fees are paid, if at all, far in the future long after attorney retention; and fees are paid, not via an actual payment, but rather, via a deduction from the client’s recovery. Implicating three well-known cognitive biases—the certainty effect, myo-

yer inputs have dropped, contingency fees have not; and (2) the deduction of interest is unlikely to be salient to consumers of legal services, so consumers are not likely to shop or bargain on this basis. Further, when looking at current practices, there is no indication that deductions are presently spurring fee reductions. Instead, in the words of a testimonial on one lender's website, once interest is deducted, clients inevitably start "paying more."¹⁵¹ Thus, when wagering, it seems doubtful that the shedding of some insurance and

pia bias, and loss aversion—these features combine to render contingent fees less salient than other attorney payment mechanisms. *See* Engstrom, *supra*, at 686–90. *See generally* OREN BARGILL, *SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS* (2012) (developing a theory of "behavioral market failure").

Interestingly, these same features—payment that is possible rather than certain; fees that must be paid, if at all, at some point in the potentially distant future; and fees that come in the form of a gain reduction, rather than affirmative payment—also obtain in the home brokerage context. There, a home may sell days, weeks, months, or even years after it is placed on the market—or theoretically not at all—and, if the home is sold, the agent's commission will come out of the sale's proceeds. Perhaps it is no surprise, then, that the home brokerage context is another area where, in the words of the U.S. Government Accountability Office (GAO), it appears that "commission rates have persisted in the same range—roughly 5 percent to 7 percent of a property's selling price—over long periods, regardless of local market conditions, housing prices, or the cost or effort required to sell different properties." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-947, *REAL ESTATE BROKERAGE: FACTORS THAT MAY AFFECT PRICE COMPETITION* 3 (2005) [hereinafter *GAO BROKERAGE REPORT*]; *see also* FED. TRADE COMM'N & U.S. DEP'T OF JUSTICE, *COMPETITION IN THE REAL ESTATE BROKERAGE INDUSTRY* 30 (2007) ("[T]he available data suggest that brokers may compete less on price than would be expected in a competitive market"); Chang-Tai Hsieh & Enrico Moretti, *Can Free Entry Be Inefficient? Fixed Commissions and Social Waste in the Real Estate Industry*, 111 J. POL. ECON. 1076, 1086 (2003) (observing that "commission rates appear to be . . . insensitive to economic forces").

To be clear, I do not suggest an absence of competition in the PI (or for that matter, the real estate) marketplace. Competition for clients is, in fact, fierce. *See Keywords with Highest Cost Per Click*, SPYFU, <http://www.spyfu.com/o/TopList.aspx?listId=3> (last visited Feb. 4, 2014) (reporting that, of the ten Google keywords with the highest "cost per click," four involve mesothelioma); Hsieh & Moretti, *supra*, at 1088–89 (describing the great lengths real estate agents will go to generate new listings). Nor do I suggest that there is *no* price competition. There clearly is some. *See* Engstrom, *supra*, at 682–83 (reviewing attorney Yellow Pages ads from thirteen cities and finding that 1.7% of PI lawyers specified a contingency fee percentage, thus explicitly competing on the basis of price). My claim is, rather, more subtle: PI lawyers compete primarily on dimensions other than price, and a reduction in lawyer inputs is unlikely to result in a reduction in fees charged clients. This mirrors the GAO's findings concerning the real estate market. *See* GAO BROKERAGE REPORT, *supra*, at 8 ("While real estate brokerage has competitive attributes . . . this competition [is] based more on *nonprice* variables . . ."); *id.* at 10 ("[T]he brokerage fee, in dollar terms, for selling a \$300,000 home is typically about three times the fee for selling a \$100,000 home, although the time or effort required to sell the two homes may not differ substantially. Similarly, commission rates do not appear to have changed as much as might be expected in response to rapidly rising home prices in recent years.").

151. The testimonial provides: "At first, I was worried that my clients would be upset about the interest passed through—they're paying more. [But] [t]hey've been very happy. They understand it completely. I was very shocked and very happy about that." AdvocateCapital, *Case Expense Funding with Advocate Capital*, YOUTUBE, at 1:49 (May 16, 2013), <http://www.youtube.com/watch?v=Xqq7q4QaV1I> (quoting client Greg Jones).

banking services will translate into lower contingency fees charged clients.

- a. Past experience suggests lower inputs do not reduce contingency fee percentages

Past experience from three arguably analogous contexts—involving (1) referral fees, (2) efforts to streamline litigation, and (3) the maturation of a mass tort—indicate that lawyers in the past have not reduced contingency fee percentages, even when case inputs have dropped considerably.¹⁵²

152. A potential counterexample involves airline accident litigation, where contingency fees are lower—often below 20%. JAMES S. KAKALIK ET AL., *COSTS AND COMPENSATION PAID IN AVIATION ACCIDENT LITIGATION* 44–45 (1988). What explains those low percentages? One possibility is that low attorney inputs *have* reduced contingency fees in this context. Plane crash cases, after all, are often straightforward, involving known victims, uncontested injuries (usually death), a known defendant, and almost certain liability. *See id.* at 53–54. But there may also be unique confounding variables. For one, many air crash victims are extremely sophisticated; their income, as a group, is “almost twice the U.S. average.” ELIZABETH M. KING & JAMES P. SMITH, *ECONOMIC LOSS AND COMPENSATION IN AVIATION ACCIDENTS*, at xi (1988). This means that plane crash victims are far more likely than most to have the knowledge and wherewithal to bargain over fees. Furthermore, airline accident cases sometimes involve claims against the United States, because, for instance, air traffic controllers’ negligence contributed to the accident. The Federal Tort Claims Act limits the contingency fee in such cases to 20% if the case settles without a lawsuit and 25% once the case is filed. KAKALIK ET AL., *supra*, at 47–48 (discussing the cap and stating that the “practical effect of the fee limitation is not clear”). Finally, because airlines’ liability is usually *so* clear, starting in 1977, many carriers started sending an important letter to victims’ families prior to their initiation of suit. One such letter advised:

You may find yourselves under pressure to sign a contingent fee retainer with an attorney whereby his fee is a percentage of the final award. The rationale for such a percentage fee is that the lawyer risks getting no fee if there is no recovery. There is no such contingency in this case.

Letter from Robert L. Alpert, Vice President, U.S. Aviation Underwriters Inc., to Victims of the July 9, 1982 Pan Am 727 Jetliner crash, *portions reprinted in* Lee S. Kreindler, *The Letter Should Not Be Sent*, *THE BRIEF*, Nov. 1982, at 4, 10. With that letter (referred to, variously, as the “Tenerife Letter” or the “Alpert Letter”) in hand, victims were perhaps more likely to view standard contingency fees with skepticism—and, in fact, knowledgeable observers have suggested that the letter exerted a downward pressure on contingency fees. For example, Lee Kreindler, a legendary plaintiffs’ lawyer who founded the firm that “represented plaintiffs in almost every major aircraft disaster in the last half-century,” has gone on record suggesting that the Alpert Letter “had a profound effect on the fees of plaintiff lawyers.” Kreindler, *supra*, at 9; Adam Liptak, *Lee Kreindler, 78, Air-Crash Lawyer, Dies*, *N.Y. TIMES*, Feb. 19, 2003, at A23. In sum, while the airline accident context could be an instance where low attorney inputs naturally resulted in lower fees (and thus, a powerful counter to the examples above), a more convincing explanation might be that these reductions were born of client sophistication, FTCA caps, and the Alpert Letter. For more on fees charged in airline accident litigation, see Brickman, *supra* note 150, at 107–12.

i. Referral fees

Referral fees first help to illustrate contingency fee stubbornness. Because one-shot PI claimants have difficulty identifying high-quality lawyers on their own, a practitioner referral market has developed. Via this referral market, certain cases (often those that are particularly large or complex) are channeled from lower echelon practitioners to higher echelon practitioners (“specialists” for shorthand)—in exchange for a sizable fee, usually somewhere between one-quarter and one-half of the specialist’s ultimate take.¹⁵³

Yet, some sophisticated clients retain specialists right off the bat, eliminating the intermediary. If fees fluctuated in a real-time way based on a lawyer’s inputs and outputs, we might expect to see specialists reduce their contingency fees in such instances. But no evidence suggests that such contingency fee cuts commonly occur.¹⁵⁴ The Vioxx litigation provides a case in point. In that litigation, one consortium of five plaintiffs’ law firms handled a total of 1,830 cases. In terms of origination, the consortium’s cases were nearly equally split; roughly half were direct retentions, while roughly half came via practitioner referrals. In the direct retentions, no referral fees were paid; in the latter, considerable sums (fees of 25%) were expended. Despite these differences, though, both groups of clients were charged the same contingency fee, on a percentage basis. Irrespective of whether the client required a referral payment, the percentage charged stayed static.¹⁵⁵

ii. The ABA’s Action Commission to Reduce Court Costs and Delay

The second example is dated—but still instructive. In 1979, the ABA created the Action Commission to Reduce Court Costs and Delay. Charged with identifying and experimenting with ways to simplify, streamline, and expedite litigation, the Commission focused its efforts on Kentucky, and by 1980, Kentucky courts had instituted a

153. Engstrom, *supra* note 148, at 862–63 (describing referral markets); *see also* DEP’T OF RESEARCH & ANALYSIS, STATE BAR OF TEX., TEXAS REFERRAL PRACTICES SURVEY REPORT 2 (2004) [hereinafter TEXAS REFERRAL SURVEY] (noting that referral fees average “30% of the attorney fee recovered”).

154. *See* TEXAS REFERRAL SURVEY, *supra* note 153, at 78 (reporting that the vast majority of lawyers (92.4%) in Texas do not typically increase attorneys’ fees when cases originate with a referring lawyer and entail referral fee payment).

155. *See* Affidavit of John Eddie Williams, Jr. ¶¶ 7–8, in Motion for Reconsideration/Revision of Order Capping Contingent Fees and Alternatively for Entry of Judgment, *In re Vioxx Prods. Liab. Litig.*, No. 2:05-MD-01657-EEF-DEK (E.D. La. Dec. 11, 2008).

variety of procedures to simplify dispute resolution.¹⁵⁶ And these reforms worked. “As a result of the new procedures,” the Commission declared in a 1984 report, “the average time from filing to disposition has been reduced from sixteen months to five months, cases involve less discovery and fewer motions, and attorneys spend less time on each case.”¹⁵⁷

Despite those enviable successes, the Commission hit a snag. The Commission, it seems, had presumed “that if delay were reduced and court procedures simplified, the time an attorney would spend on each case would be reduced and litigant costs would be reduced accordingly.”¹⁵⁸ Indeed, “[t]his assumed time-cost relationship” had been “at the heart” of the Commission’s efforts.¹⁵⁹ But the Commission had erred in assuming that lawyer savings would be shared with clients. To be sure, clients who had retained lawyers on an hourly fee basis did see significant reductions—of approximately 24%.¹⁶⁰ Contingency fee clients, however, were not so lucky. Although lawyer inputs went down, contingency fees stayed static—with the “net result,” as the Commission put it, “that with respect to these cases, lawyers are benefiting, but clients are not.”¹⁶¹

iii. Asbestos litigation

The third example comes from asbestos litigation, the longest running mass tort in American history.¹⁶² Over the years, asbestos litigation has undergone a profound transformation. In the 1970s, seeking damages from asbestos manufacturers was both difficult and dicey. To succeed, intrepid and entrepreneurial plaintiffs’ lawyers needed to convince courts to apply a newly minted and then-uncertain law of “strict” product liability, dodge a host of plausible defenses, make sense of a constellation of then-poorly understood diseases, and extract evidence from intransigent defendants. But fast forward thirty-five years, and that was no longer true. By 2005, asbestos litigation was a field where the relevant facts were known, the governing law

156. ACTION COMM’N TO REDUCE COURT COSTS & DELAY, AM. BAR ASS’N, ATTACKING LITIGATION COSTS AND DELAY: FINAL REPORT, at vii (1984).

