

11-1-2013

Duty in the Litigation-Investment Agreement: The Choice between Tort and Contract Norms when the Deal Breaks Down

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Duty in the Litigation-Investment Agreement: The Choice Between Tort and Contract Norms when the Deal Breaks Down

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* Professor of Law, Cardozo Law School. The author serves as a legal advisor to Burford but received no compensation for the preparation of this article. None of the views expressed in this Article were developed directly out of work performed for Burford, although general experience in the litigation-investment industry of course served as helpful background.

** Professor of Law, Cornell Law School. The author serves as a legal advisor on lawyer professional responsibility issues to Bentham IMF and Longford Capital but received no compensation for the preparation of this Article. None of the views expressed in this Article were developed directly out of work performed for paying clients, although general experience in the litigation investment industry of course served as helpful background.

The authors served as coreporters to the Working Group on Alternative Litigation Finance, part of the American Bar Association's Commission on Ethics 20/20. The views expressed in this article related to the Working Group are solely their own and do not represent the position of the Working Group or any of its members.

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I. INTRODUCTION

Part of the genius of the common law inheres in its ability to assimilate a new type of activity into existing categories. In the case of litigation investment (also known as third-party litigation finance, litigation funding, or alternative litigation financing), several alternative common-law characterizations are available by analogy. Is this new form of economic activity best understood as an ordinary commercial-lending contract, a form of insurance, a commercial joint venture, venture capital financing, or an alternative lawyer-client fee arrangement? The question is important not only to classical legal formalists who fetishize legal taxonomy. Categorizing litigation investment carries significant implications for the content of the parties' rights and obligations in litigation-investment relationships as well.

This Article proposes a framework of legal norms with reference to those governing relevantly similar economic activity. What makes an activity *relevantly* similar depends on a number of factors, including the parties' reasons for entering into a relationship (transferring risk, hedging, obtaining capital, drawing from the expertise of other actors, etc.), the risks associated with the relationship (opportunistic behavior, agency costs, effects on third parties, etc.), and the costs and benefits of legal rules (incentives, opportunities for strategic behavior, administration and enforcement costs, etc.). Constructing a regime of legal norms by analogy to an existing area of law requires attention to both the law's external values and principles and the law's internal normative structure; that is to say, one arguing by analogy must be attentive to the immanent

rationality of the two domains.¹ Doing so involves grasping the law from the internal point of view while understanding the underlying economic realities.

This Article begins by describing the market for investment in commercial litigation.² Litigation-investment transactions share features of existing economic relationships, such as commercial lending, liability insurance, contingent fee-financed representation, and venture capital, but none of these existing practices furnishes a suitable analogy for regulating litigation investment. Like third-party insurance, litigation investment is a way to manage the risk associated with litigation while bringing to bear the particular subject matter expertise of a risk-neutral institutional actor.³ Insurance

1. See Ernest J. Weinrib, *Legal Formalism: On the Immanent Rationality of Law*, 97 YALE L.J. 949, 951–52 (1988) (contrasting the external “political” purposes of law with the law’s intelligibility as an internally coherent phenomenon).

2. The litigation-investment market is differentiated into two sectors, consumer and commercial. See STEVEN GARBER, ALTERNATIVE LITIGATION FINANCING IN THE UNITED STATES: ISSUES, KNOWN, AND UNKNOWN 1 (2010) (describing the makeup of the litigation-investment market), available at http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf. A third sector, comprising subprime lending to plaintiffs’ law firms, is not generally considered in discussions of investment in litigation. *Id.* Consumer litigation investing companies pay cash to plaintiffs with pending lawsuits, typically personal injury claims, in exchange for an escalating percentage of the proceeds eventually recovered by way of judgment or settlement. *Id.* at 9. These payments are often marketed as a way for plaintiffs to pay living or medical expenses, although there is no restriction on what recipients can do with the funds. *Id.* at 12. The investment (funding companies strenuously resist the label “loan” to avoid the transactions being subject to state usury statutes) is nonrecourse, so that if the plaintiff loses on a motion or at trial, the funder recovers nothing. *Id.* at 10; see also Julia H. McLaughlin, *Litigation Funding: Charting a Legal and Ethical Course*, 31 VT. L. REV. 615, 620 (2007). Huge repayment obligations have also been featured in some of the reported cases involving consumer litigation funding. See, e.g., *Fausone v. U.S. Claims, Inc.*, 915 So. 2d 626, 628 (Fla. Dist. Ct. App. 2005) (referring to a repayment obligation of \$42,890). Accordingly, proposals to regulate the consumer sector of the litigation-investment market (as opposed to calls for its outright elimination) have typically focused on transparency, capping rates of return, and meaningful disclosure requirements. See, e.g., Susan Lorde Martin, *Litigation Financing: Another Subprime Industry that Has a Place in the United States Market*, 53 VILL. L. REV. 83, 115 (2008) (suggesting a set of solutions that would quell litigation-funding abuses); Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 FORDHAM J. CORP. & FIN. L. 55, 68 (2004) (suggesting disclosure requirements for plaintiffs seeking lawsuit financing). This Article will focus on the market’s commercial sector, which presents very different economic costs and benefits. See also Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 MINN. L. REV. 1268, 1275–77 (2011) (referring to commercial litigation investment as “second-wave litigation funding,” to distinguish commercial litigation from the consumer sector).

3. See Michele DeStefano, *Nonlawyers Influencing Lawyers: Too Many Cooks in the Kitchen or Stone Soup?*, 80 FORDHAM L. REV. 2791, 2829 (2012) (appealing to the value of the expertise of repeat-player investors); Jonathan T. Molot, *A Market in Litigation Risk*, 76 U. CHI. L. REV. 367, 369 (2010) [hereinafter Molot, *Litigation Risk*] (characterizing litigation investment as a market solution to the problem of hedging or offloading litigation risk); Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 107 (2010)

companies and litigation investors may be systematically in a better position to reduce the risk of litigation, either through risk pooling or information-cost advantages. Like insurance and contingent fee financing, litigation investment involves the provision of funds for legal representation by someone other than the litigant, whose interests are contractually aligned with the litigant's interests. Most lawyers who handle cases on a contingent fee basis, however, are limited in the size and complexity of cases they can self-fund, due to opportunity costs and the lack of sufficient capital to absorb a substantial loss. Litigation investment therefore provides some of the risk-transferring benefit of contingent fee representation while taking advantage of the potential of diversifying among a large pool of lawsuits. Unlike most types of insurance sold in the United States,⁴ but like contingent fee representation, the litigation-funding relationship arises only after a dispute has ripened into an actual or contemplated lawsuit.⁵ Litigation investment, like both liability insurance and contingent fee financing, also has the potential to complicate the traditional conception of legal representation as a two-party, attorney-client relationship and to increase the agency costs inherent in any principal-agent relationship.⁶

[hereinafter Molot, *Litigation Finance*] (arguing that the presence of third-party investment tends to correct for imbalances in the parties' risk preferences that interferes with accurate settlements); Charles Silver, *Litigation Funding Versus Liability Insurance: What's the Difference?* 2 (Univ. Tex. Law Sch. Law & Econ. Research Paper No. 441), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2247973 (stating third-party insurance lets individuals trade the risks of civil litigation in the present for a carrier's willingness to bear that risk in the future).

4. After-the-event ("ATE") insurance, available in the United Kingdom, functions as a hedge against the risk of having to pay costs in the event of an unsuccessful lawsuit. It is therefore more similar to litigation investment, as that term is used here, than third-party liability insurance. In fact, until recently, the legal system in the United Kingdom has taken virtually the opposite approach to the United States, prohibiting contingent fees but permitting third-party investment in litigation. See Molot, *Litigation Finance*, *supra* note 3, at 92–93.

5. Michelle Boardman vigorously contests the analogy between third-party liability insurance and litigation investment. See Michelle Boardman, *Insurers Defend and Third Parties Fund: A Comparison of Litigation Participation*, 8 J.L. ECON. & POL'Y, 673, 689–97 (2012). Her arguments are rejected by Silver, *supra* note 3, at 10–18, and one of the authors. See Anthony J. Sebok, *Control Issues: Litigation Investment, Insurance Law, and Double Standards* 27 (Cardozo Legal Studies Research Paper No. 394, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2271762 (explaining that while liability insurance can theoretically be separated into two forms, it sells as one unit in the United States because insurers typically demand selection of counsel and settlement, as well as major incidents of control in the liability litigation).

6. For the literature on the effect of third-party insurance on the attorney-client relationship, see, for example, Tom Baker, *Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons*, 4 CONN. INS. L.J. 101, 106–13 (1997); Geoffrey C. Hazard, Jr., *Triangular Lawyer Relationships: An Exploratory Analysis*, 1 GEO. J. LEGAL ETHICS 15, 21–31 (1987); Nancy J. Moore, *Ethical Issues in Third-Party Payment: Beyond the Insurance Defense*

To better inform the thinking about regulating litigation investment by analogy to existing legal categories, we suggest beginning with the risks that motivate mitigation efforts. With the most salient potential harms in mind, it may then be possible to settle on the best approach to regulate litigation investment.⁷ Depending on what we identify as the most significant risks, the solution might involve private ordering, self-regulation of the industry's practices, common-law rights of action recognized by courts in favor of affected parties, legislation or administrative rulemaking, or some combination of these approaches. Part II considers the ways in which the parties' litigation-investment relationship creates the possibility of exploitation, shirking, holding out, withholding relevant information, interference with conducting litigation, or other instances of wrongdoing. While the standard Coasean response to these risks would be that sophisticated commercial-contracting parties can simply bargain to an acceptable allocation of risks, legal impediments might prevent efficient bargaining. Because of the sequential nature of the parties' performance in a long-term commercial relationship, one party may behave opportunistically even if an efficient bargain is reached, unless legal doctrines, such as the implied duty of good faith and fair dealing, restrain such conduct, and unless the cost of

Paradigm, 4 CONN. INS. L.J. 259, 261–85 (1997); Thomas D. Morgan, *What Insurance Scholars Should Know About Professional Responsibility*, 4 CONN. INS. L.J. 1, 6–13 (1997); Robert O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511, 512–16 (1991); Stephen L. Pepper, *Applying the Fundamentals of Lawyers' Ethics to Insurance Defense Practice*, 4 CONN. INS. L.J. 27, 51–71 (1997); Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part I – Excess Exposure Cases*, 78 TEX. L. REV. 599, 614–17 (2000); Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part II – Contested Coverage Cases*, 15 GEO. J. LEGAL ETHICS 29, 33 (2001); Douglas R. Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, 9 GEO. J. LEGAL ETHICS 475, 492–96 (1996); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583, 1602–14 (1994); Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 273–80 (1995). This Article considers only one leg of the triangle, namely, the relationship between the investor and the funded client (in most cases, the plaintiff). A separate and important issue is the effect of the legal relationship with another party, such as a lawyer, on the duties owed on the recipient-funder leg of the triangle. For an analysis of these effects, see W. Bradley Wendel, *A Legal Ethics Perspective on Alternative Litigation Financing*, CAN. BUS. L. J. (forthcoming 2013) (on file with author).

7. Compare John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 289 (2010) (advocating for a governance, not rule-bound, perspective on the problems inherent in class action and aggregate litigation), with Martin H. Redish, *Class Actions and the Democratic Difficulty: Rethinking the Intersection of Private Litigation and Public Goals*, 2003 U. CHI. LEGAL F. 71, 129–37 (2003) (advocating various new rules for controlling problems inherent in class action and aggregate litigation).

monitoring the other party's performance is excessive.⁸ On the other hand, sequential performance is itself a means that can protect against various forms of misbehavior. As a matter of contract law, the search for default rules, which the parties may contract around, must be sensitive to the incentives created by the transaction itself, the parties' bargain, and other legal rules.

We will argue that contract law is better suited than regulation or tort liability to minimize both parties' risks inherent in litigation investment. However, since litigation investment is not a one-off interaction between the parties, it should be understood as a relational contract, in which the parties' respective rights and duties are not set in stone *ex ante* but evolve over time and may be adjusted as circumstances change.⁹ The legal regulation of litigation investment should not only protect the parties against opportunistic behavior but should also avoid disrupting an efficient outcome. Importantly, the parties' agreement—actual or hypothetical (in the case of duties of good faith)—is the baseline against which legal duties and remedies should be measured. The contract structures the legal

8. See, e.g., Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. LEGAL STUD. 535, 538–39 (1990) (explaining that parties are better able to seek redress for conduct that violates the contractual relationship when formalistic doctrines, like the duty of good faith, govern the agreement); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CALIF. L. REV. 2005, 2015 (1987) (stating that risk-bearing assessments in contractual relationships necessitate consideration of the costs of subsequently monitoring and enforcing contractual assignments).