157. *Id.*

158. *Id.* at 60.

159. *Id.*

160. *Id.* at ix, 66. This translated to roughly \$650 per case. *Id.* at ix.

161. *Id.* at 66.

162. Asbestos litigation is the paradigmatic “mature mass tort.” Francis McGovern has famously defined “mature mass torts” as those torts “where there has been full and complete discovery, multiple jury verdicts, and a persistent vitality in the plaintiffs’ contentions.” Francis E. McGovern, *Resolving Mature Mass Tort Litigation*, 69 B.U. L. REV. 659, 659 (1989).

was established, the diseases were well documented, and payments to plaintiffs were routinized. Indeed, Herbert Kritzer describes the evolution as follows: “In the early years of the asbestos litigation the asbestos manufacturers were able to successfully defend many mesothelioma cases; over time the defense of these claims became less and less successful, ultimately reaching the stage where there was essentially no practical defense.”¹⁶³

Over this lengthy litigation life cycle, lawyer inputs, whether measured by ingenuity exhibited, effort expended, costs incurred, or risk borne, dropped considerably. From the lawyer’s perspective, representing asbestos claimants had become much easier, more repetitive, cheaper, and less speculative. Because this savings was not shared with claimants, the litigation had also become more lucrative. As RAND researchers explained in a 2005 report:

We interviewed a number of individuals involved in asbestos litigation . . . including some of the nation’s leading asbestos plaintiff attorneys. None of the people we interviewed said they had seen any evidence that claimants’ attorney contingent fee rates had been reduced to reflect changes in the litigation. Plaintiff attorneys may have recognized savings from routinization of the litigation (e.g., the widespread use of administrative payment schedules). However, none of those we interviewed suggested that any of these savings have been passed on to claimants.¹⁶⁴

Perhaps it should come as no surprise that “mesothelioma trial lawyers” is now one of the most expensive Google keywords—costing, at last count, \$399.47 per click.¹⁶⁵

- b. Few clients comparison shop, and even if they do, clients are unlikely to shop based on this price term

Another reason to bet against the emergence of a competitive, unbundled personal injury marketplace is that prospective clients are *very* unlikely to select PI lawyers based on the lawyers’ treatment of capital costs—so there is unlikely to be shopping, bargaining, or competition on this basis.¹⁶⁶ For starters, few prospective clients ever re-

163. Kritzer Aff., *supra* note 36, ¶ 44; *see also* STEPHEN J. CARROLL ET AL., ASBESTOS LITIGATION 23, 128 (2005) (tracing this maturation).

164. CARROLL ET AL., *supra* note 163, at 103. Stephan Landsman has described fees charged in recent asbestos litigation as “the dark side” of contingent fee practice. ABA Task Force, *CFs in Mass Torts*, *supra* note 31, at 121. Herbert Kritzer has likewise opined: “Arguably a 40 percent fee in a 1978 mesothelioma case was reasonable while the same fee, and perhaps even a 33 percent fee, in a 2009 case is not.” Kritzer Aff., *supra* note 36, ¶ 44.

165. *See* SPYFU, *supra* note 150.

166. To be sure, many believe that in order for the market to operate efficiently, it would not be necessary for every client to understand the import of interest deductions. It would be suffi-

ally “shop” for a PI lawyer. Instead, research indicates that most accident victims sign up with the first attorney who offers representation.¹⁶⁷ Further, even to the extent prospective clients do consider multiple lawyers, only a small subset ever shop on the basis of price, as opposed to shopping based on other attorney characteristics such as friendliness, responsiveness, reputation, or perceived competence.¹⁶⁸ And, even if some prospective clients were inclined to shop around on the basis of price generally, there is even less reason to believe that they would shop around on the basis of *this* price term specifically. Most PI clients are unsophisticated, most are retaining a contingency fee lawyer for the first time in their lives, and most are retaining a lawyer shortly after injury.¹⁶⁹ Then, these inexperienced and often vulnerable clients are only apt to learn about interest deductions when reading a lawyer’s (complex and often lengthy) preprinted retention agreement during the lawyer and client’s first in-person meeting—once they have tentatively decided to hire a given lawyer.¹⁷⁰ And further, at the moment the retention agreement is signed, any interest deduction is extremely uncertain and exceedingly abstract. Indeed, obtaining any recovery at all is uncertain. If there is to be a recovery, its size is unknown and usually inestimable (as many lawyers will not

cient if just some consumers (“an informed minority”) understood their importance and “haggled” accordingly. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 144 (8th ed. 2011); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638 (1979). Even so, it is not clear that the “informed minority” will exist, or exert sufficient control, in this particular market. For an extended critique of the “informed minority model,” see Shmuel I. Becher, *Asymmetric Information in Consumer Contracts: The Challenge That Is Yet to Be Met*, 45 AM. BUS. L.J. 723, 736–54 (2008).

167. DOUGLAS E. ROSENTHAL, *LAWYER AND CLIENT: WHO’S IN CHARGE* 64–65 (1974) (reporting that, in a sample of fifty-nine Manhattan personal injury claimants, every single claimant “accepted the first lawyer who accepted them”); see also DEBORAH R. HENSLER ET AL., *COMPENSATION FOR ACCIDENTAL INJURIES IN THE UNITED STATES* 134 tbl.5.9 (1991) (reporting that 69% of those seeking legal representation in the aftermath of an accidental injury contacted only one attorney; only 5% contacted more than three attorneys).

168. See MACKINNON, *supra* note 41, at 187 (“While some claimants ‘shop around’ for a low, competitive price, this is the rare exception.”).

169. For more on personal injury clients’ relative lack of sophistication, see RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 35, cmt. b (1998) (“[I]t remains true that contingent-fee clients are often unsophisticated and inexperienced users of legal services . . .”). For the fact that most PI clients are retaining a lawyer shortly after injury, see INS. RESEARCH COUNCIL, *PAYING FOR AUTO INJURIES: A CONSUMER PANEL SURVEY OF AUTO ACCIDENT VICTIMS* 37 (2004) (reporting that 52% of auto accident claimants who retained counsel did so within one week of their accident). For the fact that most PI clients are retaining a lawyer for the first time in their lives, see Engstrom, *supra* note 150, at 673 (“Consumers in the PI marketplace are overwhelmingly one-shotters; few individuals are unlucky enough to sustain multiple tortiously inflicted personal injuries.”).

170. Most PI specialists have clients sign retention agreements at the first in-person meeting. KRITZER, *supra* note 45, at 115 tbl.4.1.

give clients even a ballpark estimate of how much they think the case is worth).¹⁷¹ And a deduction (itself of indeterminate size) from that (hypothetical) recovery would only take place (if at all) at some point in the (probably distant) future.

Below, I briefly recast the above concepts—the manner by which the information is conveyed and the uncertainty, delay, and manner of payment—in the language of behavioral economics and cognitive psychology to show why these characteristics are important. But the bottom-line point is simple and I think inescapable: Interest deductions are not apt to be salient to consumers of legal services.

i. Manner by which information is conveyed

First, the manner by which clients are apt to learn about interest deductions is significant. As noted, clients are only apt to learn about interest deductions when reading an attorney retention agreement, and a client reading a retention agreement has already, at least tentatively, decided to hire a given lawyer (remember, most clients sign up with the first lawyer who offers representation). Consequently, clients are apt to engage in what is sometimes called “motivated reasoning.” Engaged in motivated reasoning, they are apt to process provisions in the retention agreement “in a way that supports their desire to complete the transaction.”¹⁷² This desire may then be intensified by social forces, including the client’s interest in appearing nonconfrontational with a higher status individual who has proffered the preprinted contract—and with whom the client seeks to forge an extended relationship characterized by dependence, reliance, and trust.¹⁷³ Given these dynamics, it is perhaps no surprise that anecdotal evidence suggests that negotiation over provisions in a contingency fee contract is rare; most PI clients offer their assent to whatever terms the lawyer suggests.¹⁷⁴

171. See *id.* at 120 (stating that the lawyers he observed and spoke to “generally avoided talking about specific amounts of potential compensation during initial interviews or early in the case”).

172. Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 453 (2002).

173. See *id.* at 447–50 (discussing the important role social forces play in contract negotiation); see also Russell Korobkin, *The Borat Problem in Negotiation: Fraud, Assent, and the Behavioral Law and Economics of Standard Form Contracts*, 101 CALIF. L. REV. 51, 83–85 (2013).

174. See MACKINNON, *supra* note 41, at 21 (“In the usual case there is little negotiation over [the contingent fee contract’s] terms.”); Vonde M. Smith Hitch, Comment, *Ethics and the Reasonableness of Contingency Fees: A Survey of State and Federal Law Addressing the Reasonableness of Costs as They Relate to Contingency Fee Arrangements*, 29 LAND & WATER L. REV. 215, 245 (1994) (observing that “[o]ften clients accept whatever agreement an attorney suggests”); Eric M. Rhein, Comment, *Judicial Regulation of Contingent Fee Contracts*, 48 J. AIR L. & COM.

ii. Payment uncertain, not certain

Second, when assessing the salience of interest deductions, uncertainty is also important. Uncertainty looms large because, at the time of retention, no client can know whether interest will actually be charged on expenses. After all, interest will only be charged if there is a recovery (and it is always possible the case will be lost), and also if expenses mount (and it is always possible that the case will settle quickly, prior to the expenditure of significant sums).¹⁷⁵ Interest deductions are *never* assured. This matters because cognitive psychologists have identified what is sometimes called the “certainty effect”—“people overweight outcomes that are considered certain, relative to outcomes which are merely probable.”¹⁷⁶ Merely possible payments (like interest deductions) are excessively discounted—and their full import is obscured.

iii. Delayed, not immediate

Third, the timing of payment also matters. Even if charged, interest will not be deducted until the case is resolved, which is almost certainly no time soon. This delay implicates what behavioral economists sometimes call “myopia bias”—namely, “people value the avoidance of immediate or nearly immediate losses far more strongly than the avoidance of losses even in the not-too-distant future.”¹⁷⁷ Affected by myopia bias, individuals excessively discount (and thus insufficiently weigh) future costs, compared to near-term or immediate ones.

151, 167 (1982) (“Usually . . . there is little negotiation over the terms of the fee contract.”); accord WTC Hearing Transcript, *supra* note 2, at 11–12 (statement of Professor Anthony Sebok) (recognizing that “laypeople are not really looking carefully at retainer agreements”).

175. Overconfidence bias may further cloud client decision making. Many loans will be needed only if the case meets stiff resistance. But individuals are apt to be unjustifiably optimistic about how easily the case will be resolved. See generally George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135, 138 (1993).

176. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 265 (1979); see also Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 453–55 (1981); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974).

177. David A. Dana, *A Behavioral Economic Defense of the Precautionary Principle*, 97 NW. U. L. REV. 1315, 1324–25 (2003); accord Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 222 (1995) (“Actors systematically give too little weight to future benefits and costs as compared to present benefits and costs.”); George Loewenstein & Ted O’Donoghue, *“We Can Do This the Easy Way or the Hard Way”: Negative Emotions, Self-Regulation, and the Law*, 73 U. CHI. L. REV. 183, 189 (2006) (observing that people “generally have a hard time fully attending to future consequences”). See generally George Loewenstein & Drazen Prelec, *Anomalies in Intertemporal Choice: Evidence and an Interpretation*, in CHOICE OVER TIME 119 (George Loewenstein & Jon Elster eds., 1992).

iv. Deducted, not paid

Fourth and finally, the method of payment is also significant. When a PI claim is settled or otherwise satisfactorily resolved, a defendant will send a check to the plaintiff's lawyer. The plaintiff's lawyer will then invite the client to her office, where the lawyer will disburse to the client the client's portion of the ultimate recovery, after discharging any liens and deducting the lawyer's fee and expenditures (including, if interest is deducted, interest on those expenditures).¹⁷⁸ The client, in other words, never pays the lawyer interest; interest is instead subtracted from the client's recovery. These mechanics matter because research shows that people react to losses (actual expenditures) and foregone gains (reductions in the size of gains) very differently. Exhibiting what is often called "loss aversion," people consistently attach more disutility to losing a sum of money than failing to gain an identical sum, even controlling for wealth effects.¹⁷⁹ The fact that interest deductions will take the form of the latter is apt to blunt their salience.

The above discussion reveals that (1) in the past, a drop in lawyer inputs has not spurred a discernible reduction in contingency fee percentages; and (2) for a number of reasons, interest deductions are not apt to be salient to consumers of legal services. Two important lessons follow from those insights. First, the discussion suggests that if past is prologue—and if cognitive psychology and behavioral economics literature is to be believed—the deduction of interest is unlikely to be accompanied by a reduction in contingency fee percentages. Instead, if interest can be deducted, some banking and insurance services now embedded into the contingency fee are likely to be shed, and as contingency fee percentages remain constant, higher profits for PI lawyers are likely to prevail.¹⁸⁰ To be sure, higher profits are not necessarily

178. Baker & Silver, *supra* note 119, at 1848 ("When a plaintiff's attorney receives a settlement check, the lawyer normally deducts fees and reimbursable expenses and passes the remainder on to the client.").

179. See Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, J. ECON. PERSP., Winter 1991, at 193; Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1874 (1994); Kent W. Smith & Karyl A. Kinsey, *Understanding Taxpaying Behavior: A Conceptual Framework with Implications for Research*, 21 LAW & SOC'Y REV. 639, 648 (1987).

180. Admittedly, this begs another vexing question: If PI clients are unsophisticated, and if I am right that there is little price competition in the PI marketplace, *see supra* note 150 and accompanying text, why do lawyers need this new kind of financing in order to extract monopoly profits? Why don't they just hike their contingency fees to desired levels? To this question I offer three (concededly only partial) answers. First, external controls (such as formal fee caps and judicial supervision) exert some pressure on contingency fee percentages. See Hyman et al.,

disqualifying. Boosting profits for PI lawyers may, in fact, be socially desirable.¹⁸¹ But reflexively rubber-stamping what would be, in effect, higher profits for PI lawyers should give the public (which typically identifies excessive fees as a reason why it holds the legal profession in low regard¹⁸²), policymakers (who, in *many* states, have passed legislation specifically capping contingency fees¹⁸³), and judges (who have imposed fee caps *sua sponte* in recent quasi-class action litigation¹⁸⁴) cause for some concern.

Second, the above analysis reveals that clients will sign retainer agreements that give lawyers permission to deduct interest, but engaged in motivated reasoning and influenced by the certainty effect, myopia bias, and loss aversion, clients are likely to offer their assent while woefully underestimating the decision's real importance. Clients are, as Judge Hellerstein put it, apt to "sign . . . retainer agree-

supra note 8, at 10 tbl.2 (compiling state laws capping contingency fees). Second, Eyal Zamir and Ilana Ritov have, in experiments, found that many respondents believe it is unfair for lawyers to charge high contingency fees on a percentage basis, even when these fees yield rather low effective hourly rates. See generally Eyal Zamir & Ilana Ritov, *Notions of Fairness and Contingent Fees*, LAW & CONTEMP. PROBS., Spring 2011, at 1. Seeking to maintain their reputations for fair dealing, some lawyers might eschew contingency fee hikes, while embracing interest pass-throughs, as the latter might be perceived as more palatable. Third, though I argue above that contingency fees are less salient than other attorney fee generation mechanisms, see *supra* note 150, they are still likely more salient than interest deductions on (possible) expenses. The two types of fees, thus, might not be perfect substitutes. See *infra* note 248 (analogizing to the credit card context, where researchers have found that credit card issuers did not respond to limits on non-salient future fees by raising more salient short-term fees).

181. For example, higher profits are apt to encourage more tort litigation, and more tort litigation could be socially beneficial, providing compensation to more victims and deterring more accidents. See generally Richard L. Abel, *The Real Tort Crisis—Too Few Claims*, 48 OHIO ST. L.J. 443 (1987). Or, higher contingency fees might benefit existing plaintiffs by reducing principal-agent conflicts. See generally Michael McKee et al., *Contingent Fees, Moral Hazard, and Attorney Rents: A Laboratory Experiment*, 36 J. LEGAL STUD. 253 (2007) (showing, in a laboratory setting, that lawyer effort increases as contingent fees rise).

182. Indeed, the ABA Standing Committee on Ethics and Professional Responsibility has recognized that "lawyers are not generally regarded by the public as particularly ethical. One major contributing factor to the discouraging public opinion of the legal profession appears to be the billing practices of some of its members." ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 93-379 (1993). See also Gary A. Hengstler, *Vox Populi: The Public Perception of Lawyers: ABA Poll*, A.B.A. J., Sept. 1993, at 60, 63 (reporting on the results of a national poll which found that 59% of respondents believed that lawyers were "greedy" and 55% agreed that most lawyers "charge excessive fees").

183. See Hyman et al., *supra* note 8, at 10 tbl.2 (compiling a list of state legislation capping contingency fees).

184. In recent years, a number of judges have invoked the "quasi-class action" concept (explained in greater detail, *supra* note 131) while capping attorneys' fees, even in the absence of formal authority. See, e.g., *In re Vioxx Prods. Liab. Litig.*, 650 F. Supp. 2d 549, 564–65 (E.D. La. 2009). For context, see generally Morris A. Ratner, *Achieving Procedural Goals Through Indirection: The Use of Ethics Doctrine to Justify Contingency Fee Caps in MDL Aggregate Settlements*, 26 GEO. J. LEGAL ETHICS 59 (2013).

ments without thinking too much about what they mean.”¹⁸⁵ A sobering but profoundly important lesson follows from this insight: Client consent, which we typically count on to protect client welfare, is in this particular context apt to offer clients very little protection. I revisit this lesson in Part V, when considering how to chart a path forward.

C. *Rejoinders: In Defense of Interest Deductions*

The above concerns, I suggest, counsel caution when it comes to permitting or policing interest deductions. At the same time, however, there are three important countervailing arguments in interest deductions’ defense.

1. *Three Flavors of Fees, Only One Worrisome*

First, in evaluating the propriety of interest deductions, courts and commentators should recognize that interest pass-throughs, even when similarly structured, will not have an identical effect. To the contrary, they raise greater or lesser concerns depending on the underlying method of contingency fee calculation.

Contingency fee lawyers can calculate their fees in one of three ways. First, via what I call the “gross, no deduction” approach, a lawyer can calculate her fee from the client’s full recovery, then deduct expenses out of her own share, rather than her client’s.¹⁸⁶ Second, via the “net” approach, a lawyer can calculate her fee only after deducting all litigation expenses. Third, via what I call the “gross, client deduction” approach, a lawyer can again calculate her fee based on the client’s full recovery, but then deduct expenses out of the *client’s* share.¹⁸⁷ To illustrate, Table 2 depicts allocations under each scenario,

185. WTC Hearing Transcript, *supra* note 2, at 21.

186. This was the approach utilized by the law firm in the famous tax case *Boccardo v. Comm’r of Internal Revenue*, 56 F.3d 1016 (9th Cir. 1995). It does not appear, however, that this fee structure is frequently utilized.

187. Currently, Model Rule 1.5(c) permits the lawyer to deduct her contingency fee from the plaintiffs’ gross or net recovery, demanding only that the client be informed “whether . . . expenses are to be deducted before or after the contingent fee is calculated.” MODEL RULES OF PROF’L CONDUCT R. 1.5(c). In 1987, the ABA Action Commission to Improve the Tort Liability System advocated a net-recovery approach. Specifically, the Commission declared:

Courts should prohibit the practice of taking a percentage fee out of the gross amount of any judgment or settlement. Contingent fees should be based only on the net amount recovered after litigation disbursements such as filing fees, deposition costs, trial transcripts, travel, expert witness fees, and other expenses necessary to conduct the litigation.

ACTION COMM’N TO IMPROVE THE TORT LIAB. SYS., AM. BAR ASS’N, REPORT TO THE HOUSE OF DELEGATES 29 (1987). The Action Commission further explained:

assuming a \$100,000 gross recovery, with \$10,000 in case costs and a contingency fee of 33%.

TABLE 2: LAWYER AND CLIENT RECOVERIES UNDER
VARIOUS SCENARIOS

	To Lawyer	To Client
Gross, No Deduction	\$23,000	\$67,000
Net	\$29,700	\$60,300
Gross, Client Deduction	\$33,000	\$57,000

As Table 2 shows, the calculation approach matters—for lots of reasons, not least of which is the propriety of interest deductions. Under the gross, no deduction approach, after all, there is no deduction for costs and no interest pass-through, so the issue is moot. Under the net approach, meanwhile, interest deductions are still not particularly problematic: Because the lawyers' and clients' fortunes are bound together, the lawyer has a powerful built-in incentive to economize on interest, as well as other expenditures.¹⁸⁸ The problematic scenario is thus chiefly confined to the gross, client deduction approach, as it alone makes the client wholly responsible for expenses and thereby insulates the lawyer from the effects of exorbitant spending. The good news is that the approach is not permissible everywhere. Some states, including New York, Kansas, and New Jersey, demand that expenses be deducted before the contingency fee is calculated.¹⁸⁹ The bad news, though, is that the gross, client deduction approach is permissible in most states. Where it is permissible, it appears to be utilized by

The prohibition on applying contingent fees to gross judgments or settlements . . . is needed because clients rarely think about the difference between net and gross recoveries when they enter contingent fee agreements (or indeed even when a case is settled), and the difference can be quite substantial and seriously affect the ratio of the plaintiff's recovery to that of the attorney.