9. The literature on long-term and relational contracting is extensive. See, e.g., Jay M. Feinman, *The Significance of Contract Theory*, 58 U. CIN. L. REV. 1283, 1299–1304 (1990); Clayton P. Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINN. L. REV. 521, 533–52 (1985); Robert W. Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565, 571–79; Gidon Gottlieb, *Relationism: Legal Theory for a Relational Society*, 50 U. CHI. L. REV. 567, 585–93 (1983); Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 946–48 (1990); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755, 755–57 (1988); Robert A. Hillman, *Court Adjustment of Long-Term Contracts: An Analysis Under Modern Contract Law*, 1987 DUKE L.J. 1, 4–14; Robert A. Hillman, *The Crisis in Modern Contract Theory*, 67 TEX. L. REV. 103, 123–27 (1988); Stewart Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465, 471–77; Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 66–67 (1963); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 886–900 (1978); Ian R. Macneil, *The Many Futures of Contract*, 47 S. CAL. L. REV. 691, 735–44 (1974); Ian R. Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340, 397–416 (1983) [hereinafter Macneil, *Internal and External*]; Scott, *supra* note 8, at 2012–18; G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 228–32 (1991); Richard E. Speidel, *The Characteristics and Challenges of Relational Contracts*, 94 NW. U. L. REV. 823, 827–31 (2000); Richard E. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 NW. U. L. REV. 369, 400–04 (1981); Richard E. Speidel, *The New Spirit of Contract*, 2 J.L. & COM. 193, 199–208 (1982).

relationship, subject to an overarching implied norm of mutual good faith and fair dealing throughout the performance of the contract.¹⁰ The good faith duty does not prevent the parties from contracting around various default rules, which is to say that extracontractual norms should play relatively little role in regulating commercial litigation investment. Courts, however, may interpret the parties' bargain in light of the course of dealing between the parties and, perhaps, trade custom, as long as courts are attempting to understand the agreement itself, not applying freestanding norms of reasonableness or good faith. We base our proposal, which makes contract law central to protecting the parties' interests after they form the litigation agreement, on our close examination of the bilateral risks associated with litigation investment.

The following points, which we expand upon in Part II, briefly summarize the ways in which the shared ownership of a legal claim may harm one party and, as a result of existing law, further may lead to inefficient or abusive conduct by both parties:

(1) *Information asymmetry.* Duties of confidentiality and concerns about waiving the attorney-client privilege may impede full information sharing among the parties.¹¹ Claim holders have the

10. See RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). The strong claim of relational contract theorists is that contracts are irrelevant in long-term commercial relationships. See, e.g., ROBERT A. HILLMAN, *THE RICHNESS OF CONTRACT LAW: AN ANALYSIS AND CRITIQUE OF CONTEMPORARY THEORIES OF CONTRACT LAW* 256–66 (Aleksander Peczenik & Frederick Schauer eds., 1997) (explaining that contract law fails to acknowledge that minds rarely meet at a single time with regard to important contract terms and that, instead, parties rely on relational norms like flexibility and solidarity to govern their written agreements). More traditionalist-minded contract scholars respond that the implied term of good faith and fair dealing creates sufficient flexibility *within* a contract to allow the parties to adjust the terms of their relationship in a long-term interaction. See, e.g., *id.* at 143–52 (stating that judges use good faith as a safety valve to ensure minimum levels of fairness in contracting). We use the term "relational contract" here in its sociological sense to identify a long-term commercial relationship without suggesting a normative implication that contract law is irrelevant.

11. The attorney-client privilege protects confidential communications between a lawyer and client made for the purpose of obtaining or providing legal assistance to the client. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 68 (2000). It is therefore considerably narrower than the duty of confidentiality recognized in the rules of professional conduct for lawyers, which cover (in most states) all information relating to representation of the client. See MODEL RULES OF PROF'L CONDUCT R. 1.6(a) ("A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent . . ."). If an investor seeks access to communications protected by the attorney-client privilege, there is a risk that sharing those communications will waive the privilege. There is some uncertainty in the law regarding the application to litigation funding of the common-interest exception to this waiver doctrine. See, e.g., *Leader Techs., Inc. v. Facebook, Inc.*, 719 F. Supp. 2d 373, 376–78 (D. Del. 2010) (declining to apply the common-interest exception to communications shared with a litigation investor). Arguably, the *Leader Technologies* case was wrongly decided, as some authority permits the sharing of communication as long as it is related to a common "legal, factual, or

opportunity to conceal bad facts in order to induce a substantial investment, knowing that the investor will then bear much of the risk of a negative litigation outcome. Withholding information may also enable a claim owner to capture more upside potential if the investor is unaware of facts suggesting that a claim is a particularly attractive investment. Investors, therefore, must expend resources on due diligence in order to avoid financing a losing claim.¹²

(2) *Shirking*. A plaintiff may have an incentive to take the money and run, refusing to cooperate in prosecuting the litigation and thereby destroying the value of the investor's asset. A setback during the litigation process may cause the claim owner to lose interest even though some value may remain in the claim. In the liability insurance context, contractual duties of cooperation require the insured to participate actively in the defense of the litigation. Litigation-investment contracts may similarly require funded claimants to

strategic" interest. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 76 cmt. e (emphasis added); see Douglas R. Richmond, *Other People's Money: The Ethics of Litigation Funding*, 56 MERCER L. REV. 649, 675–76 (2005) (arguing for application of the common-interest exception to litigation-investment transactions). Documents and other tangible things covered by the work-product protection may be shared more freely with litigation investors. Work-product protection is waived only where covered materials are disclosed to third parties "in circumstances in which there is a significant likelihood that an adversary in litigation will obtain the materials." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 91 cmt. b. The client may give informed consent to the sharing of information covered by the duty of confidentiality (which a fortiori includes attorney-client privileged communications and work product material). MODEL RULES OF PROF'L CONDUCT R.1.6(a). Reasonable care requires lawyers to advise clients of the risk of privilege waiver when sharing privileged communications with others. See AM. BAR ASS'N COMM'N ON ETHICS 20/20, INFORMATIONAL REPORT TO THE HOUSE OF DELEGATES 24–25 (2011), 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 (explaining that a typical state bar ethics limitation covers lawyers warning clients about the risk of waiving the attorney-client privilege).

12. See, e.g., Molot, *Litigation Risk*, *supra* note 3, at 389–90 (explaining that when given the choice between losing a deal, leaving a deal behind in escrow for the lawsuit's duration, or paying a premium to third-party litigation insurers, investors could reasonably prefer to pay the premium). Maya Steinitz argues that litigation investment is analogous to venture capital ("VC") funding, observing that VC funds use diversification to mitigate risk. See Maya Steinitz, *The Litigation Finance Contract*, 54 WM. & MARY L. REV. 455, 480 (2012) ("Like VC[funds], which create and manage portfolios of high risk in potentially high-return companies, litigation finance firms develop portfolios of high-risk, high-return litigations."). While commercial litigation-investment funds may seek a diversified portfolio of investments, at present time, at least in the United States, these funds do not have a sufficient number of active investments at any one time to benefit significantly from diversification. Individualized due diligence is therefore an essential aspect of commercial litigation investment. Steinitz argues that there is more of a track record of performance regarding companies as opposed to legal claims. *Id.* at 481. That may be so with respect to some companies and some legal claims, but other legal claims, including the Ecuadorian litigation she uses as a case study, have progressed far enough that there is a lengthy paper trail of discovery and pleadings that can be used by an investor to evaluate the claim. See *id.* at 465–79.

cooperate in the prosecution of the lawsuit. Like all such contractual obligations, the investor may incur monitoring costs, which are exacerbated by the reluctance of claimants and their counsel to share communications covered by the attorney-client privilege. In the absence of due diligence, the parties may have to agree to various monitoring and bonding mechanisms to assure each other that they will not undermine the value of the shared asset.¹³

(3) *Control*. A plaintiff's incentives are not always aligned with those of a third-party investor. A settlement that the plaintiff might accept in the absence of third-party funding, for example, may be disadvantageous to the investor. Similarly, a plaintiff may prefer to proceed to trial notwithstanding a favorable settlement offer, knowing that a litigation-funding agreement has covered the expenses to that point, in effect gambling with the investor's money. Knowing ex ante of this possibility, as well as the problem of shirking discussed previously, the parties may prefer to agree that the investor has the right to participate in important strategic decisions relating to the litigation, including whether to accept a settlement offer. In the liability insurance context, the contract allocates the right to settle to the nonlitigant (the insurer), subject to duties of good faith.¹⁴ In the litigation-investment context, however, this approach contains some legal risks. Courts may deem the investment contract voidable ex post as champerty¹⁵ or deem the investor to have a fiduciary relationship

13. See Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 136 (1989) (explaining that because higher interest rates are demanded when anticipated debtor misconduct is high, borrowers can allay these concerns by agreeing to monitoring or bonding mechanisms, such as providing lenders with periodic financial information or personal guarantees for the loan).

14. See Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1118 (1990) (discussing the duty-to-settle doctrine and the insurer's control over the settlement decision in a typical liability insurance contract).

15. Champerty is maintaining a suit in return for a financial interest in the outcome. *Osprey, Inc. v. Cabana Ltd. P'ship*, 532 S.E.2d 269, 273 (S.C. 2000) (quoting *In re Primus*, 436 U.S. 412, 424 n.15 (1978)). Champerty is prohibited in almost half of American jurisdictions. Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 98–99 (2011); see Stephen Gillers, *Waiting for Good Dough: Litigation Funding Comes to Law*, 43 AKRON L. REV. 677, 684–85 (2010). Gillers discusses the notorious case of *Rancman v. Interim Settlement Funding Corp.*, 789 N.E.2d 217, 218, 220–21 (Ohio 2003), which invalidated a litigation-funding contract largely due to its effect on the parties' incentives to settle. See Gillers, *supra*, at 682–86; see also *Weaver, Bennett & Bland, P.A. v. Speedy Bucks, Inc.*, 162 F. Supp. 2d 448, 451 (W.D.N.C. 2001) (explaining that funding created a disincentive to settle for less than \$1.2 million, so plaintiff refused a \$1 million settlement offer); *Kraft v. Mason*, 668 So. 2d 679, 682 (Fla. Dist. Ct. App. 1996) (defining prohibited champerty in terms of “officious intermeddling” by a third party). The law in other jurisdictions, notably Australia, permits the parties to agree by contract that a third-party investor can make decisions relating to litigation strategy. See *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 CLR 386 ¶ 88 (refusing to hold that a third-party investor's control over litigation was contrary to public policy). See generally Jasminka Kalajdzic

with the claimant by virtue of the extent of control assumed over the conduct of the litigation.¹⁶

(4) *Opportunities foregone*. In any contract, the parties decide at the outset how to allocate risks and opportunities. As the relationship unfolds, one of the parties may come to regret the decisions it made at the outset.¹⁷ In a litigation-investment contract, for example, the investor may have captured a large but relatively unlikely upside opportunity in exchange for presently funding the lawsuit. If the investor realizes a sizeable return on its investment from a substantial verdict at trial, the claim owner may regret relinquishing this upside opportunity and seek to void the agreement. In most cases, contract law will regard this tactic as impermissible double-dipping because the owner already obtained the benefit of the bargain by receiving an amount certain when the agreement was formed. There may be a few situations, however, in which a subsequent change in circumstances was both unforeseeable at the outset and material to the commercial relationship between the parties. In that case, contract law might allow one of the parties to reform the contract.

By emphasizing the contract as fundamental, we wish to emphasize that the parties' commercial interaction is not the kind of special relationship that creates tort- or agency-law duties. Part III.A takes up this argument. Because the norm of good faith and fair dealing is rooted in the parties' bargain, contract law, not tort law, determines whether bad faith conduct within a litigation-funding relationship is actionable. Despite the linguistic homonymy, breach of an implied term of good faith in a contract is not the same thing as freestanding tort bad faith,¹⁸ nor is it equivalent to breach of a fiduciary duty.¹⁹ A litigation investor is not obligated to act solely in

et al., *Justice for Profit: A Comparative Analysis of Australian, Canadian and U.S. Third Party Litigation Funding*, 61 AM. J. COMP. L. 93, 93 (2013) (exploring third-party litigation funding in the United States, Australia, and Canada).

16. Fiduciary duties are discussed *infra* Part III, when we discuss Powers's explanation for why bad faith claims in third-party insurance contracts are handled under tort.

17. See Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 780–86 (1983) (discussing reasons a person may regret making a contract).

18. See, e.g., Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions After Two Decades*, 37 ARIZ. L. REV. 1153, 1156 (1995) (suggesting that the term for the liability of insurers to their insureds for emotional distress and other consequential damages was inspired by the contract doctrine of good faith, but the appropriation of this label caused definitional problems and confusion from the outset).

19. As discussed at length in Part III.C, the duty of good faith between the parties that arises as part of any contract is not the same thing as either a fiduciary duty, as would exist in a partnership or trusteeship relationship (or, for that matter, in the attorney-client relationship), or the kind of duty that gives rise to a tort cause of action, as would be the case in a third-party

the interests of the claim holder, nor is the claim holder obligated to act solely in the interests of the investor. It is consistent with the contractual duty of good faith for the parties to act solely in their own interests.²⁰ For similar reasons, an analogy between the litigation-investment contract and a joint venture, partnership, or other type of fiduciary commercial relationship fails.²¹ In brief, the litigation-investment relationship is an ordinary, arm's length commercial transaction subject to the usual contractual duties of good faith but not governed by fiduciary norms.