Id. This bold proposal was not adopted, however. Instead, the ABA's House of Delegates merely called for courts to "discourage the practice of taking a percentage fee out of the gross amount." *Proceedings of the 1987 Midyear Meeting of the House of Delegates*, 112 A.B.A. ANN. REP. 1, 39–40 (1987) [hereinafter *1987 ABA Proceedings*]. For withering criticism of the gross, client deduction approach, see generally Hodes, *supra* note 16.

188. See Ted Schneyer, *Legal-Process Constraints on the Regulation of Lawyers' Contingent Fee Contracts*, 47 DEPAUL L. REV. 371, 384 n.56 (1998) (discussing the gross-net distinction and observing that "[t]he net-recovery approach might motivate the lawyer to economize on the expenses that are advanced").

189. See KAN. RULES OF PROF'L CONDUCT R. 1.5(d) (2007); N.J. RULES OF COURT R. 1:21-7(d) (2004); N.Y. JUD. LAW § 474-a(3) (McKinney 2005).

the majority or vast majority of contingency fee practitioners.¹⁹⁰ And, again, when it is utilized, the lawyer has no independent financial incentive to rein in profligate spending.

2. *Reduced Agency Costs and Encouraged Investment*

The above analysis shows that we should be cautious in condemning all interest deductions. Sometimes, such as when “net” contingency fee agreements are utilized, they are not likely to pose much of a problem. Further, as we will now see, in some instances interest deductions may be downright beneficial, with the ability to reduce agency costs and encourage the optimal investment in litigation.

By tying the lawyer’s earnings to the existence and size of the client’s recovery, the contingent fee helps to align the incentives of the PI lawyer and client—and, in fact, this is one of the contingency fee’s principal advantages over available alternatives, such as hourly or fixed fees.¹⁹¹ Unfortunately though, the alignment is imperfect, as the contingency fee tempts some lawyers to skimp on case preparation.¹⁹² This temptation arises from the fact that clients who have agreed to pay a flat (non-tiered) contingency fee want as much attorney time as possible. The more time spent investigating facts, reviewing docu-

190. See Annand & Green, *supra* note 122, at 95 (“Almost without exception, plaintiffs’ attorneys’ fees are calculated from the *total* amount of the settlement or verdict *before* costs are taken into consideration.”); Wendel Aff., *supra* note 4, ¶ 17 (“In many states, the customary practice is to calculate fees on the gross amount.”); see also, e.g., KRITZER, *supra* note 45, at 41 (stating that, in his survey of Wisconsin practitioners, “the fee is usually described as being based on the gross recovery (i.e., before the lawyer is reimbursed for expenses),” although some lawyers, in practice, give clients more advantageous treatment); Baker & Silver, *supra* note 119, at 1857 & n.103 (describing “frequently seen” contingency fee contracts that provide for “a fee of 40% of any recovery, with litigation expenses to come out of the client’s share of the proceeds”). Indeed, some consider the gross, client deduction approach the default approach. Annotation, *Expenses Incurred by Attorney as Affecting Amount of His Compensation Under Contingent Fee Contract*, 116 A.L.R. 1244, 1245 (1938) (“Except where the contract specifically provides to the contrary, the courts generally take the view that . . . [the lawyer’s] percentage is to be computed upon the gross recovery, and that he is entitled to reimbursement from the share of his client for disbursements made by him.”). But see ABA Task Force, *CFs in Mass Torts*, *supra* note 31, at 123 (asserting, without citation: “In a typical contingent fee contract, the lawyers’ expenses come ‘off the top’ of any recovery. The fee is then calculated as a percentage of the award, net of those expenses.”); Robert N. Amkraut, Note, *Taxing Contingency Fee Attorneys as Investors: Recognizing the Modern Reality*, 71 WASH. L. REV. 745, 747 (1996) (asserting, without citation: “The most common contingency agreement provides for a ‘net fee.’”).

191. Aligning incentives is particularly important since the PI client, unlike the corporate client, has very little capacity to monitor her lawyer’s work or evaluate the case’s ultimate outcome. For more on these difficulties, see Engstrom, *supra* note 150, at 673 n.212.

192. To be sure, many attorneys will be able to resist this temptation, whether driven by reputational concerns, the personal satisfaction that comes from a job well done, a desire to comply with formal ethical mandates, or an urge to avoid potential liability for professional negligence.

ments, and drafting motions, the better. At the same time, though, attorneys have an incentive to devote time to a claim only up to the point where further investment is not profitable for the firm. Since the attorney is typically only entitled to a portion (roughly 33%) of the ultimate settlement or judgment, the attorney's optimal investment may be far below the investment desired by the client or needed to maximize the value of the case. In short, the attorney may be tempted to work too little and settle too soon—and this temptation is thought to be a real drawback of contingency fee financing. Indeed, it has been dubbed “the chief agency problem posed by percentage contingent fees.”¹⁹³

Although rarely discussed, expenses can exacerbate this familiar dynamic. Bearing the out-of-pocket cost of case preparation may, that is, tempt lawyers to spend too little, either because the opportunity cost of investment is too high (more could be earned if firm funds were invested in something other than *this* case's preparation) or because day-to-day cash-flow problems inhibit sufficient investment.¹⁹⁴ Indeed, facing cash-flow problems, some mass tort lawyers may pressure some unlucky clients to settle prematurely in order to generate income to finance the litigation for the rest of the client inventory—a practice Judge Jack Weinstein has dubbed “prim[ing] the pump.”¹⁹⁵

Regardless of who pays the tab, by injecting more money into PI litigation, lawyer lending may obviate these day-to-day cash-flow and “pump priming” concerns. But, without interest deductions, rapidly escalating costs and spiraling interest payments on those costs may

193. Schneyer, *supra* note 188, at 393. For more on this underinvestment incentive, see MacKinnon, *supra* note 41, at 198; Kevin M. Clermont & John D. Currihan, *Improving on the Contingent Fee*, 63 CORNELL L. REV. 529, 536–43 (1978); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 688–90 (1986); Murray L. Schwartz & Daniel J.B. Mitchell, *An Economic Analysis of the Contingent Fee in Personal-Injury Litigation*, 22 STAN. L. REV. 1125 (1970). Of course, when discussing “premature settlements,” it should be noted that the decision whether to settle is formally reserved for the client. But, in reality, lawyers powerfully influence client decision making. See, e.g., ROGER BRYANT HUNTING & GLORIA S. NEUWIRTH, *WHO SUES IN NEW YORK CITY?: A STUDY OF AUTOMOBILE ACCIDENT CLAIMS* 108 (1962) (“When it came to settlement, most frequently it was the lawyer who decided which offer would be accepted and when.”).

194. See Burch, *supra* note 29, at 1294 (“Given aggregate litigation's expense, a real danger exists that the contingent-fee attorney may run out of resources with which to prosecute the case. Consequently, she might cut corners in critical areas”); see also Michael Jonathan Grinfeld, *Justice on Loan: It's Not Heartstrings but Purse Strings that Determine the Fate of Big Consumer Cases*, CAL. LAW., July 1999, at 38, 41 (quoting California lawyer Ned Reilly: “The biggest danger from my perspective is that there are a number of lawyers out there who are willing to sell their clients down the river because they don't have the money.”).

195. JACK B. WEINSTEIN, *INDIVIDUAL JUSTICE IN MASS TORT LITIGATION: THE EFFECT OF CLASS ACTIONS, CONSOLIDATIONS, AND OTHER MULTIPARTY DEVICES* 77 (1995).

still tempt some lawyers to settle cases prematurely.¹⁹⁶ To make the point concrete: If the lawyer must pay a lender a \$10,000 financing charge every month a case remains pending, the prospect of next month's \$10,000 charge might induce the lawyer to pressure the client to accept today even a lowball offer of settlement. On the other hand, the ability to pass interest charges along to clients may *reduce* the lawyer's temptation to settle too quickly, reducing principal-agent problems and better aligning lawyer and client incentives.

3. Access to Justice

A third advantage of interest deductions is that they may encourage more lawyers to initiate certain risky and resource-intensive claims, thus ameliorating a problem that plagues certain segments of the personal injury marketplace.¹⁹⁷

Far better than flat or hourly fees, the contingency fee provides a "key to the courthouse" for many who, whether due to impecuniousness or risk aversion, would in its absence have no practical access to the rights and remedies the law provides.¹⁹⁸ Yet, just as we saw above that the contingency fee aligns lawyer and client interests, though only imperfectly, here we see that the contingency fee provides access, though only partially. Most notably, because the contingency fee effectively limits what lawyers can earn (the fee on a case with \$100,000 in damages maxes out around \$40,000¹⁹⁹), a downside of the contingency fee is that it "discourages the bringing of small, meritorious claims"—particularly if the case is high risk and involves substantial out-of-pocket investment.²⁰⁰

196. See Molot, *supra* note 17, at 101 ("A law firm paying interest on an outstanding loan, like a plaintiff who has received a cash advance, will have a strong incentive to settle early and repay its debt from the proceeds.").

197. Of course, encouraged claims will not *necessarily* be meritorious. If many are not, this "advantage" could end up being a drawback.

198. Philip H. Corboy, *Contingency Fees: The Individual's Key to the Courthouse Door*, 2 LITIG., Summer 1976, at 27; see Richard M. Birnholz, Comment, *The Validity and Propriety of Contingent Fee Controls*, 37 UCLA L. REV. 949, 953 (1990) ("The most often cited justification for the contingency fee is that it allows access to the courts to those who lack the means to pay a lawyer's hourly fees.").

199. Contingency fees exceeding 40% are rare. U.S. GEN. ACCOUNTING OFFICE, GAO/HRD-87-55, MEDICAL MALPRACTICE: CHARACTERISTICS OF CLAIMS CLOSED IN 1984, at 48-49, 49 tbl.3.10 (1987) (reporting that, out of a sample of 16,348 medical malpractice claims, attorneys in only 610 claims (or 3.8% of the sample) charged contingency fees exceeding 40%). In states that have imposed statutory caps on contingency fees, a lawyer's maximum compensation is lower still, presumably exaggerating the dynamics discussed herein. See, e.g., CAL. BUS. & PROF. CODE § 6146(a) (West 2012) (limiting contingency fee awards, pursuant to a sliding scale, in "connection with an action for injury or damage against a health care provider").

200. Clermont & Currivan, *supra* note 193, at 573.

These days, the above dynamics have particular bite in the medical malpractice marketplace.²⁰¹ Medical malpractice cases are very risky (only about a quarter of claims succeed at trial), and they require hefty investments (reliant on highly compensated experts, readying a typical medical malpractice case for trial requires nearly \$100,000, not counting attorney time).²⁰² Thus, as one might expect, when damages are small, or even moderate, medical malpractice victims have a very difficult time finding competent counsel. Indeed, Joanna Shepherd recently conducted a national survey of plaintiffs' attorneys to explore medical malpractice victims' access to the civil justice system.²⁰³ In the course of this survey, lawyers with experience representing medical malpractice plaintiffs were asked whether they would accept a medical malpractice case with less than \$50,000 in damages, even if the case was a sure thing (with a 95% likelihood of success). Only 1.18% of Shepherd's 259 plaintiffs' attorney respondents said yes. In fact, most lawyers would not even accept a slam dunk case with less than \$250,000 in damages. And when the case's likelihood of success dropped, lawyers' selectivity soared. With a 51% chance of success, most lawyers would not accept any case below a \$500,000 damage threshold.²⁰⁴

Shepherd's survey data mirror the picture from other reliable sources: Many medical malpractice victims who sustain minor, or even moderate, injuries can find no lawyer, and as a consequence, only a small proportion of meritorious medical malpractice cases make their way into court.²⁰⁵ According to the ABA Task Force on Contingent

201. Non-asbestos product liability suits also exhibit these attributes. Like medical malpractice cases, product liability cases are pricey to prepare, *see supra* note 39, and are more often lost than won. *See* LYNN LANGTON & THOMAS H. COHEN, BUREAU OF JUSTICE STATISTICS, U.S. DEP'T OF JUSTICE, CIVIL BENCH AND JURY TRIALS IN STATE COURTS, 2005, at 4 & tbl.5 (2009), available at <http://bjs.ojp.usdoj.gov/content/pub/pdf/cbjtsc05.pdf> (reporting that plaintiffs won only 20% of non-asbestos product liability trials). Thus, though the product liability literature is not as developed, it seems likely that those with small to mid-sized product liability suits are also priced out of the PI marketplace.

202. For trial success, *see* LANGTON & COHEN, *supra* note 201, at 3–4. For the high cost of preparing medical malpractice claims, *see supra* note 39.

203. *See* Shepherd, *supra* note 39; *see also* Nora Freeman Engstrom, *Bridging the Gap in the Justice Gap Literature*, JOTWELL (May 6, 2013), <http://torts.jotwell.com/bridging-the-gap-in-the-justice-gap-literature/>.

204. Shepherd, *supra* note 39 (manuscript at 36 tbl.14).

205. *See* PETER A. BELL & JEFFREY O'CONNELL, ACCIDENTAL JUSTICE: THE DILEMMAS OF TORT LAW 10 (1997) ("Many plaintiffs' tort lawyers will not represent a claimant in a products liability or medical malpractice case . . . unless the client has injury claims worth more than \$100,000 This means that many persons with significant but not crushing injuries will not be able to get a lawyer, even if the law would eventually grant them compensation."); Stephen Daniels & Joanne Martin, *Plaintiffs' Lawyers, Specialization, and Medical Malpractice*, 59 VAND.

Fees, “Only about one out of fifty valid medical malpractice events in this country is ever made the subject of a claim for injury.”²⁰⁶

The above indicates there’s a problem that plagues the personal injury marketplace: Some injury victims who are legitimately hurt and who are entitled by law to compensation cannot secure legal representation. This, again, is a problem that lawyer lending could ameliorate. Even without deductions, lawyer loans offer a mechanism to offload some expense, and also (if nonrecourse loans are utilized) some risk, currently on lawyers’ shoulders onto lenders’ shoulders. The ability to share these expenses and this risk should reduce lawyers’ justifiable fear of high-cost, high-risk representation. Further, specifically permitting the passing of interest onto clients is a way to compensate, or at least not disadvantage, the lawyers who actually roll up their sleeves and make substantial out-of-pocket investments.²⁰⁷ Moreover, if lawyer loans and interest deductions become commonplace, it is likely more lawyers will be able and willing to offer medical malpractice clients legal representation, possibly increasing the pool of legal talent available.

V. WHERE DO WE GO FROM HERE?

Part IV reviewed interest deductions from both a formalist and a functionalist perspective and concluded that these deductions are a mixed blessing. While the deduction of interest admittedly does not violate any relevant Rule (provided the client consents in the retainer agreement, the interest charged is itself “reasonable,” and so forth), rubber-stamping the deduction of interest is nevertheless problematic. Interest deductions: (1) raise a number of difficult ethical questions that defy easy resolution; (2) are likely to increase transaction costs, further burdening an already expensive system and further depleting plaintiffs’ recoveries; and (3) may be a backdoor way to increase lawyer profits at client expense. But Part IV also offered three practical

L. REV. 1051, 1064 (2006) (“[S]pecialists are unlikely to take low-value cases even if there is evidence of malpractice.”).

206. TASK FORCE ON CONTINGENT FEES, AM. BAR ASS’N TORT TRIAL & INS. PRACTICE SECTION, REPORT ON CONTINGENT FEES IN MEDICAL MALPRACTICE LITIGATION 3 (2004); *accord* Jennifer Arlen, *Reality Check: How Malpractice Facts Changed Malpractice Liability Theory*, in 2011 EMPIRICAL STUDIES OF JUDICIAL SYSTEMS (Yun-chien Chang ed., forthcoming 2014) (manuscript at 12) (identifying “under-claiming by patients injured by medical negligence” as one of two “core problems plaguing the malpractice system”). Of course, the unavailability of counsel is just one of several explanations for this low rate of claiming.

207. As it is, recall, lawyers who extend significant advances are subjected to harsh tax treatment, take on extra risk in the event of defeat, and incur an opportunity cost; by sinking funds into ongoing cases instead of investing those monies elsewhere, they sacrifice the interest they would have otherwise earned.

reasons why we might not want to condemn interest deductions entirely: (1) not all retainer agreements that allow for the deduction of interest are created equal—meaning that “gross, client deduction” contracts should be the target of our concern; (2) the deduction of interest may, in some instances, reduce principal-agent problems, encouraging the lawyer’s optimal investment in litigation and deterring premature settlements; and (3) interest deductions may encourage the litigation of certain meritorious but risky and resource-intensive claims.²⁰⁸

A. *Five Possible Policy Alternatives*

Having mapped these various considerations, this final Part turns to the prescriptive analysis: what ought to be done. In charting a path forward, a wide range of options exists on the continuum from simply allowing interest deductions with minimal oversight (the approach adopted by most ethics committees so far) to outright banning, with lots of options in between. Below, in subpart A, I set forth five possible alternatives on this continuum and sketch some advantages and disadvantages of each. Then, in subpart B, I conclude by offering my own proposal for how interest deductions ought to be regulated.

1. *Laissez Faire Approach*

Starting at the libertarian end of the continuum, the first option is a “laissez faire approach.” This approach entails blessing deductions as long as the interest charged is reasonable, interest is only charged on loans utilized to fund legitimate case expenses, the client consents to the deduction in the retainer agreement after being apprised of the arrangement’s terms, and the statement given to the client at the case’s conclusion accurately reflects the interest charged on expenses advanced.²⁰⁹

This laissez faire approach has four principal advantages. First, it is the prevailing approach, adopted by most ethics committees so far. Thus, to the extent there is anything like governing “precedent” in this area, that precedent is followed. Second, the approach sets forth a fairly clear and easily administered rule. Lawyers will know, in advance, what their duties are vis-à-vis clients, and judges will not become interest deduction referees. Third, the laissez faire approach

208. These are not the only reasons not to ban interest pass-throughs. Others are discussed below.

209. As discussed in Part IV.B.1, some state ethics committees appear to omit this “retainer agreement” qualifier. I include it here, however, because I believe it is both required by Model Rule 1.5 and practically beneficial.

implicitly recognizes that, since the cost of financing is real, it should be treated like any other expense of litigation—which is to say, subtracted from client recoveries. To single financing charges out for disparate treatment is, one might argue, anomalous—and potentially inefficient.²¹⁰ Fourth and finally, the approach respects freedom of contract. Absent fraud or unconscionability, that is, courts typically enforce contracts, and respecting contracts is thought to be (generally) socially beneficial. Rational actors, the thinking goes, do not enter into agreements that leave them worse off, so voluntary agreements produce mutual gains.²¹¹ Given that backdrop, if the attorney and client agree that the attorney might take out a litigation loan and further agree that if a loan is obtained the client will bear responsibility for interest charges thereon, there is an argument that judges and policy-makers should not meddle in the parties' judgment.

But there are also disadvantages to this *laissez faire* approach. First and most obviously, the approach green-lights interest deductions even though, as discussed above, these deductions raise a number of unresolved ethical issues and could be quite harmful for clients.

A second problem is that the *laissez faire* approach elevates freedom of contract, but freedom of contract in this sphere has never been sacrosanct. To the contrary, courts, legislatures, and bar disciplinary authorities have *always* had a say in how agreements between lawyers and clients are drafted, structured, and enforced. Indeed, lawyers and clients might want to enter into contingency fee arrangements in divorce and criminal defense cases—but they can't, stymied by Rule 1.5(d).²¹² Lawyers and clients might decide that the client should surrender the right to control settlement—but they can't, stymied by Rule 1.2(a).²¹³ Lawyers and clients might want the attorney's compensation to come in the form of movie rights—but they can't, stymied by Rule 1.8(d).²¹⁴ Lawyers and clients might want to agree, in advance, to bind the client to an aggregate settlement—but they can't, stymied by Rule 1.8(g).²¹⁵ Further, irrespective of client consent, most states won't permit the attorney to increase her contingency fee once

210. See HARVEY S. ROSEN, PUBLIC FINANCE 323–25 (7th ed. 2005) (explaining that the differential taxation of inputs is socially inefficient); cf. *infra* note 248 (noting that, in the credit card context, Congress has clamped down on non-salient fees, to apparently positive effect).

211. See Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 284 (1995) (describing the “efficiency argument” which presumes that contracts improve the well-being of both parties).

212. MODEL RULES OF PROF'L CONDUCT R. 1.5(d) (2013).

213. *Id.* R. 1.2(a).

214. *Id.* R. 1.8(d).

215. *Id.* R. 1.8(g).

the representation is underway.²¹⁶ No matter the client's position, statutory contingency fee caps limit what attorneys can charge.²¹⁷ And, even absent a statutory cap, "excessive" or "unreasonable" fees have long been prohibited—and contingency fees, generally, have long been scrutinized.²¹⁸ It thus seems odd to defer to the parties' preferences in the interest deduction arena while overruling party preferences in many other roughly analogous contexts.²¹⁹

Moreover, there is an argument that, if we are inclined to set aside client preferences in some contexts, doing so in this context makes particular sense. The "bargain principle," which undergirds our deference to contracts, "itself, rest[s] on the empirical premise that in making a bargain a contracting party will act with full cognition to rationally maximize his subjective expected utility."²²⁰ But here, that "empirical premise" is dubious. There is, instead, ample reason to doubt client cognition and rationality. As previously noted, most personal injury clients are unsophisticated, most are hiring a lawyer shortly after injury, and most are hiring a lawyer for the first time in their lives.²²¹ Given their inexperience and vulnerability, they are unlikely to carefully scrutinize or comprehend even a very clear statement set forth in a retainer agreement about the deduction of interest on case expenditures. Furthermore, as also previously discussed, behavioral economics and cognitive psychology literature teaches that whether to permit the deduction of interest is exactly the kind of decision that is apt to be distorted by predictable biases. Engaged in motivated reasoning and influenced by the certainty effect, myopia bias,

216. See *supra* note 119.

217. See *supra* note 183.

218. MODEL RULES OF PROF'L CONDUCT R. 1.5; see also, e.g., Wunschel Law Firm, P.C. v. Clabaugh, 291 N.W.2d 331, 334 (Iowa 1980) ("[T]he courts have authority to monitor and determine the reasonableness of contingent fee contracts under their inherent power to regulate the bar."); Tonn v. Reuter, 95 N.W.2d 261, 265 (Wis. 1959) ("A contingent fee contract is always subject to the supervision of the court as to its reasonableness."); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 35 cmt. b (1998) ("[C]ourts scrutinize contingent fees with care in determining whether they are reasonable."); SPECIAL COMM. ON THE TORT LIAB. SYS., AM. BAR ASS'N, TOWARDS A JURISPRUDENCE OF INJURY: THE CONTINUING CREATION OF A SYSTEM OF SUBSTANTIVE JUSTICE IN AMERICAN TORT LAW 6-35 (1984) ("[E]ven without formal rules, courts can provide and have exercised significant supervisory power over the fairness of fees."). Indeed, courts' supervisory authority has been well established for over a century. See CANONS OF PROF'L ETHICS Canon 13 (1908) ("A contract for a contingent fee where sanctioned by law, should be reasonable under all the circumstances of the case, including the risk and uncertainty of the compensation, but should always be subject to the supervision of a Court, as to its reasonableness.").