Comparing the development of contract and tort actions for bad faith in insurance cases,²² we will further argue that tort bad faith is appropriate in some insurance relationships, specifically with respect to third-party (liability) insurance, but not others, specifically first-party insurance. Bad faith in the first-party context is an instance of a familiar problem in contract law. The parties contemplate ex ante the harms that result from breach and thus can bargain over appropriate breach-related remedies. By contrast, a betrayal of trust in the third-

insurance contract. See *infra* Part III.C. “[A] decreasing number of courts allow plaintiffs to exploit the vagueness of ‘bad faith’ to obtain redress for a generalized misfortune caused by the defendant’s disagreeable conduct.” STEVEN J. BURTON & ERIC G. ANDERSON, *CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT*, at xxi (1995). It will be clear in the discussion that follows that we are arguing that courts do, and should, recognize an implied term of good faith and fair dealing as part of any litigation-investment contract, but this is not the same as a free-floating norm of good faith that arises as a matter of law, i.e., in tort.

20. See John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1658 (1989) (“[A] contracting party may seek to advance his own interests in good faith while a fiduciary may not . . .”).

21. See E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1357–60 (1985) (discussing problems with analogizing fiduciary relationships to contractual relationships).

22. See, e.g., Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1397–400 (1994) (discussing compensatory damages in insurers’ good faith and bad faith denials of claims and examining the stories insurers tell when marketing their services versus the stories they tell when handling claims); Jay M. Feinman, *The Insurance Relationship as Relational Contract and the “Fairly Debatable” Rule for First-Party Bad Faith*, 46 SAN DIEGO L. REV. 553, 554 (2009) (discussing relational contract theory and illustrating its application to the problem of the standard being applied in first-party bad faith cases); Henderson, *supra* note 18, at 1153–56 (discussing the evolution of the law regarding the obligations of an insurer in a first-party situation); Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions: Refining the Standard of Culpability and Reformulating the Remedies by Statute*, 26 U. MICH. J.L. REFORM 1, 4 (1992) (exploring the common-law and statutory background of the tort of bad faith in insurance situations and analyzing courts’ varying standards of culpability); Douglas R. Richmond, *An Overview of Insurance Bad Faith Law and Litigation*, 25 SETON HALL L. REV. 74, 76 (1994) (broadly examining bad faith law and litigation); Alan O. Sykes, *“Bad Faith” Breach of Contract by First-Party Insurers*, 25 J. LEGAL STUD. 405, 405 (1996) (discussing extracontractual damages as a solution to bad faith breach by insurers); Sharon Tennyson & William J. Warfel, *The Law and Economics of First-Party Insurance Bad Faith Liability*, 16 CONN. INS. L.J. 203, 203 (2009) (discussing states’ varying approaches to bad faith law in first-party insurance).

party context exposes the betrayed party to particularly devastating harms, with damages that are impossible to predict *ex ante*.

Section III.B argues that a litigation-investment transaction is a long-term commercial relationship in which the parties share ownership of an asset in circumstances that create risks for both parties. A cause of action is an asset whose value can be affected by the actions of the claimant and the claimant's lawyer.²³ Commercial litigation-investment transactions generally involve transferring money in a lump-sum payment or, more commonly, in a series of payments, to the claimant in exchange for a share of the proceeds of the litigation.²⁴ As a result, the claimant and the investor share ownership of an asset. As with many instances of divided ownership rights, each co-owner faces the risk that the other owner or owners will do something, or fail to do something, that has an asymmetric effect on the asset's value.²⁵ Divided ownership enables one of the parties to engage in opportunistic behavior, a risk that legal rules may either mitigate, as with the doctrine of waste, or exacerbate, as with the rule of capture.²⁶

These risks are specific to the interaction between the parties and not susceptible to generalized treatment *ex ante* as a matter of tort law. Notwithstanding the dependence of the parties' mutual rights and duties on an underlying agreement, it would be a mistake to search for a single moment in time when the parties definitively established all of the terms of an agreement.²⁷ Uncertainty over the effect of contract terms increases with the duration of the investment, which means that parties investing in complex litigation will have difficulty planning and allocating risks at the outset. They accordingly may need to rely on the standard-like norms of good faith and fair dealing within a contractual allocation of rights and responsibilities.

23. See Maya Steinitz, *How Much Is That Lawsuit in the Window? Pricing Legal Claims*, 67 VAND. L. REV. 1887 (2013) (proposing that the solution to the problem of pricing legal claims in third-party-funding agreements lies with staged funding).

24. See GARBER, *supra* note 2, at 15.

25. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* §§ 3.9–3.10, at 72–86 (5th ed. 1998); Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1029 (1995) (considering the effects of splitting an entitlement between buyers and sellers); Richard A. Epstein, *Past and Future: The Temporal Dimension in the Law of Property*, 64 WASH. U. L.Q. 667, 717 (1986) (discussing how, in the context of condominiums and cooperatives, a unanimity requirement between coowners invites opportunistic behavior).

26. See generally Bruce M. Kramer & Owen L. Anderson, *The Rule of Capture—An Oil and Gas Perspective*, 35 ENVTL. L. 899, 899–900 (2005) (discussing the rule of capture used in determining ownership of oil and gas).

27. See Ian R. Macneil, *Commentary, Restatement (Second) of Contracts and Presentiation*, 60 VA. L. REV. 589, 594 (1974) (stating contract law cannot achieve total presentiation).

Implied terms of good faith should be understood with reference to the parties' actual bargain, however, and not defined against freestanding duties of reasonableness. Certain instances of exploitation or opportunistic behavior may give rise to contractual liability for breach of an implied term of good faith. But again, the touchstone for evaluating opportunism is the parties' agreement, including the opportunities foregone by each party as a result of the bargain.²⁸ In a commercial litigation-investment contract, neither party will likely be in a vulnerable position prior to the bargaining process. If an improvident bargain makes one party vulnerable, well, that is just the risk that sophisticated parties run when they enter into contracts. To put it another way, the litigation-investment relationship is not an inherently fiduciary one in which the parties are subject to a duty of overriding good faith—"[n]ot honesty alone, but the punctilio of an honor the most sensitive," as Judge Cardozo famously put it.²⁹ Nor do the reasons supporting fiduciary duties in the third-party-insurance context apply to litigation-investment contracts. The duties of good faith that the parties owe to each other are defined in relation to the agreement of the parties; the duties are not free-floating tort-type duties that arise as a matter of law. The hypothetical transaction considered in the next part illustrates the parties' mutual risks in the context of a litigation-investment contract.³⁰

28. See Fischel, *supra* note 13, at 138 ("Opportunistic behavior occurs whenever one party attempts to obtain, at the expense of the other, a benefit not contemplated by the initial agreement, either explicitly or implicitly."). The definition of opportunistic behavior in terms of opportunities foregone as part of the initial agreement is at the core of Burton's definition of contractual good faith. See Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 373 (1980) (stating bad faith performance occurs when discretion is used to capture opportunities foregone as part of the initial agreement).

29. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (explaining that "[a] trustee is held to something stricter than the morals of the market place"). The California Supreme Court explained the difference between fiduciary relationships and ordinary commercial relationships as follows:

The relationship of seller to buyer is not one ordinarily vested with fiduciary obligation. . . . In such transactions, the seller is held to the mores of the marketplace. A fiduciary, by contrast, assumes duties beyond those of mere fairness and honesty in marketing its product—he must undertake to act on behalf of the beneficiary, giving priority to the best interest of the beneficiary.

Comm. on Children's Television, Inc. v. Gen. Foods Corp., 673 P.2d 660, 676 (Cal. 1983) (citation omitted).

30. This hypothetical is drawn from the authors' experience but is not modeled after any particular deal.

II. TYPOLOGY OF RISKS IN LITIGATION INVESTMENT

To demonstrate our argument that commercial litigation-investment agreements should be viewed as a species of relational contracts, we offer in this part a highly stylized example of a transaction that reflects many (if not all) of the bilateral risks associated with litigation investment. We would like to stress that the following example is merely a heuristic; not only is it unlikely that the parties would behave as described below, but some of the contract terms bargained for are highly unusual, although they are not, we believe, so farfetched as to be completely outside the range of possibility.³¹

A. Hypothetical Transaction

The underlying claim. Owner has a claim against his business partner, Partner, arising out of Partner's alleged breach of the partnership agreement. Owner seeks both money damages and an injunction against Partner to prevent Partner from competing in the same field (smartphone-application development) for two years. The basis for the injunction is a noncompete clause in the partnership agreement. Because much of Owner's wealth is tied up in the partnership, the assets of which are the subject of the dispute, Owner cannot afford to pay a sophisticated law firm to handle the litigation on an hourly basis. The allegations of breach involve Partner's use of partnership-owned technology to develop a competing line of smartphone apps, so it is foreseeable that the litigation will be expensive and involve substantial fees for expert witnesses. The local lawyers who handle cases on a contingent fee basis are unfamiliar with this type of litigation and therefore unwilling to represent Owner. Faced with the prospect of being unable to finance what he reasonably believes to be a meritorious lawsuit, Owner approached a litigation-investment firm, Investor, about purchasing a share of Owner's claim against Partner.

Preferences regarding outcomes. In the course of the negotiations with Investor, Owner told Investor that the potential damages recovery is important, but it is far more important to obtain an injunction against Partner's future competition in the app industry. Owner said that the injunction is so central that he would not consider bringing a suit against Partner unless he was reasonably

31. We also would like to stress that the illustration is not based on an actual litigation-investment contract.

sure that he would get the injunction. Indeed, if it were not possible to obtain an injunction, Owner would prefer to “lump it,” by staying in the business partnership with Partner, whom he hates. Nevertheless, as long as it is possible to obtain damages without foregoing the possibility of an injunction, Owner said he would prefer to receive a large damages award, as he believes an infusion of capital is necessary to develop and market a promising new series of apps.³² Upon hearing this, the president of Investor concluded that Owner’s preference for an injunction was not absolute and that Investor could persuade Owner to accept a substantial settlement offer including only monetary relief. “Everyone has his price,” thought the president. Owner did not tell Investor that he was an extremely risk-averse person by nature and would have a very hard time foregoing a certain present advantage in exchange for the possibility of a substantial future gain.

The investment agreement. Owner and Investor reached an agreement under which Investor would make an initial investment of \$500,000 in exchange for 20% of the amount recovered by way of judgment or settlement. Under the contract, Investor’s recovery percentage increases with the passage of time since the initial investment so that Investor’s share goes to 30% after one year, 40% after eighteen months, 50% after two years, and so on. The contract provides that Owner has an option to request future contributions by Investor in exchange for an increased share of the recovery, but Investor has no obligation to make future contributions. The first-round investment and all subsequent contributions are contingent upon the completion of due diligence by Investor, using a law firm selected by Investor. The outside law firm and Owner agreed to execute a common-interest agreement, providing that any information disclosed by Owner will be held in strictest confidence and that neither Owner nor the outside firm intend to waive the attorney-client privilege in any confidential communications between Owner and Owner’s litigation counsel. Owner and Investor agreed that they will consult about the litigation firm that Owner will retain as counsel in the suit against Partner, and Owner will not enter into a retainer agreement without the consent of Investor, consent not to be unreasonably withheld. Owner promised to use funds received from Investor solely for the purpose of paying the expenses of litigation,

32. In other words, Owner’s preference for an injunction is lexically prior to the preference for any amount of money. The two outcomes are incommensurable from Owner’s point of view.

including fees for attorneys and experts.³³ Owner also undertook to keep Investor reasonably informed of the status of the litigation and to consult with Investor about important tactical decisions, including the scope of claims to be pursued, the extent and timing of discovery, motions to be filed, and so on. Finally, Owner and Investor agreed that Owner will inform Investor of any offers of settlement, will consult with Investor about whether to accept a settlement offer, and will not enter into a settlement agreement or a dismissal with prejudice of the lawsuit without obtaining Investor's consent.

Relationship with Owner's counsel. After consultation with Investor, Owner retained a sophisticated commercial-litigation firm, Law Firm, to represent him, agreeing to pay Law Firm on an hourly basis.³⁴ Prior to signing the engagement agreement, however, Owner did not inform the lead lawyer from Law Firm on the case, Lawyer, about the agreement with Investor. When she later learned of the investment contract, two provisions of the agreement troubled Lawyer: the due diligence to be conducted by a separate law firm and the contractual assignment to Investor of the right to accept or reject settlement offers. After consultation with Law Firm's in-house general counsel, Lawyer requested that Owner give informed consent for Lawyer to disclose information to Investor protected by Lawyer's professional duty of confidentiality,³⁵ and Owner readily agreed. On the issue of settlement and control, Lawyer informed Owner that she had an obligation to exercise independent professional judgment and render candid advice,³⁶ and that Owner retained the authority to make decisions regarding settlement. Owner responded that he had decided to delegate this authority to Investor by contract and was willing *ex ante* to trust that Investor would make a decision relating to settlement that was in Owner's best interests. Reasoning that she had no professional obligations to Investor and that she would get paid in any event, Lawyer somewhat reluctantly agreed to represent Owner, knowing of the contract with Investor. Lawyer did inform Owner, however, that as a matter of agency law she retained the

33. Counsel for Investor structured the contract in this way to avoid the risk that a direct payment of attorneys' fees could be seen as compromising the independent professional judgment of the attorneys representing Owner. See MODEL RULES OF PROF'L CONDUCT R. 1.8(f) (2013) (stating a lawyer must not accept compensation for representing a client from someone other than the client).