219. Schneyer, *supra* note 188 (collecting some of these examples); Joseph M. Perillo, *The Law of Lawyers' Contracts Is Different*, 67 FORDHAM L. REV. 443 (1998) (same).

220. Eisenberg, *supra* note 177, at 212.

221. See *supra* note 169.

and loss aversion, prospective clients are likely to accede to the lawyer's request without even the faintest clue of the decision's true import.

Nor are these concerns merely theoretical. For a concrete example, consider again the World Trade Center Disaster Site Litigation. In that litigation, as Judge Hellerstein challenged the attorneys' proposed deduction of interest, it became clear that, though paperwork clients had signed at the start of the case included a warning that the lawyers might borrow money and bill clients for associated charges, the \$6.1 million deduction still took many by surprise.²²² Defending his conduct, Paul Napoli indignantly replied: "We followed the rules. Do people want to have it sky-written over their house every day? . . . They didn't read it. Or maybe they didn't care at the time."²²³ Paul Napoli *did* follow the rules—and his clients were nevertheless caught unaware. That is, I suggest, entirely predictable and precisely the problem.

In sum, when confronted with how to regulate the deduction of interest, most authorities have opted for a *laissez faire* approach. But though it has some important advantages, this approach is also susceptible to criticism: It ignores various problems with interest deductions cataloged above. It defers to the attorney-client contract, even though there is a strong reason to suspect lawyer opportunism and simultaneously doubt client cognition. And in deferring so completely to the client contract, notwithstanding these concerns, the approach is inconsistent with analogous instances when the Model Rules override client consent—and, for that matter, the approach is also at odds with many other instances within contract law more generally, where courts nullify contracts when one party's consent is apt to be infected by one or more well-known cognitive biases.²²⁴ It is thus, I suggest, probably not ideal.

222. Appelbaum & Hallman, *supra* note 68; Joseph Goldstein & Susan Edelman, *Assembly Speaker Sheldon Silver's Firm Gets Cut of 9/11-Suit Payouts*, N.Y. POST, Aug. 22, 2010, at 5 ("Workers said they had no knowledge of the loans and no idea they would be socked with the interest charges. Some were stunned when they opened their settlement-proposal letters last month to learn their awards would be slashed by hundreds to thousands each.").

223. Appelbaum & Hallman, *supra* note 68 (quoting Paul Napoli); *see also* Napoli Bern, *Statement to Our Clients*, *supra* note 30 (stating that clients had been warned that deducted charges might "include interest on funds borrowed to finance the litigation," and continuing: "If you review the retainer agreement (contract) you signed when you retained our office for this litigation, you will see the information there.").

224. *See* Eisenberg, *supra* note 177 (suggesting that contracts are often nullified when one party's consent is apt to be infected by one or more well-known cognitive biases and providing examples of liquidated damages provisions, door-to-door sales contracts, and certain form contracts); *see also* Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Uncon-*

2. *Business Transaction Approach*

A second, marginally more protective approach is to continue to permit interest deductions but hold that charging a client interest should be treated as a business transaction between the lawyer and the client, subject to the requirements and protections of Model Rule of Professional Conduct 1.8(a). Triggering Rule 1.8(a): (1) the transaction's terms must be objectively "fair and reasonable to the client"; (2) the terms must be "fully disclosed" to the client and conveyed "in a manner that can be reasonably understood"; (3) the client must be advised of the "desirability of seeking" independent counsel about the transaction and given a "reasonable opportunity" to seek such counsel; and (4) the client must offer consent to the transaction in writing.²²⁵

There is precedent for holding that interest deductions fall within Rule 1.8(a)'s ambit. At least one state ethics committee has imposed the safeguard, as does the *Restatement*.²²⁶ And, though it's true that interest deductions are not *obviously* "business transactions" as the phrase is commonly understood and typically applied, triggering Rule 1.8(a) nevertheless seems sensible.

The *Restatement* offers the following justification for imposing special restrictions on attorney-client transactions:

A lawyer's legal skill and training, together with the relationship of trust that arises between client and lawyer, create the possibility of overreach[] Furthermore, a lawyer who engages in a business transaction with a client is in a position to arrange the form of the transaction or give legal advice to protect the lawyer's interests rather than advancing the client's interests.²²⁷

scionability, 70 U. CHI. L. REV. 1203, 1207 (2003) ("When a contract term is salient to purchasers, the market can be trusted to provide an efficient version of the term When a contract term is non-salient to most purchasers, the market check on seller overreaching is absent, and courts should be suspicious of the resulting term.").

225. MODEL RULES OF PROF'L CONDUCT R. 1.8(a) (2013).

226. Specifically, the *Restatement* cautions that a lawyer may advance the costs and expenses of litigation, with the client to repay the advance, but if a lawyer seeks to impose on the client "more extensive" obligations, including a payment of "interest," the transaction implicates section 126. Like Rule 1.8(a), section 126 bars a lawyer from participating in a business transaction with a client unless the client is fully informed, the transaction is objectively "fair and reasonable," and the client is "encouraged, and given a reasonable opportunity, to seek independent legal advice concerning the transaction." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 126 (1998); cf. *id.* § 36 cmt. c. For a state ethics opinion invoking Rule 1.8(a), see Ky. Bar Ass'n Comm. on Ethics and Unauthorized Practice of Law, Legal Ethics Op. E-420 (2002). Cf. Ohio Bd. of Comm'rs on Grievances & Discipline, Op. 2001-3 (2001) ("A law firm's decision to obtain a loan from a third party financial institution does not involve the lawyer in a business transaction with a client, provided that the loan is not secured by the client's settlement or judgment.").

227. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 126 cmt. b.

Applying that justification—if special safeguards are needed when circumstances “create the possibility of overreach” and the lawyer may be tempted to advance her own pecuniary interest at the expense of her client—there is a strong argument that special safeguards ought to be imposed in the lawyer lending context. Indeed, the very decision to take out a loan can involve these dynamics. A lawyer who takes out a loan may have the option to instead forge a relationship with co-counsel. The latter entails ceding to co-counsel a portion of the lawyer’s contingency fee; the cost of the former can be shifted to clients. The choice is fraught and the temptation is obvious. Likewise, when selecting a lender, lawyers face another fraught choice. As noted, lawyers can opt for a lender that offers (more expensive) non-recourse loans or (less expensive) recourse loans. Nonrecourse loans are better for lawyers; unlike recourse loans, these loans need not be repaid in the event of defeat.²²⁸ But recourse loans are cheaper for clients. The lawyer must decide whether to advance her own financial interest or safeguard her client’s financial interest—clearly implicating the rationale of Rule 1.8(a).

Additionally, apart from the fact that applying Rule 1.8(a) accords with the Rule’s underlying justification, compelling lawyers to step through its hoops also makes practical sense. Though admittedly not as effective as Napoli’s proposed “sky-writing,” warning clients that the deduction decision is so important that it may be wise to seek the advice of “independent legal counsel” is apt to encourage marginally greater attentiveness. Further, the Rule contains a powerful substantive safeguard. As noted, it obligates covered transactions to be “fair and reasonable.” In policing that restriction, courts hold that if the lawyer and client have entered into a business transaction and the client subsequently challenges the transaction’s substantive fairness, standard burdens are flipped. The client does not have to show overreach; rather, the lawyer must “establish that the transaction was fair and conducted in good faith.”²²⁹ Indeed, some courts go further, requiring the lawyer to prove the transaction’s substantive fairness by

228. Remember, unless the retainer agreement provides otherwise, the client is apt to be indifferent to this repayment. *See id.* § 38 cmt. e (“Under a contingent-fee contract . . . a client who does not prevail is not liable to the lawyer for court costs and litigation expenses, unless the client agreed to pay them or nonrefundable advances by the lawyer of such costs and expenses are unlawful in the jurisdiction.”). For more on a client’s liability for court costs and litigation expenses in the event of defeat, see *supra* note 41.

229. *Estate of Short*, 785 P.2d 1167, 1170 (Wyo. 1990); *see also Hunnicutt v. State Bar*, 748 P.2d 1161, 1167 (Cal. 1988) (“When an attorney-client transaction is involved, the attorney bears the burden of showing that the dealings between the parties were fair and reasonable and were fully known and understood by the client.”).

“clear and convincing evidence.”²³⁰ The possibility of such scrutiny is bound to cause a lawyer contemplating an interest deduction to think hard about the transaction’s substantive terms—and induce her to steer clear of any financing arrangement that would unduly deplete the client’s ultimate recovery.²³¹

Nevertheless, while Rule 1.8(a)’s safeguards may be both doctrinally justifiable and practically beneficial, there is a strong argument that they still offer clients insufficient protection.

3. *Veto Approach*

Following the lead of Judge Hellerstein in the World Trade Center Disaster Site Litigation, a third, somewhat more protective approach would be to permit deductions (either with or without Rule 1.8(a) protections), while encouraging courts to review contingent fees and expenses for reasonableness at the conclusion of each case when interest deductions are in the offing.

There are numerous advantages to this case-by-case, after-the-fact “veto” review. For starters, it should be uncontroversial. Notwithstanding parties’ freedom of contract, it is well established that courts have inherent authority to review contingency fee agreements for reasonableness.²³² Further, the veto approach avoids one-size-fits-all treatment; courts could disallow interest deductions only when they are unreasonable under the circumstances. And perhaps best of all, the approach promises to match the *need* for judicial involvement with the *ease* of judicial involvement. That is, interest charges are apt to be high in cases with substantial expenditures; cases with substantial expenditures are bound to be cases that have been aggressively litigated; and cases that have been aggressively litigated are bound to be precisely the cases judges know well.²³³

230. See, e.g., *K.M.A. Assocs., Inc. v. Meros*, 452 So. 2d 580, 581 (Fla. Dist. Ct. App. 1984) (“Business transactions between attorney and client are subject to the closest scrutiny. The burden is placed upon an attorney to establish by clear and convincing evidence the fairness of an agreement or transaction purporting to convey a property right from a client to his attorney.” (quoting *Smyrna Developers, Inc. v. Bornstein*, 177 So. 2d 16, 18 (Fla. Dist. Ct. App. 1965))); see also CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* § 8.11.3 (1986).