34. The agreement between Owner and Law Firm thus avoids the problem of fee-splitting, which makes litigation-investment contracts complex in contingent fee representation. See MODEL RULES OF PROF'L CONDUCT R. 5.4(a) (stating a lawyer must not share fees with a nonlawyer).

35. MODEL RULES OF PROF'L CONDUCT R. 1.6(a).

36. *Id.* R. 2.1.

authority to make certain decisions, regardless of the Owner-Investor contract.³⁷

Settlement inflection point. Investor transferred \$500,000 to Owner as the first tranche of funding under the agreement. Owner used \$250,000 to establish a retainer with Law Firm as an advance payment against future legal services.³⁸ He used the rest to pay for a lavish vacation in Thailand with his family, including transportation on a private jet. The litigation proceeded through discovery and a round of dispositive motions. All appeared to be going well for Owner when the trial court denied Partner's motion for summary judgment on Owner's claim for breach of fiduciary duty. Eleven months after the initial disbursement to Owner, Partner offered to settle for \$4 million and a license to use partnership-owned technology in apps to be developed separately. Owner informed both Lawyer and Investor of this settlement offer. Lawyer advised Owner that the offer was an extremely attractive one. She reported that Partner's \$4 million offer included a significant premium to avoid the restriction on competition. Partner believed that he would be able to finance a substantial settlement based on the market potential of technology he was developing, but this would not be possible if he were restricted from working in the industry for two years. Lawyer further stated that, in her judgment, it would be extremely difficult to obtain injunctions against future competition under state partnership law because courts prefer to award money damages for breach. Thus, if Owner insisted upon going to trial, he would not only risk losing the \$4 million settlement amount, but also would be highly unlikely to obtain an injunction. (Lawyer conveyed to Owner her estimate of the likelihood of obtaining an injunction as "7–10%, best case scenario.") Nevertheless, as Lawyer pointed out, Owner ultimately had the authority to decide whether to accept the offer.³⁹ Finally, Lawyer

37. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 23 (2000) (providing that, as a matter of agency law, as between the lawyer and client, the lawyer retains the authority to refuse to perform acts that are unlawful or contrary to the order of a tribunal).

38. See *id.* § 38 cmt. g (permitting retainers to secure advance fee payments).

39. See MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (requiring lawyers to abide by client's decision whether to settle a matter). Because Law Firm was compensated on an hourly basis, its only incentive to continue litigating was revenue from the ongoing hourly billing of Owner. If, on the other hand, Law Firm had a contingent fee agreement with Owner, it may have had an incentive either to (1) advise acceptance of the settlement offer, if its share of the proceeds divided by the hours expended to date yielded an effective hourly rate that exceeded what the firm could have realized by working on an hourly basis for other clients, or (2) advise rejection of the settlement offer if there were sufficient upside potential in a substantial recovery at trial. For a sophisticated analysis of the lawyer's incentives under hourly and contingent fee structures, see Kevin M. Clermont & John D. Currihan, *Improving on the Contingent Fee*, 63 CORNELL L. REV. 529, 534–37 (1978).

informed Owner that Law Firm had exhausted the retainer and would withdraw from representing Owner unless Owner replenished the retainer with another \$250,000.⁴⁰ Owner's lavish vacation left him with no funds available with which to pay Law Firm and gave him no alternative other than to request another round of funding from Investor.

Dénouement. At this point, eleven months had passed since Investor's initial investment. Investor realized that if the litigation settled in the next month, its share of the recovery would be worth \$800,000, but if the case settled later, Investor would be entitled to the increased one-year rate of 30% of the recovery, or \$1.2 million. Thus, Investor requested "some time to study the issues" before making a decision regarding settlement. After the one-year rate-reset date had passed, Investor informed Owner that, in its judgment, the settlement offer was highly advantageous and should be accepted by Owner. Owner reminded Investor that his preference had always been for an injunction over damages, no matter how sizeable the damages award. He falsely told Investor that Lawyer had estimated the likelihood of obtaining an injunction at 40%. Owner also told Investor that he had exhausted the first tranche of funding and was requesting a second tranche in order to pay for the projected costs of litigation through trial. Investor responded that Owner would be permitted to reject the settlement offer, but that no further funds would be forthcoming. Without any means to pay for continued representation, Owner felt coerced into accepting the settlement, which he did. Owner received \$2.8 million, and Investor received \$1.2 million, yielding an approximately 42% return on its investment. Nevertheless, Owner was upset at foregoing the opportunity to obtain an injunction against Partner and felt that he had been "squeezed" by Investor's decision to deny the second tranche of funding. The more he thought about it, the more distressed he became. He began to suffer from anxiety, sleeplessness, irritability, headaches, and nausea. He retained a tort lawyer on a contingent fee basis and filed a lawsuit against Investor alleging breach of contract, "bad faith," breach of fiduciary duty, and intentional infliction of emotional distress, seeking punitive as well as compensatory damages.

40. A violation of numerous ethical obligations, but that is immaterial for present purposes. See ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 11-458 (2011), available at http://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/11_458_nm_formal_opinion.authcheckdam.pdf (stating that modification of an existing fee agreement is only permissible if the lawyer can show the modification was reasonable under the circumstances at the time and the modification was communicated to and accepted by the client).

This hypothetical, although somewhat exaggerated, illustrates many of the risks faced by the parties to a litigation-investment contract. The remainder of this Part discusses those risks in detail. Part III then considers the tort and contract remedies that someone in Owner's position may assert and argues for a contract-based scheme of rights and remedies.

B. The Varieties of Risk in Litigation Investment

1. Information Asymmetry

Private information tends to increase transaction costs. In the case of litigation investment, a party to litigation typically knows much more about facts affecting the claim's value than does the party's lawyer or a third-party investor. The likelihood of the claim's success on the merits depends on many things, including the credibility of key witnesses, the existence of favorable documentary evidence, and even psychological factors, such as the party's preferences with respect to risk (a risk-averse party being more willing, all things equal, to accept a low settlement offer than a risk-neutral party). A lawyer deciding whether to represent a plaintiff pursuant to a contingent fee agreement must evaluate the strength of the plaintiff's case based on limited information, but at least the attorney-client privilege protects the lawyer's communications with the client from compelled disclosure. Though some have argued that lawyer-client communications may be shared with nonlawyer investors without waiving the attorney-client privilege, a leading case reached the opposite conclusion by finding the common-interest exception inapplicable.⁴¹ Even if the claimant's lawyer believes that it would be in her client's best interests to obtain funding from a litigation-investment firm, the lawyer will be obligated to counsel the client not to share any information under circumstances that could potentially waive the attorney-client privilege.

In our hypothetical, Investor made it a condition of funding that Owner permit a due diligence investigation. Investor requested the right to use a law firm it selected to conduct the investigation, knowing that the litigation would involve complex intellectual property and business-law issues. Because a lawsuit had not yet been filed, Investor did not have the option to scrutinize pleadings and other litigation filings to determine the strength of Owner's claims.

41. See *supra* note 11 (discussing *Leader Techs., Inc. v. Facebook, Inc.*, 719 F. Supp. 2d 373, 373 (D. Del. 2010)).

Investor suggested sharing confidential and potentially privileged information with the due diligence firm, and Lawyer agreed.

Given the uncertainty over the application of the common-interest doctrine, one might fault Lawyer for this decision, but the important point is that the law governing confidentiality and privilege potentially creates an impediment to the kind of information sharing that would allow Investor and Owner to reach an efficient outcome. Even a highly competent due diligence analysis, however, would not reveal all private information that might be necessary to reach such an outcome, including Owner's risk aversion and the fact that his preference for an injunction over monetary damages was quite strongly held and unlikely to yield in the presence of a substantial monetary settlement offer.

As the hypothetical case progressed, other information asymmetries developed. For example, Owner had access to Lawyer's estimate of the likelihood of obtaining an injunction at trial. If Owner chose to remain mum about that likelihood, Investor could not force him to divulge the estimate. In our example, Owner lies about the estimate, which of course is another possibility when one party has private information. One way to avoid this sort of problem would be to recognize a dual attorney-client relationship so that Law Firm had a duty of communication with Investor as well as Owner. If that were the case, Law Firm would be obligated to "promptly comply with reasonable requests for information" from Investor.⁴² Lawyers tend to resist strongly the imposition of duties to a Client *B* or third party in addition to their ordinary professional obligations to Client *A*.⁴³ The

42. MODEL RULES OF PROF'L CONDUCT R. 1.4(a)(4).

43. See, e.g., Morgan, *supra* note 6, at 8–9 (discussing the difficulties a lawyer might face when representing both the insurance company and the insured and stating the one-client model is preferable); Pepper, *supra* note 6, at 28 (stating the one-client model is preferable). In the liability insurance–defense context, some states maintain that only the insured is the client of the lawyer, but even those states often recognize some duties running to the insurer, despite not acknowledging the insurer as fully a client for all purposes. See, e.g., Paradigm Ins. Co. v. Langerman Law Offices, 24 P.3d 593, 602 (Ariz. 2001) (holding that when an insurer retains an attorney for its insured, the attorney has a duty to the insurer that exists even when the insurer is not a client); Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294, 297 (Mich. 1991) (stating the relationship between the insurer and attorney for the insured is not an attorney-client relationship but is more than a mere commercial relationship); *In re* The Rules of Prof'l Conduct, 2 P.3d 806, 821 (Mont. 2000) (stating that disclosures of billing statements to insurers are impliedly authorized in order to carry out representation); Nev. Yellow Cab Corp. v. Eighth Jud. Dist. Ct. *ex rel.* Clark, 152 P.3d 737, 739 (Nev. 2007) (holding that, in the absence of a conflict, counsel retained by an insurance company to represent its insured represents both the insurance company and the insured); Givens v. Mullikin *ex rel.* Estate of McElwaney, 75 S.W.3d 383, 395 (Tenn. 2002) (stating that even though an insurance company lacks the right to control an attorney hired for the insured, it still might try to exercise actual control, but this does not become invidious until the attempted control creates conflicts of interest). See generally 4

absence of a dual attorney-client relationship heightens the risk presented by asymmetric information but may reduce other risks, such as the monitoring costs a client must expend to ensure that her attorney is not breaching an obligation because of divided loyalties.⁴⁴

2. Shirking

In any relationship in which one party acts on behalf of another, the principal may have to expend time, effort, and money to ensure that the agent acts in the principal's best interests and does not engage in shirking or other self-interested behavior.⁴⁵ In an

RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 30:3 (2009) (discussing the tripartite relationship between the insured, the insurer, and the defense counsel).

44. In theory, the problem of divided loyalties is handled by conflict-of-interest rules, particularly in this context. See MODEL RULES OF PROF'L CONDUCT R. 1.7, 1.8(b), 1.8(f) (explaining how lawyers should behave regarding matters that could create conflicts of interest with their current clients). Virtually all conflict-of-interest prohibitions are waivable by the client if the client gives informed consent. As a matter of the intersection between insurance law and professional-responsibility norms, the insurance contract often operates as advance consent. The trouble is, the advance-consent argument only works if there are no conflicts of interest: "In a conflict-free situation, the purchase of a liability policy, containing such a provision [i.e., allowing the insurer to select counsel for the defense of the insured], has been held to be a prior consent by the insured to the dual representation." MALLEN & SMITH, *supra* note 43, at 150 n.9. Because the dual-client situation presents problems only where conflicts of interest actually arise, the constructive advance waiver accomplished through the insurance policy does not really help. See, e.g., *Swiss Reinsurance Am. Corp. v. Roetzel & Andress*, 837 N.E.2d 1215, 1218–19, 1222–25 (Ohio Ct. App. 2005) (holding that, under the circumstances, where there was a conflict of interest created by an excess-of-limits claim and an assertion of bad faith in failing to settle within limits, the insurer lacked standing to sue the lawyer for malpractice). Where conflicts arise, many jurisdictions fall back on either a single-client view or an implied priority given to the interests of the insured. The *Givens* case is one example. The Tennessee Supreme Court stated:

While this practical reality raises significant potential for conflicts of interest, it does not become invidious until the attempted control seeks, either directly or indirectly, to affect the attorney's independent professional judgment, to interfere with the attorney's unqualified duty of loyalty to the insured, or to present "a reasonable possibility of advancing an interest that would differ [sic] from that of the insured."

75 S.W.3d at 395 (quoting Bd. of Prof'l Responsibility of the Supreme Court of Tenn., Formal Ethics Op. 2000-F-145, at 4 (2000), available at <http://www.tbpr.org/Attorneys/EthicsOpinions/Pdfs/2000-F-145.pdf>). These cases show that the single-client vs. dual-client question, much debated in the literature, is in some ways of lesser importance than the question of what duties a lawyer owes to whom, regardless of whether the object of duties is regarded as a "client" or not.

45. See generally Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 *ECONOMETRICA* 7, 18–29 (1983) (modeling optimal-incentive payment structure to minimize welfare loss stemming from a principal's inability to monitor its agent's actions); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 308 (1976) ("The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent."); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 *BELL J. ECON.*

attorney-client relationship, for example, the client would prefer that the attorney invest the optimal amount of effort into the case to maximize its value to the client. At the same time, however, the attorney's profit from working on the case varies based on the amount of time the attorney invests. Given opportunity costs, no rational attorney wishes to work more hours than necessary on any one client's case.⁴⁶ Under an hourly billing arrangement, the marginal value to the attorney of each additional hour stays constant even after there is a marginal decrease in the return to the client.⁴⁷ An hourly arrangement thus incentivizes attorney effort above optimal levels. In a contingent fee arrangement, on the other hand, the client pays a fixed percentage regardless of hours worked, so the client's interests are best served when the attorney devotes a large amount of time to working on the client's case. Yet, the attorney has an incentive to work fewer hours to maximize the effective hourly rate obtained by working on the client's matter.⁴⁸ A contingent fee arrangement therefore leads to suboptimal levels of attorney effort. Ultimately, then, the client must incur costs in addition to attorney compensation to ensure optimal attorney investment.

In our hypothetical, Investor attempted to mitigate the risk of shirking by setting up a series of smaller contributions rather than making a large, up-front investment. If Owner proved to be less than diligent in prosecuting the litigation, Investor could simply refuse to make further contributions. Investor also sought to have a role in making decisions related to the litigation by contractually requiring the Owner to consult with Investor about tactical decisions. Lawyer

55, 55–57, 65–66 (1979) (applying principal-agent fee structures to negligence vs. strict liability legal regimes, insurance, lawyer-client relationships, and shareholder-management relationships).

46. See, e.g., Clermont & Currivan, *supra* note 39, at 535–36 (arguing that attorneys paid by the billable hour have no economic incentive to work optimal hours on a matter, while attorneys working for contingency are incentivized to minimize hours worked by accepting a suboptimal settlement); Bruce L. Hay, *Contingent Fees and Agency Costs*, 25 J. LEGAL STUD. 503, 518–20 (1996) (arguing that higher contingency percentages better incentivize lawyers to maximize client return when heavy investment of lawyer time is needed to approach the ceiling value of the claim); Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. 189, 200–01 (1987) (showing that attorneys paid on contingent basis are incentivized to accept suboptimal settlements to avoid the extra time investment of trial); Murray L. Schwartz & Daniel J.B. Mitchell, *An Economic Analysis of the Contingent Fee in Personal-Injury Litigation*, 22 STAN. L. REV. 1125, 1134–36 (1970) (arguing that attorneys paid on a contingent basis will invest time in a case until their expected profit from an additional hour of work falls to their market hourly billing rate).

47. See Clermont & Currivan, *supra* note 39, at 538–39 (reasoning that an assumption of diminishing marginal returns on lawyer hours worked is realistic since rational lawyers will prioritize the most pivotal tasks).

48. *Id.* at 543–46.

wisely distanced herself from any obligation to take instructions from Investor. If Owner directed Lawyer to do something that was both lawful and within Owner's decisionmaking authority, however, Lawyer would have no grounds for refusing to follow her client's instructions.

In addition, Owner breached the contract by blowing \$250,000 of the funds on a trip to Thailand, which illustrates the risk in any case of shared ownership that one of the owners will act self-interestedly and contrary to the interests of the other owner. Obviously, Investor would have preferred that Owner use the funds to pay the legal fees that would increase the value of Owner's claim. Because monitoring Owner's use of funds would be impractical, Investor considered making payments directly to Law Firm but decided against it because the law governing lawyers created too many complications.

Similarly, Investor dithered for a while before responding to the settlement offer because delay would increase its percentage of recovery. That sort of conduct, if unexcused, would be an example of contractual bad faith. On the other hand, Investor's decision not to provide the second tranche of funding presents a much more difficult issue of contract law. The relational nature of the contract may create a heightened duty of good faith, but it also may be the case that Investor was at liberty to simply walk away from the deal and not provide further funding, since the parties could have bargained for the full amount of funding up front and chose not to do so.

3. Control

From the perspective of a litigation investor, lack of control is not a risk *per se*. In fact, were the investor confident that the claim owner's interests aligned with his own *and* that the owner's abilities to pursue those interests were equal or superior to the investor's, then it would be in the investor's interest to shift as much control as possible to the owner and free ride off of the litigant's efforts. But neither of these assumptions is necessarily true, which makes lack of investor control a serious risk in commercial litigation investment.

Claim owners often have different interests than investors for many of the same reasons that plaintiffs often have different interests than their attorneys.⁴⁹ Because an investor has diversified her

49. See Coffee, *supra* note 7, at 307–08 (describing consequences of divergent risk preferences of risk-averse class action–plaintiff's counsel and relatively risk-neutral class members).

portfolio of cases, she may be less invested in the outcome of the case than the claim owner; similarly, because she is a repeat player, the lawyer may be more interested in settling any single individual case for less than its true value (or at least the value the owner prefers).⁵⁰ Like a contingent fee lawyer who has invested in her client's case, there may come a point where the investor foresees no additional expected return for any additional investment and rationally would prefer settlement where the client (who is spending someone else's money) would prefer to continue to litigate.⁵¹ A plaintiff may have other concerns in addition to the monetary recovery at issue in the litigation—she may be seeking to change the law or to obtain nonmonetary remedies, such as injunctive relief, which will have no value to the investor unless they are monetized through settlement and release (which may not be what the plaintiff wants).⁵²

Our hypothetical is structured around the incommensurable preferences of Owner and Investor, in an injunction and a monetary award, respectively. Their interests were thus misaligned at the outset. Investor's president believed that Owner was exaggerating his preference for an injunction, while Owner meant what he said. These preferences collided when Partner offered a substantial monetary settlement but refused to agree to entry of an injunction. At this point, Owner and Investor were mutually vulnerable. Investor risked losing the \$800,000 to which it was entitled (which it inflated into \$1.2 million by delaying decision on the settlement offer), and Owner

50. See, e.g., Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 297–98 (1998) (showing positive correlation between contingency lawyers' median effective hourly rate and the lawyers' annual volume of contingency cases).

51. See Clermont & Currivan, *supra* note 39, at 543–44 (describing client's desire to maximize return without taking into account the value of time invested by the lawyer); Coffee, *supra* note 7, at 307 (explaining that the individual plaintiffs in a class action suit are more willing to risk trial than the attorneys, who often have more investment and potential return at stake). Of course, one major difference between the investor and the lawyer is that the lawyer's continued participation and advice to the plaintiff is governed by the rules of professional responsibility, a constraint not present in litigation finance.

52. A parallel risk arises in liability insurance when the liability insurer demands, as a condition of accepting the duty to defend, control over settlement. Some insureds (especially physicians) have tried to sue their insurers for settling claims *within* policy limits without regard to some other interest the insured may have had. Sebok, *supra* note 5, at 30. No court has recognized such a claim. See, e.g., *Hurvitz v. St. Paul Fire & Marine Ins. Co.*, 135 Cal. Rptr. 2d 703, 712 (Ct. App. 2003) (citing *W. Polymer Tech., Inc. v. Reliance Ins. Co.*, 38 Cal. Rptr. 2d 78, 85 (Ct. App. 1995)) (explaining that the law does not require the insurer to take into account the insured's entire well-being, but only the judgment at risk in the claim against the insured); *Shuster v. S. Broward Hosp. Dist. Physicians' Prof'l Liab. Ins. Trust*, 591 So. 2d 174, 176–77 (Fla. 1992) (“The . . . insured was put on notice that the agreement granted the insurer the exclusive authority to control settlement and to be guided by its own self-interest when settling the claim for amounts within the policy limits.”).

risked losing the opportunity to obtain an injunction at trial, which, assuming Lawyer's estimate was accurate, was a nonzero but still highly remote possibility.

What norms should regulate the relationship between Owner and Investor at a point when their interests come into conflict? While one might simply say "good faith and fair dealing," it makes a great deal of difference whether these duties arise as a matter of contract or tort law. Contract good faith means, essentially, fairness in performance of the parties' bargain.⁵³ If the agreement permitted Investor to discontinue funding the litigation, then Investor arguably did not act in bad faith by refusing to provide the second tranche. By contrast, tort bad faith is a vaguer, more open-ended standard that may permit Owner to recover from Investor in these circumstances.

Separate from the question of divergent interests, the investor and plaintiff may have divergent views about the best way to achieve those interests. The disagreement could be honest and sincere, but it needs to be resolved nonetheless, since the plaintiff's attorney needs to be instructed.⁵⁴ Sometimes disputes over strategy and tactics may be pretexts for disputes over money, for example, where the plaintiff wants "belts and suspenders" litigation support or to file an expensive brief, and the investor worries this will lead to another request for funding. Other times, disputes may simply reflect genuine disagreements over substance. The client may prefer a novel theory of liability that the investor fears will alienate the court, or the investor may become disenchanted with the attorneys initially selected by the plaintiff and may seek to have them replaced or—if he is willing to spend the money—shadowed by a second firm that specializes in this area of law. The parties in our hypothetical had a relatively ill-defined set of communication obligations, based roughly on the lawyer-client duties of communication set out in ABA Model Rule of Professional Conduct 1.4, but did not include any practical mechanism for enforcing these duties.

Regardless of the nature and source of the disagreement over control, these disagreements may ripen at any time during the

53. See *infra* Part III.B.

54. Our hypothetical is constructed with the assumption that it is not a true dual-client representation as occurs in many states pursuant to the representation of tort defendants under a liability insurance policy providing for the insurer to retain and compensate counsel for the defense of the insured. See *supra* note 9 for the extensive literature on the "triangular" attorney-insurer-insured relationship. In the hypothetical, Owner is the only party giving instructions to Law Firm. Although Owner had previously made a contractual delegation of his right to make decisions regarding settlement, the contract did not require Owner to provide an instruction to Law Firm that it should look to Investor for the decision.

litigation. Disagreements over settlement, of course, can only arise after the case has progressed enough that settlement negotiations are underway. Disagreements over tactics can emerge very early on, from the selection of counsel, venue, or legal arguments to the day-to-day decisions about experts and discovery requests. An investor may wish to bargain for more extensive control or may be willing to trust the claim owner and its counsel. Any opportunity for control, however, brings with it the possibility that one party will believe control is being exercised in the interests of the other party. In the hypothetical, the settlement offer crystalized the divergent interests of the parties and turned a previously well-functioning relationship into a struggle for control over the disposition of the parties' jointly owned asset.

The risks that arise from suboptimal investor control may not be remediable. Every litigation-investment transaction begins with 100% of legal control in the plaintiff's hands. This is because, absent either a voluntary act of assignment or involuntary equitable subrogation, every legal claim, whether based on tort, contract, or property, belongs to the original party in interest. It is a matter of some controversy and some dispute whether and to what extent the party in interest in a suit may alienate incidents of control over their suit.⁵⁵

For purposes of this Article, we shall assume the most permissive view: free alienability of choses in action is the rule and can be limited only under special circumstances for reasons of public policy.⁵⁶ This means that the framework assumed by this Article is one where parties are at liberty to alienate in full any chose in action for any reason and therefore are at liberty to alienate any lesser power (or combination of lesser powers) over that chose in action to a stranger.⁵⁷ This assumption will allow us to see more clearly the

55. See Sebok, *supra* note 5, at 9–31 (stating that arguments against allowing alienation of some or all control over litigation by claim owners are not supported by common law principles). *But see* AM. BAR ASS'N COMM'N ON ETHICS 20/20, *supra* note 11, at 22–24 (discussing jurisdictions that condition legality of litigation finance on lack of control being secured by investor).

56. It may be the case, for example, that litigation investment should not be permitted in divorce cases where the interests of children may be affected by, for example, the direct or indirect control by an investor.

57. This means that the assignment and the sale of control cannot violate independent obligations in law, e.g., it cannot be for “improper” purposes. See DAN B. DOBBS, THE LAW OF TORTS 1263–64 (2001) (discussing RESTATEMENT (SECOND) OF TORTS § 767 (1979) and listing the Restatement “factors” that determine whether interference is improper); *Toste Farm Corp. v. Hadbury, Inc.*, 798 A.2d 901, 906 (R.I. 2002) (“To prevail on a claim alleging tortious interference with contract, a plaintiff must show ‘(1) the existence of a contract; (2) the alleged wrongdoer’s knowledge of the contract; (3) his [her, or its] intentional interference; and (4) damages resulting therefrom.’” (quoting *UST Corp. v. Gen. Rd. Trucking Corp.*, 783 A.2d 931, 937 (R.I. 2001))).

effectiveness of any particular risk-mitigation strategy in relation to maximizing investor control, which is, from the investor's point of view, probably a primary and unalloyed good. As we will detail below, we can only see clearly the benefits of risk mitigation as measured against a dimension such as control if we can weigh accurately the strategy's desirability given its costs.

4. Opportunities Foregone

Some contracts are risky because, although both parties know what each hopes to gain in the exchange, one or both parties cannot trust the other to perform certain acts known to be essential *ex ante*. In litigation investment, these risks are captured mostly under the headings of information asymmetry and shirking. As the discussion of control indicated, there are a number of reasons why parties may not define explicitly which "control acts" are essential to performance *ex ante*: they may not know, or they may see the cost of defining (and negotiating) which terms are essential as so costly as to be not worth the effort.