231. See Roy Ryden Anderson & Walter W. Steele, Jr., *Ethics and the Law of Contract juxtaposed: A Jaundiced View of Professional Responsibility Considerations in the Attorney-Client Relationship*, 4 GEO. J. LEGAL ETHICS 791, 796 (1991) (observing that Rule 1.8(a) is “calculated” to “chill[]” attorney-client transactions).

232. See *supra* note 218 (collecting citations).

233. By contrast, in the typical contingency fee context, fees are apt to be unreasonably high in cases that settle quickly and require little attorney investment. Those cases are apt to be ones without significant judicial involvement; in fact, many such cases are likely to be resolved without the initiation of suit. Cf. Engstrom, *supra* note 148, at 845–49 (questioning the fees charged

But still there are drawbacks. For one, past experience cautions that judges might be reluctant to exercise their supervisory authority—and thus may fail to offer clients sufficient protection. As noted above, judges have long had the power to review contingency fee contracts. But, in practice, it is a power few have exercised.²³⁴ Further, even if judges *were* to start reviewing fees and expenses for reasonableness, such case-by-case, after-the-fact scrutiny is hardly ideal. If consistently undertaken, such review would impose heavy demands on scarce judicial resources.²³⁵ The review would pose problems from a legal process perspective, as it would require judges to decide whether a plaintiffs' lawyer's fee and expense package is acceptable, typically without any detailed standard to apply, clear precedent to follow, or adversarial presentation of evidence to sharpen the issues for decision.²³⁶ It would inevitably lead to horizontal inequity, as judges are almost certain to differ in their willingness to green-light these agreements. And, perhaps worst of all, because such a veto would come so late in the game, this *ex post* review would invariably deny plaintiffs' lawyers the predictability needed for budget and planning purposes.

4. License Approach

Recognizing that the after-the-fact veto approach is susceptible to criticism, a fourth, somewhat more protective alternative is to impose what I will call a "license" approach.²³⁷ This approach borrows from

by "settlement mills"—i.e., high volume, heavy advertising PI law firms that resolve claims quickly, often without formal litigation).

234. See Schneyer, *supra* note 188, at 399 ("[T]he fact is that trial judges almost never initiate such reviews in the cases before them."); Lester Brickman, *Contingency Fee Abuses, Ethical Mandates, and the Disciplinary System: The Case Against Case-by-Case Enforcement*, 53 WASH. & LEE L. REV. 1339, 1351 n.49 (1996) ("[W]ith the exception of class actions, judicial scrutiny of contingency fees today . . . is receding to the point of irrelevance.").

235. See Schneyer, *supra* note 188, at 400 (observing that "judicial scrutiny of contractual contingent fees on any significant scale would make overwhelming demands on judicial resources").

236. *Id.* at 399–400 (making this point and observing that judges typically rely on the adversarial presentation of evidence "to reach sound decisions"). Most cases are resolved by settlement, so by the time expenses are reviewed, the interests of plaintiffs' counsel and defendants are roughly aligned. Meanwhile, clients will only rarely have the sophistication or inclination to raise an after-the-fact objection. *Cf.* WTC Pls.' Memo, *supra* note 1, at 2–3 (representing that "of the releases received thus far from our clients, all have accepted this expense"). Further complicating these inquiries from a legal process perspective, there is some question whether lawyers would breach their fiduciary duties in defending their own interest deduction, if the client would be better off in the deduction's absence. For consideration of this difficult question in an analogous context, see generally Baker & Silver, *supra* note 119.

237. Another possible approach straddles the veto and license approaches described above. That is, policymakers could *require* (rather than merely encourage) judges to review and approve contingency fee agreements whenever interest is deducted. There is some precedent for such obligatory review. See, e.g., *In re Estate of Sass*, 616 N.E.2d 702, 705 (Ill. App. Ct. 1993) ("[T]he trial court must carefully scrutinize any contingency fee agreement that is applied to a

the *Manual on Complex Litigation*. The *Manual* provides that, when reimbursement will be sought for unusual expenditures—here, the *Manual* gives the example of “special computer installations, costly expert services, or elaborate trial exhibits or demonstrations”—plaintiffs’ counsel “should advise the court . . . and obtain clearance before incurring the expenses.”²³⁸ Adopting the *Manual*’s framework, states could require that lawyers who plan to deduct interest charges from client recoveries first obtain judicial permission.

This license approach has some points in its favor. First, it would avoid a few unwelcome surprises: Lawyers would know whether interest deductions would be permitted before interest charges are incurred. Additionally, the burden of seeking judicial clearance could deter the *reflexive* charging of interest; lawyers presumably would not charge their clients interest, and subject themselves to judicial scrutiny, save when there is a legitimate need. Further, because the judge’s approval would have to be obtained before interest charges could be incurred, the license approach necessarily compels lawyers to disclose funding arrangements to judges early on. This disclosure would empower judges to supervise the litigation with an eye toward broadly protecting client interests (to ensure, for example, not only that the deduction is reasonable and fees are fair, but also that client confidences are preserved and the lawyer’s loyalty remains undivided).²³⁹ Finally, because judges *must* act in order to approve the lawyer’s request, this approach minimizes the possibility of benign judicial neglect. If a license is required, in other words, judges could grant the lawyer’s request or deny the lawyer’s request; unlike in the

minor.”); *Abel v. Tisdale*, 619 P.2d 608, 611 (Okla. 1980) (“We hold that in a wrongful death action, a trial judge must review, and set, if necessary, a reasonable attorney’s fee to be assessed against a minor’s portion of the settlement proceeds.”); ARIZ. UNIFORM RULES OF PRACTICE FOR MED. MALPRACTICE CASES R. 3 (1990) (requiring lawyers to submit a fee-and-expense statement to the trial court upon the conclusion of a medical malpractice action and obligating the judge to either approve the fees and expenses or set the matter for further proceedings within ten days) (repealed Oct. 10, 2000); *cf.* FED. R. CIV. P. 23(h) (granting judges power to “award reasonable attorney’s fees and nontaxable costs” in certified class actions). Yet still, this approach is susceptible to criticism, for many of the reasons set forth above.

238. MANUAL FOR COMPLEX LITIGATION (FOURTH) § 14.221, at 203 (2004). The *Manual* also explains that opposing counsel should be alerted, but for reasons explained *infra* at note 244, advising opposing counsel probably is not desirable.

239. Judge Jack Weinstein has long advocated early disclosures to facilitate judicial supervision. See Jack B. Weinstein, *The Democratization of Mass Actions in the Internet Age*, 45 COLUM. J.L. & SOC. PROBS. 451, 470 (2012) (“[T]he court should be made aware of any third-entity financing arrangements as soon as possible. This will allow the court to better supervise the litigation on an ongoing basis to ensure that client interests are not compromised.”); see also WEINSTEIN, *supra* note 195, at 77 (“No matter how the case is financed, all financial arrangements should be revealed in advance to the court.”).

veto realm, judges could not simply sit on the sidelines, ignoring the matter entirely.

Still, there are drawbacks. Notably, the license approach remains plagued by many problems that bedeviled the veto approach discussed above. The license approach, that is, continues to make significant demands on scarce judicial resources (indeed, because it compels the judge to act, the license approach makes greater demands), continues to raise legal process problems, and continues to inject horizontal inequity into the proceedings. Furthermore, although accelerated, the decision to permit or deny pass-throughs would still come quite late. That is, a lawyer still would not know whether interest could be deducted until after the retention agreement had been signed and a lawsuit had been filed. This means the license approach continues to force lawyers to accept representation under a cloud of financial uncertainty. Finally, and arguably worst of all, some judges might be slow to rule on financing motions. If they are, the need to obtain a court's judgment before incurring financing charges might end up being a real obstacle, paralyzing aspects of the litigation until a ruling is obtained.

5. *An Outright Ban*

A final option would, of course, be to ban interest pass-throughs entirely. A blanket proscription has a significant benefit: As a bright-line rule, it would be clear, knowable, and easy for judges and disciplinary counsel to administer. Still, a ban's disadvantages swamp that benefit. Outlawing interest deductions is extremely paternalistic. It is a blunt instrument, failing to take account of instances when interest deductions might advance the interests of clients.²⁴⁰ And worst of all, a ban could have a grave unintended consequence. Notably, there is no *rule* requiring lawyers to advance the expenses of personal injury litigation. Doing so is customary, but it's not compulsory.²⁴¹ Given this latitude, if banned from deducting interest, PI lawyers could simply (and legally) circumvent the prohibition by obligating clients to front case costs—while simultaneously steering impoverished clients to outside lenders who would presumably be all too eager to advance necessary funds. To be sure, that practice would be at least salient to

240. An example might be a medical malpractice case with modest damages, especially if a contingency fee cap is in place.

241. Indeed, the retainer agreement in at least one high-profile case made the client responsible for the expenses of litigation. MICHAEL D. GREEN, *BENDECTIN AND BIRTH DEFECTS: THE CHALLENGES OF MASS TOXIC SUBSTANCES LITIGATION* 116 (1996) (describing the fee agreement in the original Bendectin litigation initiated by the Mekdeci family, which obligated the family to "pay all the costs of the suit").

clients; clients would at least *realize* they were retaining a lawyer who obligated them to secure outside third-party financing.²⁴² But an outright ban that's easily circumvented is not a satisfactory solution.

B. A Proposal

Given these various options and objections, my own recommendation would be to permit interest deductions but subject them to both judicial oversight and the "business transaction" safeguards of Model Rule 1.8(a). For starters, state authorities should follow the lead of the *Restatement* and the Kentucky Bar Association Ethics Committee to declare that interest deductions are business transactions subject to the procedures and protections of Rule 1.8(a). Though certainly no panacea, as noted above, subjecting the deduction to the safeguards of Rule 1.8(a) should make the decision somewhat more salient for clients, while also making the charging of interest significantly more onerous for lawyers, which is apt to chill—and moderate—the practice.

From there, states ought to craft default rules to identify circumstances when deductions will be "presumptively impermissible" or "presumptively permissible." For example, a state may rule that interest deductions are "presumptively impermissible" when either (1) the lawyer's contingency fee agreement utilizes the "gross, client deduction" approach, or (2) the deduction exceeds the interest rate generally proscribed by the state's usury law.²⁴³ If neither exists, the interest deduction may be deemed "presumptively permissible."