The risk underlying the loss of control is paradigmatic of relational contracts.⁵⁸ The ideas of role integrity, reciprocity, and planning are central features of relational contracts.⁵⁹ In relational commercial contracts, as in the case of the risk of loss of control, many terms are left unspecified. Sometimes this is because the relevant acts are unknown. But often, the relevant acts *are* known; in those circumstances—just like in the risk of loss of control—the cost of specifying when and at what price those acts must be secured may be sufficiently high to wreck the contract formation process if pursued *ex ante*.⁶⁰

For example, the owner of a claim must know (or at least can be assumed to know) that there is always a slight chance that the value of their claims is much more than they imagine. This could, they know, lead them to regret their original investment promise with the investor. Contract terms could be negotiated *ex ante* to deal with this problem, but doing so could undermine the good will and sense of cooperation necessary to form a contract at all. The cost of these negotiations may be high, and the possibility necessitating these costs might be very remote, so a rational party would leave the question of defection alone and "cross that bridge when they come to it."

58. See *supra* note 9 (citing academic literature discussing relational contracts).

59. Feinman, *supra* note 22, at 555 (citing IAN R. MACNEIL & PAUL J. GUEDEL, CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONS, at v (3d ed. 2001)).

60. *Id.* at 556.

In our hypothetical, the risk of a foregone opportunity comes not so much at the risk that there will be a huge upside (and the regret that comes with it) but that, at the outset, there are interests that pose huge upfront negotiating costs in order to avoid a relatively remote possibility. Owner did tell Investor that he had at least two goals (money and professional independence from Partner), and Owner and Investor agreed on a price for shared control over the joint pursuit of these two ends. We have already observed how litigation-investment contracts must explicitly accommodate the risk of loss of control. But the point we are making is now slightly different.

One of two things may have happened in our hypothetical, both of them highlighting a risk slightly different than the practical problem of how Owner (or Investor) can get the degree of control optimal for their known preferences. First, Owner may have underestimated his relative preference for the injunction (and the professional independence it promised) when he negotiated the contract, and the risk of him doing that may have been something Investor reasonably anticipated or unreasonably discounted.⁶¹ Or, Owner may have estimated his relative preference for the injunction but rationally recognized that the cost of negotiating to preserve its possibility would have been very high, given that his true preferences may have seemed idiosyncratic to Investor, and that any time spent dwelling on this contract term would have colored the negotiations over all the other terms where Owner and Investor basically shared the same premises and values. It is not obviously irrational to tacitly agree not to plan for the possibility that the injunction would be waived in exchange for more money because the probability of securing the injunction was close to zero without the contract.

Whatever the reason for failing to rationally plan for that possibility, once it ripens into a real option, the Investor and the Owner may disagree about whether the contract requires the Investor to credit the Owner's newly revealed preference. Designing the contract to provide an exceptional resolution to the risk of foregone opportunities *ex ante* will enhance both the contract and the joint value of the litigation-funding enterprise.

61. The existence of cognitive errors and the variety of these biases that lead to the errors is known. *See, e.g.*, Ward Farnsworth, *The Legal Regulation of Self-Serving Bias*, 37 U.C. DAVIS L. REV. 567, 568 (2003) (defining self-serving bias as "the tendency to make various judgments in a manner skewed to favor one's own self-interest"); Gillette, *supra* note 9, at 543-44 (describing contractual parties' tendency to discount low-probability events when making decisions in conditions of uncertainty).

III. TOOLS FOR MITIGATING LITIGATION-INVESTMENT RISK

A. Tort and Other Extracontractual Remedies

1. Introduction

At first glance, tort law is not a likely mechanism for controlling risk in litigation investment. The fact that the relationship between the investor and owner is contractual suggests that contract law should control risk. But to invoke the investment contract as a reason to allow contract law to exclusively define the rights, obligations, and remedies of the parties to the agreement is to beg the question, “When does tort law provide remedies for injuries arising between parties to a contract?”⁶² The history of private law is one of constant adjustment around what William Powers called the “border” between tort and contract.⁶³ Even brief reflection over the curriculum of a first-year torts class reveals just how porous that border is: medical malpractice, which is generally a matter of contract law in civilian systems, is almost exclusively handled by tort in the common law, as are claims between purchasers and sellers of consumer products, despite the fact that sales contracts govern those transactions.⁶⁴

The “economic loss rule”⁶⁵ denies recovery in negligence for “a financial loss that is not causally connected to personal injury or

62. See William Powers, Jr., *Border Wars*, 72 TEX. L. REV. 1209, 1215–16 (1994) (highlighting the implied duty of good faith as an area where tort and contract legal regimes collide).

63. *Id.* at 1209.

64. See, e.g., Richard A. Epstein, *Medical Malpractice: The Case for Contract*, 1 AM. B. FOUND. RES. J. 87, 94 (1976) (“[Medical malpractice and product liability claims] are today regarded as species of tort law and they place too much pressure on a system of law that works best at keeping people apart, not bringing them together.”); Richard A. Epstein, *Medical Malpractice, Imperfect Information, and the Contractual Foundation for Medical Services*, 49 LAW & CONTEMP. PROBS. 201, 201 (1986) (noting that tort law governs medical-malpractice claims); William L. Prosser, *The Assault upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099, 1102 (1960) (detailing the “assault” upon privity as it then stood in 1960 and the advent of “a general rule imposing negligence liability upon any supplier, for remuneration, of any chattel”); William L. Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791, 791 (1966) (hailing the “fall of the citadel of privity” of contract as a restriction on recovering for product-related injury); William L. Prosser, *The Implied Warranty of Merchantable Quality*, 27 MINN. L. REV. 117, 122–125 (1943) (discussing the expansion of liability in tort-based breaches of warranty in sales contracts).

65. See, e.g., Robert J. Rhee, *A Production Theory of Pure Economic Loss*, 104 NW. U. L. REV. 49, 49 (2010).

property damage suffered by the same plaintiff.”⁶⁶ It is the default answer to the question of whether contract or tort should control in cases like the litigation investment described in Part II.⁶⁷ The economic loss rule, however, is not a single rule, although it refers to the general observation that in the common law claims for pure economic loss in tort are disfavored.⁶⁸ The range of exceptions to the economic loss rule is broad, so it does not easily fall into neat analytical categories.⁶⁹ At its core, the economic loss rule bars recovery by “strangers—that is[,] . . . persons with whom the defendant has no relationship by contract, undertaking, or specific legal obligation.”⁷⁰ But even this relatively fixed rule has exceptions, namely so-called transferred loss cases involving, among other things, subrogation and duties to avoid causing economic loss that is “particularly foreseeable.”⁷¹ The rule becomes riddled with even more exceptions when applied to cases in which the defendant and plaintiff have some sort of relationship, legal or otherwise. After *Hedley Byrne v. Heller*, any pretext that the economic loss rule could be applied in a predictable fashion *ex ante* was abandoned.⁷² Skirmishes (what Powers called “border wars”) abounded,⁷³ perhaps the most significant

66. Bruce Feldthusen, *What the United States Taught the Commonwealth About Pure Economic Loss: Time to Repay the Favor*, 38 PEPP. L. REV. 309, 311 (2011) (citing Rhee, *supra* note 65, at 49).

67. See DAVID W. ROBERTSON ET AL., CASES AND MATERIALS ON TORTS 251 (4th ed. 2011) (“Traditional Anglo-American tort law denied recovery in negligence for [pure economic] losses, and there is still a pronounced reluctance to redress them.”). For an argument on the relative indeterminacy of the economic loss rule, see Gregory S. Crespi, *Good Faith and Bad Faith in Contract Law: Reflections on A Cautionary Tale and Border Wars*, 72 TEX. L. REV. 1277, 1289 (1994).

68. Dan B. Dobbs, *An Introduction to Non-Statutory Economic Loss Claims*, 48 ARIZ. L. REV. 713, 713 (2006) (“The stand-alone or ‘pure’ economic loss covered by the economic loss rules refers to pecuniary or commercial loss that does not arise from actionable physical, emotional or reputational injury to persons or physical injury to property.”).

69. See, e.g., Anita Bernstein, *Keep It Simple: An Explanation of the Rule of No Recovery for Pure Economic Loss*, 48 ARIZ. L. REV. 773, 782–83 (2006) (listing various scholarly attempts to categorize economic loss torts).

70. Dobbs, *supra* note 68, at 715.

71. Peter Benson, *The Problem with Pure Economic Loss*, 60 S.C. L. REV. 823, 850–52 (2009); see Anthony J. Sebok, *The Failed Promise of a General Theory of Pure Economic Loss: An Accident of History?*, 61 DEPAUL L. REV. 615, 621 (2012) (observing California’s willingness to find tort liability for economic loss when defendants could foresee the likelihood of economic harm to known third parties).

72. [1964] A.C. 465 (H.L.) (U.K.). See Feldthusen, *supra* note 66, at 317 (“[After *Hedley Byrne*,] Commonwealth lawyers and judges abandoned the exclusionary rule or replaced it with unpredictable, unprincipled *ad hoc* decisions.”).

73. Powers, *supra* note 62, at 1209.

over pure economic loss that defective products caused to customers.⁷⁴ To say that the rule is clear and that contract and tort are dichotomous ignores the reality of the situation.⁷⁵ Members of the American Law Institute so resisted an effort to make the economic loss rule black letter law by entrenching it in the *Restatement (Third) of Torts* that the Reporter advocating exactly this position resigned in frustration.⁷⁶ We can see why some American lawyers would find it reasonable to treat litigation-investment contracts under negligence law. After all, the courts have substantial experience with negligent-performance or negligent-service cases, a category of transactions where the plaintiff suffers pure economic loss due to the negligence of its counterparty.⁷⁷

Traditionally, the economic loss rule has not been applied to pure services transactions.⁷⁸ Even after the recent return of the economic loss rule in products liability, a case could be made that the rule should not apply to contracts for services, despite its application to sales contracts.⁷⁹ But even if this presumption were correct, it would not, as an initial matter, tell courts how to handle cases where the service provider expressly limits liability for defective services.⁸⁰ We know that, in some cases, not only does the economic loss rule not apply to certain service contracts, but in a subset of those contracts, the law does not allow promisees to waive through explicit waiver the

74. See Gary T. Schwartz, *Economic Loss in American Tort Law: The Examples of J'Aire and of Products Liability*, 23 SAN DIEGO L. REV. 37, 70–77 (1986) (discussing *Seely v. White Motor Co.*, 403 P.2d 145, 147 (1965)); see also Sarah Borstel Porter, *Economic Loss in Product Liability: Strict Liability or Uniform Commercial Code?* *Spring Motors Distributing, Inc. v. Ford Motor Co.*, 28 B.C. L. REV. 383, 390–91 (1987) (explaining the important distinction drawn by the California Supreme Court in *Seely* between recovery for personal injury and economic loss).

75. Schwartz, *supra* note 74, at 49.

76. See Feldthusen, *supra* note 66, at 320 (noting that the ALI membership continues to insist that “the law of economic negligence should be situated within a general tort of negligence” (quoting letter from Mark Gergen)).

77. See *id.* at 309 n.3 (noting that American courts recognize economic loss claims stemming from negligent performance of professional services).

78. JULIAN B. MCDONNELL & ELIZABETH J. COLEMAN, *COMMERCIAL AND CONSUMER WARRANTIES* 1–47 (Matthew Bender, rev. ed.) (citing *Cargill, Inc. v. Boag Cold Storage Warehouse, Inc.*, 71 F.3d 545, 550–52 (6th Cir. 1995); *Bailey Farms, Inc. v. NOR-AM Chem. Co.*, 27 F.3d 188, 191–93 (6th Cir. 1994); *In re Merritt Logan, Inc.*, 901 F.2d 349, 360–64 (3d Cir. 1990); *Dairyland Ins. Co. v. Gen. Motors Corp.*, 549 So. 2d 44, 45–47 (Ala. 1989); *N. Am. Chem. Co. v. Superior Court*, 69 Cal. Rptr. 2d 466, 471–80 (Ct. App. 1997); *Cooley v. Big Horn Harvestore Sys.*, 767 P.2d 740 (Colo. App. 1988); *Duffin v. Idaho Crop Improvement Ass'n*, 895 P.2d 1195, 1199–1202 (Idaho 1995); *McCarthy Well Co. v. St. Peter Creamery, Inc.*, 410 N.W.2d 312, 315–17 (Minn. 1987)).

79. Dobbs, *supra* note 68, at 723–27.

80. *Id.* at 727.

tort duties owed to them.⁸¹ This is evidence of a very strong rejection of the economic loss rule in at least a subset of cases involving contracts.

The foregoing discussion about the courts' rejection of the economic loss rule in service contracts tells us something simple and important. Notwithstanding frequent reliance upon something called "the economic loss rule," it is nothing more than a rule of thumb. Further, its many gaps and exceptions teach an important lesson about how tort law protects pure economic interests. There is no way to deduce whether tort duties arise from litigation-investment contracts by asking, as an abstract matter, whether they are more like a service contract or a sales contract. It seems that even this level of reasoning by analogy may still be too crude and indeterminate. Our proposal is to approach the question much in the spirit of Rawlsian "reflective equilibrium," that is, to use as our starting point a concrete doctrinal practice that seems close in structure and purpose to the contract in question. We can then test whether the reasons for treating it under the rubric of tort law fits our intuitions about whether the right balance is struck between the competing ends we hope to serve—protecting the investor from owner-imposed risks and protecting the owner from investor-imposed risks.⁸²

2. Freestanding Tort Liability for Bad Faith

a. Bad Faith in the Noninsurance Context

In fact, the best place to start our inquiry is an examination of why a litigation-investment contract is not a service contract at all. The investor is not providing a service to the owner in any

81. *Id.* Dobbs used the example of service contracts to provide legal representation.

82. See JOHN RAWLS, A THEORY OF JUSTICE 48–51 (1971). The method of reflective equilibrium in ethics begins with considered judgments about what principles ought to regulate action. The agent then seeks to systematize those judgments with reference to more abstract theoretical principles. "[W]e may want to change our present considered judgments once their regulative principles are brought to light." *Id.* at 49. A relatively limited scope of theoretical perspectives may be tested by the method of reflective equilibrium because, out of the whole range of positions for which there is a conceivable philosophical argument, only a limited number of theories will be familiar enough for consideration by an agent with bounded rationality. Rawls does not use the term bounded rationality but emphasizes that moral concepts and the a priori are too slender a basis for a theory of justice; rather, the starting point is the "moral sentiments" of people deliberating about justice. See *id.* at 51. Our methodology similarly begins with considered judgments about the way cases ought to be decided, with reference to familiar doctrinal categories such as contract, tort, and insurance law. The analysis does not begin with highly abstract principles, but more general theoretical considerations are used to regulate and systematize intuitive judgments.

conventional sense of the term. The chief purpose of the contract is to provide financial resources to the owner so that he can purchase legal resources to pursue the claim. A secondary purpose, as noted above, might be to monetize the claim so that the owner can sell the expected value of his claim if, as is often the case, the present value of the contingent claim is greater to him than its future value at judgment.⁸³ As explained in Part II, there may be many covenants and other features of the contract that produce consequences similar to those that the investor would produce if she held herself out as an advisor or “litigation coach,” but those are potential secondary effects of the contract’s primary goal, which is to maximize the mutually owned asset—the claim.

If the foregoing is correct, then it seems that the advocate for analogizing the litigation-investment contract to a service contract has a heavy burden of proof. But before we even begin to examine whether the burden can be met by invoking some set of other unnamed countervailing factors, it must be noted that, as the Dobbs quote above illustrated, the economic loss rule falls less heavily on certain service contracts than others.⁸⁴ Lawyers stand in a position of trust with their clients that goes beyond mere reliance that the “service provider” will do what she has promised to the best of her ability. Professionals exercise judgment in circumstances where the client lacks not only technical expertise but also the capacity to weigh competing alternatives to determine what is in its best interest. In this sense, the obligations of lawyers or physicians are more like those of fiduciaries since they are supposed to put the client’s relevant interest (in legal success or health) above their own if there ever is a conflict between the two. Further, most professionals who are subject to tort duties that cannot be waived are themselves obliged to conform their conduct to an independent code of professional responsibility. These codes consists of more than norms of conduct; they include professional institutions that can articulate professional norms, apply those norms

83. See Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697, 737 (2004) (“The price at which a claim is sold . . . will reflect an expected value of the judgment . . .”); Isaac M. Marcushamer, *Selling Your Torts: Creating a Market for Tort Claims and Liability*, 33 HOFSTRA L. REV. 1543, 1573–74 (2005) (analyzing the incentive structure of microeconomic markets for tort claims).

84. Dobbs, *supra* note 68, at 727 (“[B]ases for subjecting lawyers and perhaps some other professionals to negligence liability do indeed exist. When you retain someone for the express purpose of being on your side, he cannot rightly contract to be your adversary instead or to be on your side but free to be negligent.”).

outside of courts, and impose sanctions that are not penal but can still result in serious hardship.⁸⁵ None of this is true of litigation funding.

If we turn to tort claims arising from pure economic losses between parties who have nonservice contracts, the landscape becomes sparse indeed. The tort of bad faith breach of contract is a tale of an extraordinary rise and fall.⁸⁶ The tort of bad faith rose to prominence in the insurance context.⁸⁷ But after a brief period of intense academic excitement, the tort fell dramatically in almost every other context.⁸⁸

The *Seaman's* case⁸⁹ involved a maritime oil retailer that leased business space from the city of Eureka, California in a recently redeveloped waterfront area. Seaman's success depended largely on obtaining a long-term supply contract with a major oil company so that it could sell diesel fuel to ships coming into Eureka. Seaman's entered into a contract with Standard Oil of California, terminated negotiations with the other oil companies, and modified its lease to increase its space. Then, because of unforeseen external political

85. The norms of a profession may be contested by other legal institutions, and the resulting tug-of-war may result in an unstable balance of power between actors who compete to define the norms of a profession. See Susan P. Koniak, *The Law Between the Bar and the State*, 70 N.C. L. REV. 1389, 1401 (1992) (detailing "a far more active competition between state and group norms" than traditionally suggested). The tort obligations of accountants and other professionals are not as well developed and robust as those of lawyers, and it is harder to say that the economic loss rule does not apply at all, since these professionals can limit liability by waiver in ways that lawyers cannot. See Gary T. Schwartz, *American Tort Law and the (Supposed) Economic Loss Rule*, in PURE ECONOMIC LOSS IN EUROPE 94, 96 (Mauro Bussani & Vernon Valentine Palmer eds., 2003); see also Bernstein, *supra* note 69, at 787 (listing professionals in addition to lawyers liable in tort for "flawed services": accountants, architects, drug-testing laboratories, notary publics, and adoption agencies).

86. Since the 1970s "the law has witnessed the birth, growth, and death of the 'bad faith' tort—the cause of action for tortious breach of the covenant of good faith and fair dealing implied in every contract." Kerry L. Macintosh, *Gilmore Spoke Too Soon: Contract Rises from the Ashes of the Bad Faith Tort*, 27 LOY. L.A. L. REV. 483, 484 (1994) (emphasis omitted).

87. See, e.g., Henderson, *supra* note 22, at 1 ("The opportunity to witness the appearance of a wholly new tort in the legal universe is rare indeed."); Stephan Landsman, *Juries as Regulators of Last Resort*, 55 WM. & MARY L. REV. (forthcoming 2014) (describing the reasons for the rise and institutional acceptance of the tort of bad faith in third- and first-party insurance coverage).

88. See Kyle Graham, *Why Torts Die*, 35 FLA. ST. U. L. REV. 359, 368 (2008):

A tort does not have to be old to die. A tort claim for bad faith denial of the existence of a contract was first recognized . . . by the California Supreme Court [and] that same court repudiated the bad faith denial of contract tort just eleven years later.

See also Curtis Bridgeman, Note, *Corrective Justice in Contract Law: Is There a Case for Punitive Damages?*, 56 VAND. L. REV. 237, 269 (2003) ("The bad-faith tort arose in the 1950s [and] . . . reached its apex in Montana with a few cases that allowed such causes of action even absent a special relationship . . . [but by the 1990s] states once again restricted the tort to insurance cases.").

89. *Seaman's Direct Buying Serv., Inc. v. Standard Oil Co.*, 686 P.2d 1158 (Cal. 1984).

events, the federal government threatened to restrict Standard Oil's access to foreign oil unless it and Seaman's participated in a complex and expensive series of hearings. Because Seaman's would be financially unable to continue operations throughout a lengthy trial, it asked Standard to stipulate to the validity of their contract and told Standard of its financial plight. In reply, Standard's representative laughed and said, "See you in court."⁹⁰ Seaman's went out of business and thereafter brought an action against Standard Oil claiming, among other allegations, that Standard's refusal to honor the contract was a tortious breach of the implied covenant of good faith and fair dealing arising from a contract that caused Seaman's significant consequential damages.

The California Supreme Court viewed Seaman's position as analogous to that of an insured and cited a plethora of bad faith cases, including *Comunale v. Traders & General Insurance Co.*,⁹¹ *Crisci v. Security Insurance Co.*,⁹² and *Gruenberg v. Aetna Insurance Co.*⁹³ The court drew the parallel at a relatively high level of abstraction, simply noting that the common law imposed a duty of good faith and fair dealing on all contracts.⁹⁴ It recognized that allowing a tort remedy for the breach of that duty, as it had in the insurance cases, took the law into "largely uncharted and potentially dangerous waters."⁹⁵ The voyage into those waters was stormy indeed and caused, in the words of the California Supreme Court, "much confusion and conflict . . . regarding the scope and application of our *Seaman's* holding."⁹⁶ Eleven years after it first expanded the bad faith tort, the Court decided to limit it to insurance contracts.⁹⁷

In Texas, a similar effort to expand bad faith beyond insurance was also attempted, as Mark Gergen has documented.⁹⁸ Like California, Texas had an early experience with the application of bad faith in a noninsurance context that might, had it been allowed to grow, have blossomed into a general tort claim for bad faith.⁹⁹ *Manges v. Guerra* involved a contract between two investors in mineral rights.

90. *Id.* at 1162.

91. 328 P.2d 198, 201 (Cal. 1958).

92. 426 P.2d 173, 176-77 (Cal. 1967).

93. 510 P.2d 1032, 1037 (Cal. 1973).

94. *Seaman's*, 686 P.2d at 1166.

95. *Id.* at 1166-67.

96. *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 676 (Cal. 1995).

97. *Id.*

98. Mark Gergen, *A Cautionary Tale About Good Faith in Texas*, 72 TEX. L. REV. 1235, 1235 (1994).

99. *Manges v. Guerra*, 673 S.W.2d 180, 181-83 (Tex. 1984).

The majority owner took advantage of the executive powers granted under the contract to enrich himself and third parties at the expense of the minority owner.¹⁰⁰ The Texas Supreme Court allowed the injured counterparty to sue for actual and exemplary damages, citing the duty of good faith as the ground for the claim.¹⁰¹ Gergen observed that despite some victories in the lower courts, Texas never extended *Manges* beyond insurance.¹⁰² In the employment context, the effort to allow employees to sue in tort for bad faith dismissals suffered a serious setback when the California Supreme Court repudiated *Seaman's*.¹⁰³ A very small number of states have recognized the right of employees to seek tort damages in cases where an employer has violated the implied covenant of good faith in the employment contract.¹⁰⁴ The effort in the area of lender liability to establish a freestanding bad faith tort has also not fulfilled its initial promise.¹⁰⁵ California reversed an early decision recognizing the duty,¹⁰⁶ and, despite cases such as *K.M.C. Co. v. Irving Trust Co.*¹⁰⁷ and *First National Bank v. Twombly*,¹⁰⁸ violations of the covenant of good faith

100. *Id.* at 183.

101. *Id.*

102. Gergen, *supra* note 98, at 1244. Gergen observed one exception, *Schmueser v. Burkburnett Bank*, which involved a service contract and was a “radical” outlier. *See* 937 F.2d 1025 (5th Cir. 1991).

103. *See* *Foley v. Interactive Data Corp.*, 765 P.2d 373, 395 (1988) (declining to analogize the relationship between insurer and insured with the “usual” employment relationship).

104. *See* *Firestone v. Oasis Telecomms., Data, & Records, Inc.*, No. DV 00-328, 2003 WL 25960324 (Mont. Dist. Ct. Nov. 19, 2003) (concluding that a special relationship could have existed that would give rise to a bad faith–dismissal claim); *State v. Sutton*, 103 P.3d 8, 19 (Nev. 2004) (traditional tort damages such as “injury to the feelings from humiliation, indignity and disgrace to the person” may be awarded); *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1369–70 (Nev. 1987) (recognizing a bad faith–dismissal tort for specific instances).

105. *See* *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985) (recognizing tortious breach of the implied obligation of good faith and fair dealing in banking contracts); Werner Ebke & James Griffin, *Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*, 49 OHIO ST. L.J. 1237, 1246 (1989) (“[M]ost courts have refused to find a special relationship between a lender and its borrower sufficient to support recovery for a tortious breach of the duty of good faith and fair dealing.”). *K.M.C.* is discussed further in Part III.B. *See infra* notes 164–65 and accompanying text.

106. *Commercial Cotton Co. v. United Cal. Bank*, 163 Cal. Rptr. 551 (Ct. App. 1985), *overruled by* *Copesky v. Superior Court*, 229 Cal. Rptr. 338 (Ct. App. 1991).

107. 757 F.2d 752 (6th Cir. 1985).