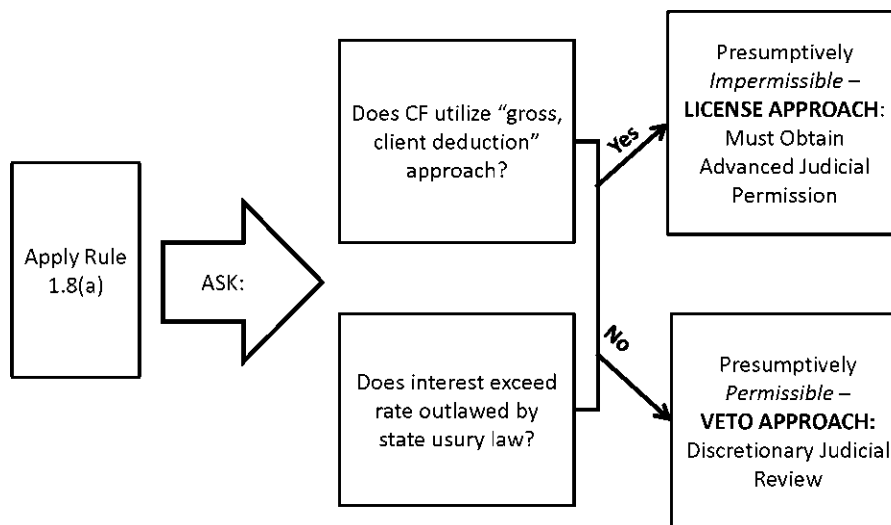
The stringency and standard of judicial review then ought to vary based on the deduction's classification. If a lawyer seeks to deduct interest even when doing so is presumptively *impermissible*, he should be obligated to obtain a license before proceeding. He ought to be compelled to notify the presiding judge (*ex parte* would be fine) of his intent, and he ought to be compelled to obtain the presiding judge's

242. See WTC Pls.' Memo, *supra* note 1, at 2 ("The alternative [to the loan from Counsel Financial] would have been to require the clients, most of whom are uniformed civil servants or construction workers, to make a payment of the costs from their own monies.").

243. This is not to imply that usury laws formally apply to the transaction; they typically won't because usury laws do not apply to contingent obligations. Usury laws are instead referenced because a state's statutorily proscribed rate of interest is a useful proxy for what policymakers consider to be an excessive rate of interest. So, for example, Florida's general usury law outlaws interest exceeding 18% per year. See FLA. STAT. § 687.02 (2011). If a Florida lawyer sought to deduct interest at a rate exceeding 18% per year, under my proposal, he would be compelled to seek advanced judicial permission. States without usury laws (e.g., Utah, South Carolina, and New Hampshire), or with unusually low usury limits (e.g., Alabama, Minnesota, West Virginia, and Wisconsin) might consider substituting another interest rate, such as 15%.

permission before incurring financing charges.²⁴⁴ Exercising this authority, the judge should only permit the charge if he is persuaded, by a preponderance of the evidence, that the fees and expenses are “fair and reasonable to the client.” Alternatively, if a lawyer seeks to deduct interest when doing so is presumptively permissible, the deduction should merely be subject to judges’ after-the-fact discretionary (“veto”) review, much like contingency fees are currently. If the judge chooses to review the transaction, he should only disallow the deduction if he is persuaded, by a preponderance of the evidence, that the fees and expenses are *not* “fair and reasonable to the client.” Elements bearing on the judge’s fairness determination might include (1) whether alternative financing is or was available, (2) whether the contingency fee contains a discernible discount from the fee charged in the absence of the deduction of interest, and (3) whether the plaintiff is or is not sophisticated. Figure 1 below offers a visual depiction.

FIGURE 1: PROPOSED REGULATION OF INTEREST DEDUCTIONS



This regime has a number of benefits. It strikes a balance between the interests of the lawyer and the interests of the client, and it is neither totally paternalistic nor totally libertarian. It also contains a

244. Ex parte, in camera review may be helpful, though of course, the judge and plaintiffs’ lawyer must be careful not to engage the merits of the case in the defendant’s absence. Furthermore, judges might also find that it is helpful for the lawyer’s client to be present, so that the judge can gauge whether the client truly understands the terms of—and his responsibility for—the financing. *Accord* Weinstein, *supra* note 239, at 470 (advocating in camera disclosures to guard against giving “an additional edge to defense counsel” who might benefit from knowing “that the plaintiffs’ attorney is under a financial strain”).

mix of clear, up-front guidance (in the form of rule-like “presumptions”), which should be helpful for planning and budgeting purposes, back-end judicial oversight, which should provide a final, targeted check on lawyer overreach, and some flexibility, in that lawyers can obtain variances (in the form of “licenses” or “vetoes”) to depart from “presumptions” whenever specific circumstances require.

The regime also has two important subsidiary benefits. First, by encouraging courts to be more vigilant when lawyers utilize the “gross, client deduction” approach, the proposed regime tacitly encourages lawyers to calculate contingency fees only after deducting litigation expenses (the “net” approach). This nudge toward the net approach is apt to reduce moral hazard, and it is also consistent with a 1987 Declaration of the ABA House of Delegates, which resolved that “[c]ontingent fees should normally be based only on the net amount recovered” and called for courts to “discourage the practice of taking a percentage fee out of the gross amount.”²⁴⁵ Second, by ramping up scrutiny when the cost of financing exceeds the maximum interest rate permitted by the state’s usury law, the approach tacitly encourages lawyers to take out recourse, rather than nonrecourse, loans. This encouragement stems from the fact that some recourse lenders—but, as far as I can tell, no nonrecourse lenders—offer loans at rates below many state’s usury law limits.²⁴⁶ Recourse loans are generally preferable because they limit moral hazard; as the lawyer must repay the recourse loan in the event of a loss, the lawyer retains some incentive to limit litigation expenses (recall Part IV.B.2) and also shop for a lender with reasonable rates. Nonrecourse loans eliminate these incentives.

Even so, the proposal is admittedly imperfect. Subjecting financing charges, but not other litigation expenses, to special scrutiny, the approach differentially burdens business inputs, which could be both socially inefficient²⁴⁷ and also, potentially, counterproductive, simply relocating, rather than ameliorating, lawyer opportunism.²⁴⁸ Further-

245. 1987 ABA Proceedings, *supra* note 187, at 40. For more on this Declaration, see *supra* note 187.

246. Compare *supra* notes 68, 78, 80 and accompanying text, with *Usury Laws by State*, LOANBACK, <http://www.loanback.com/category/usury-laws-by-state/> (last visited Nov. 29, 2013) (compiling state usury law limits).

247. See *supra* note 210 and accompanying text.

248. If interest deductions are singled out for special scrutiny, a PI lawyer intent on earning higher profits could conceivably circumvent such scrutiny by turning his sights elsewhere. With appropriate client consent, he could, for example, make “secretarial costs” a new “expense” of litigation. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 38 cmt. e (suggesting that a lawyer could charge separately for secretarial services “if the client was told of the billing practice at the outset of the representation”). Or, as long as the lawyer is not bumping up against a contingency fee cap, he might sidestep the above limits by raising his contingency fee,

more, because it includes both vetoes and licenses, the proposal is susceptible to some of the criticisms leveled above. Finally and more generally, the proposal's administration is somewhat complicated, and the conclusion that interest deductions trigger Rule 1.8(a) is bound to generate controversy. Others may work to improve the proposal—something I would not just accept, but applaud. But some kind of balanced and targeted approach is bound to be better than a complete ban or the status quo.

VI. CONCLUSION

On one level, this Article has addressed a single, important, and timely question: Whether personal injury lawyers who choose to take out loans from third-party lenders to cover case costs and litigation expenditures ought to be permitted to pass associated interest charges along to their clients. To tackle that question, Part II traced the evolution of plaintiff-side financing and sketched a fairly detailed (though still incomplete) portrait of the burgeoning lawyer lending industry.²⁴⁹ Then, having laid that factual foundation, Part III assembled existing authority, and finding that authority wanting, the Article proceeded in Part IV to analyze interest deductions from scratch. This analysis revealed that interest deductions pose real risks, but also have some potential benefits. Given that, Part V puzzled over how these deductions might be regulated to harness their advantages while mitigating the potential for abuse and, after weighing the pros and cons of

on a percentage basis. See Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1731 n.109 (2012) (observing that, if a court refuses to enforce a one-sided nonprice provision, the stronger party may respond by raising the price, “leaving weaker parties worse off than if the original contract had been enforced”).

Yet, though standard economic theory suggests that actors in an efficient market will, one way or another, find a way to levy additional charges, behavioral economics theory might suggest otherwise, as other fee generation mechanisms might be marginally more salient to consumers. Notably, in the somewhat analogous credit card context, Congress has clamped down on certain fees, to positive effect. Specifically, in 2009, Congress passed the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (CARD Act), Pub. L. No. 111-24, 123 Stat. 1734 (codified in scattered sections of 15 U.S.C.). Enacted on the theory that certain fees, collected far in the future, are non-salient to consumers, the CARD Act, among other things, curtails over-the-limit fees and late fees credit card issuers can charge consumers. In recent research, Oren Bar-Gill and Ryan Bubbs have found that, since the Act took effect, there have been “significant reductions in [the] two types of fees directly regulated by the CARD Act . . . but no substantial increases in other credit card rates and fees to compensate for the consequent loss in fee revenue.” Oren Bar-Gill & Ryan Bubbs, *Credit Card Pricing: The Card Act and Beyond*, 97 CORNELL L. REV. 967, 999 (2012); see also Sumit Agarwal et al., *Regulating Consumer Financial Products: Evidence from Credit Cards* 159–60 (Oct. 3, 2013) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2330942 (reaching similar conclusions). See generally *supra* note 150 and accompanying text (suggesting that the PI legal services industry is not an efficient market).

249. For a few important, but still unanswered, questions, see *supra* note 29.

a range of possibilities, offered a suggestion for how the interest-deduction quandary might be reasonably resolved. This Article, on one level, thus offers a detailed analysis of a particular, albeit deceptively difficult, question.

Yet, at a deeper level, this Article's aim has been wholly different—and altogether more ambitious. The question of interest deductions, that is, does not just matter in its own right. It is also a lens through which to see, and begin to cure, three overlapping but distinct deficiencies in contemporary legal scholarship at the intersection of litigation finance and legal ethics.

First, the Article has brought overdue attention to the costs of litigation. It has endeavored to show that case costs, though long neglected, are critically important. Going forward, scholars ought to pay more attention to how litigation is financed and how these financing arrangements shape, and possibly distort, parties' litigation incentives.

Second, in separately considering *just* lawyer lending and in looking hard at a mechanism's on-the-ground operation, the above analysis has attempted to reorient future ALF scholarship. To this point, that is, ALF scholarship has too often analyzed the three ALF arrangements en masse, which means many have engaged broad theoretical questions without pausing to consider how particular arrangements are structured and what existing mechanisms they supplant or supplement. Leading by example, this Article has tried to show that disaggregated analysis is helpful—and even seemingly inconsequential details (e.g., “can interest charges be passed to clients?”) can have profound practical effects. Before celebrating or condemning “ALF's arrival,” we need to develop a far deeper and richer understanding of the different mechanisms within the ALF marketplace—including how they work, how much they cost, and how they are (and ought to be) regulated.

Third and finally, this Article has challenged ethicists' method of inquiry when confronted with litigation finance questions going forward. I have suggested that, where rules are vague and offer little guidance and where decisions will have significant and predictable social welfare effects, courts, ethics committees, and commentators ignore those effects at their peril. We need to move beyond bare formalism to instead adopt a more utilitarian—and more practically grounded—method of analysis. To be sure, this analysis will be messy. But taking stock of a policy decision's on-the-ground impact is also necessary, for only by mapping how a given decision will affect client welfare can we even begin to craft sensible, and targeted, policy solutions.