108. *First Nat'l Bank v. Twombly*, 689 P.2d 1226, 1230 (Mont. 1984); *see also* *Luxonomy Cars, Inc. v. Citibank, N.A.*, 408 N.Y.S.2d 951, 954 (App. Div. 1978) (“[A] tort may accompany a breach of contract, but only where the contract creates a relation out of which springs a duty, independent of the contract obligation, and that independent duty is also violated.”); *State Nat'l Bank of El Paso v. Farah Mfg. Co.*, 678 S.W.2d 661, 683 (Tex. App. 1984) (analyzing a violation of the covenant of good faith and fair dealing under the duress framework).

and fair dealing are now mostly viewed as a matter of contract law.¹⁰⁹

It is hard to say why courts have not expanded the tort of bad faith. At first glance, it would appear as if wholly suspending the economic loss rule makes sense from the perspective of efficiency, although the debate over the threat of damages awards beyond what conventional contract principles would justify has raged for years and would take us beyond the scope of this Article.¹¹⁰ Powers's explanation, which he called a "purposive or structuralist approach," has some appeal, but we are not sure about the level of abstraction at which he chose to locate or discover deep-seated structures or purposes in the common law.¹¹¹ Powers claims that the basic purpose of contract law is to instantiate "the ideology of autonomy and consent and [to] assign[] decision-making power to markets."¹¹² While we are sympathetic to this claim (on a descriptive, if not normative, level), we object to the next step in his argument, which is to suggest that tort law can therefore be best understood as a "gap filler" that "waits in the background to step in and resolve the disputes that occur when no contractual relationship is present."¹¹³ We think that this is not only a strange way of defining legal concepts that have been more or less coequal in the history of the common law but also, for our purpose, is not very enlightening. The question raised by the sporadic application of the economic loss rule is, to put it in Powers's words, when is there "no contractual relationship . . . present"¹¹⁴ despite the presence of a contract? We know there must sometimes be no such relationship, because there is, at least in the area of insurance law, a tort of bad faith.

Powers, to be fair, had an answer for these cases as well (which makes sense, as he developed this theory in the context of an article about the tort of bad faith breach of contract). His solution goes something like this: when contract law "step[s] out of the way by its

109. "The trend in the case law, however, is against imposing tort liability for a lender's breach of the implied covenant of good faith." *Implied Covenant of Good Faith and Fair Dealing*, in 4 BUSINESS TORTS § 37.04 (David G. Heiman ed., rev. ed. 2013); see also Gergen, *supra* note 98, at n.100 (collecting cases).

110. See generally Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 371 (1990) (arguing that punitive damages should not be used as a response to inefficiencies that follow underenforcement of the law); Steve Thel & Peter Siegelman, *You Do Have to Keep Your Promises: A Disgorgement Theory of Contract Remedies*, 52 WM. & MARY L. REV. 1181, 1183 (2011) (characterizing contract law in terms of "promisor expectation" remedies).

111. Powers, *supra* note 62, at 1224.

112. See *id.* ("Contract law, along with its accompanying prime directive of agreement and consent, sets its own limits.").

113. *Id.*

114. *Id.*

own terms,” tort law (or some other area of law) “might step in.”¹¹⁵ Powers’s example of contract law “stepping out” comes exclusively from insurance bad faith.¹¹⁶ Insurance contracts are governed by tort when the insurer has a “conflict of interest.”¹¹⁷ An insurer who can expose an insured to risk in order to preserve the possibility of a better result for itself at trial (as in the classic third-party bad faith case) cannot be constrained by contract law, so contract law needs to call in support from the outside.¹¹⁸

Powers’s abstract rhetoric is attractive. Contract and tort should be complementary, and we think that the analysis should ask the same question that Powers asks: what can contract do that tort cannot, and vice versa? The specifics of his argument have a question-begging quality, however. First, the doctrinal line drawn by Texas courts, which Powers endorses, seems to exclude cases where a contracting party exercises executor power over resources jointly owned with a counterparty—which can exist in many contexts other than first-party insurance, as the *Manges* case demonstrates. Second, the rationale Powers offers to explain why the conflict of interest that an insurer faces in a third-party liability case is different from the pursuit of self-interest in first-party contract disputes just restates his conclusion. He simply says that “the insurer is a fiduciary with an obligation to defend the insured according to the insured’s best interests.”¹¹⁹ An insurer is not technically a fiduciary, although some courts have held that, with regard to the duty to settle and duty to defend, the insurer’s duty is like that of a fiduciary.¹²⁰

Some insurance-law scholars have no patience for those who conflate “fiduciary-like duties” for purposes of ascertaining whether

115. *Id.* at 1229:

[C]ontract law itself should tell us which body of law should control. If contract law purports to decide the case, the negligence paradigm (and its cousin, good faith) should stay in the background. Again, this does not mean that contract law will always trump tort law; instead, it means that contract law, not tort law, should tell us which paradigm should control.

116. *Id.* at 1230.

117. *Id.*

118. *Id.*

119. *Id.* at 1229.

120. See *Van Noy v. State Farm Mut. Auto. Ins. Co.*, 16 P.3d 574, 581 n.4 (Wash. 2001) (Talmadge, J., concurring) (quoting Douglas R. Richmond, *Trust Me: Insurers Are Not Fiduciaries to Their Insureds*, 88 KY. L.J. 1, 2 (2000)):

The duty of a fiduciary to his beneficiary is essentially that of a trustee. A fiduciary ‘is bound to act in the highest good faith toward his beneficiary’ and he may never seek to gain an advantage over his beneficiary by any means. A fiduciary must give priority to his beneficiary’s best interest whenever he acts on the beneficiary’s behalf. A fiduciary owes his beneficiary a duty of undivided loyalty, meaning that a fiduciary cannot abandon or stray from this relationship to further his own interests.

tort or contract applies with the proposition that insurers *are* fiduciaries.¹²¹ We agree. If the courts are going to fill in gaps left by contract with “fiduciary-like” tort duties, they need a better reason than saying, in effect, that contract law cannot protect counterparties to whom “fiduciary-like” duties are owed. That argument is circular.

b. Bad Faith in the Insurance Context

i. Third-Party Insurance Bad Faith

So what is it about the insurance contract that has led to such a rapid and complete consensus that it needs to be complemented by tort duties?¹²² The third-party cases, which were the vanguard for the tort of bad faith, are easy to understand in terms of the risks described in Part II.

In the *Crisci v. Security Insurance Co.* case, for example, the insured was subject to the risks of shirking and loss of control.¹²³ The company defended its insured but declined an offer to settle for \$10,000 (the policy limit) in a case in which its claims manager and attorney both thought there was a significant likelihood of a much larger judgment. The company appeared to decide that, since its own risk was capped at \$10,000, it might as well take a shot at convincing a jury that a smaller verdict (or none at all) was warranted. Even when the plaintiffs dropped their demand to \$9000 and Crisci offered to pay \$2500 of that amount, the insurer refused to offer more than \$3000 (the out-of-pocket medical expenses of one of the plaintiffs). At trial, the jury awarded \$101,000. This award ruined the insured, a seventy-year-old immigrant widow.¹²⁴ She filed a bad faith action against her insurer claiming economic damages and mental

121. See, e.g., Silver & Syverud, *supra* note 6, at 285–86 (“The hallmarks of agency—fiduciary duty and control—are missing from the relationship between the company and the insured.”).

122. This conclusion is not universally shared, although it is a dominant view in both the courts and in the academy. Robert Jerry has argued that contract law could have provided insureds with the same level (or at least an adequate level) of protection as the bad faith tort. See Robert H. Jerry, II, *The Wrong Side of the Mountain: A Comment on Bad Faith’s Unnatural History*, 72 TEX. L. REV. 1317, 1342 (1993).

123. See *Crisci v. Sec. Ins. Co.*, 426 P.2d 173, 173–76 (Cal. 1967) (explaining that defendant’s insurance company declined to settle when it believed a jury verdict would award damages of less than \$100,000 even when specifically authorized to settle by defendant.).

124. *Id.* at 175–76. In the ensuing settlement, Mrs. Crisci lost the rental property that was her sole source of income as well as everything else of value that she owned. *Id.* According to the Court, her health declined, she suffered mental illness, and she attempted suicide. *Id.*

distress.¹²⁵ The trial court awarded Crisci full damages, including \$25,000 for pain and suffering. The California Supreme Court upheld the award, saying that the insured had a right to rely on the company not to “gamble with the insured’s money to further its own interests.”¹²⁶

The language of *Crisci* emphasized both the noncommercial motive behind Crisci’s purchase of insurance¹²⁷ and her trust in the insurer to take her interests into account and to act “reasonably” when handling her settlement negotiations.¹²⁸ It also emphasized the inexorable economic incentives written into the contract itself. It was obvious (although perhaps not to Crisci) that the contract created, in many circumstances, a conflict of interest between the insurer and the insured. Therefore, Crisci faced both shirking risks and control risks. The inexorable conflict identified by the court—that in some circumstances going to trial rather than settling the case will be to the advantage of the insurer—is a classic example of the negative consequences flowing from one party putting the other party’s money at risk. This is shirking in the sense that, by purchasing a low probability of saving between \$0 and \$10,000, the insurer forced Crisci to “pay for” a much larger risk that she would have to pay a large amount of money (which turned out to be \$100,000). This is no different from one party to a contract taking more than his fair share of the profits of a joint undertaking or, in the case of litigation investment, the claim owner not investing any time or energy into the litigation after the investor has delivered the funds.

Whether the shirking risks alone are enough to justify suspending the economic loss rule in first-party insurance cases is not something we can easily answer, but we do not need to, since it is obvious that, in the eyes of most observers (including, for example, Powers), the risk that the insurer will exercise control over the insured’s litigation in ways that ignores the insured’s preferences and desires seems to push the case over the boundary line. By control, we do not mean only that the insured harmed Crisci’s economic interests through its unilateral control, since that seems to simply restate the

125. In fact, Crisci assigned her bad faith claim to the plaintiffs as part of her settlement, a point irrelevant to this discussion. *See id.*

126. *Id.* at 177.

127. *Id.* at 179 (“Among the considerations in purchasing liability insurance, as insurers are well aware, is the peace of mind and security . . .”).

128. *Id.* at 176 (Insurer was expected to “give the interests of the insured at least as much consideration as it gives to its own interests; and that when ‘there is great risk of a recovery beyond the policy limits’ ” to exercise reasonable judgment on behalf of the insured. (quoting *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 201 (Cal. 1968))).

shirking risk again; rather, we mean something more specific. The insurer literally ignored Crisci's agency in the litigation; it ignored her preferences about settlement strategy, and it even went so far as to ignore her offer to participate in the settlement by contributing \$2500. Thus, if Crisci believed—as some laypeople do—that third-party liability insurance would provide sufficient resources to effectively litigate, her expectations of securing partial control over her litigation through the insurance contract were disappointed.¹²⁹

This analysis suggests a limited role for tort bad faith principles in commercial litigation-investment contracts where one party utterly ignores the expressed preferences of another. The situation in our hypothetical is different, however, because the claim owner's preferences were part of the negotiations over the investment contract. Owner could have bargained for the right to make settlement decisions without obtaining Investor's approval, but that was not the agreement the parties reached. Perhaps Owner received terms that were more favorable in other respects, such as the return to which Investor would be entitled at various points in time. Nevertheless, the distinction remains that the parties in the hypothetical bargained over their outcome-related preferences, unlike the parties in *Crisci*.

The above analysis, which emphasizes the lay consumer's perspective, may seem relevant only to *consumer* litigation investment, a field that, as noted above, this paper avoids.¹³⁰ A large

129. It is a separate question whether the California Supreme Court should have read into the liability insurance contract any form of shared control. Most liability contracts can be read to transfer all control over litigation to the insurer unless there is a special "consent to settle" clause. See Sebok, *supra* note 5, at 28–30 ("[T]he standard liability contract does not require an insurer to take into account the insured's litigation preferences . . ."). Laypeople may resent when their insurance company settles what they believe are frivolous claims instead of resisting them. See James Fischer, *Insurer-Policyholder Interests, Defense Counsel's Professional Duties, and the Allocation of Power to Control the Defense*, 14 CONN. INS. L.J. 21, 40 (2007):

The policyholder wishes to contest liability, perhaps to avoid the stigma of responsibility or the economic consequences of a finding of fault. A defense limited to the issue of damages may be perceived by the policyholder as an acknowledgment of legal responsibility. For some individuals such an admission may be difficult to make even in the face of clear evidence of fault. Some individuals can live with the vagaries of life. They will accept the decision to focus the litigation on minimizing the loss even though it means admitting, or being understood as admitting, responsibility for conduct they do not actually believe was legally wrongful. Other individuals will find such conduct morally and emotionally repugnant.

130. Given the structure of consumer litigation-investment contracts today, the risks posed by those contracts are both fewer and somewhat one-sided. The main risks of consumer litigation-investment contracts imposed by the owner upon the investor are: information asymmetry (the claimholder may lie about the facts underlying their claim) and shirking (the claimholder may "take the money and run" either before or after conclusion of the case). The investor cannot impose symmetrical risks on the owner because consumer litigation investment is not staged and never transfers any control over to the investor.

proportion of the bad faith cases discussed in the literature involve individuals who are consumers, which has led some observers to limit their discussion of the law of bad faith to the perspective and needs of individual consumers.¹³¹ Nonetheless, the law of bad faith protects businesses as well as individuals, and courts do not apply the law differently based either on the insured's legal status, level of sophistication, or level of perceived economic dependency.¹³² Courts have adopted the correct approach to shirking; the conflict of interest that presented itself in the *Crisci* case is the same regardless of whether the insured was a seventy-year-old woman, a school district, or a large multinational corporation.¹³³ It is an open question whether the risk of loss of control would generate the same degree of pressure to push across the border from contract to tort where the insured is a corporation or a sophisticated, high-net worth individual. To our knowledge, no court has said as much. We think that courts should be more willing to turn in cases in loss of control cases involving consumers. In commercial litigation investment, the claim owners are either corporations or sophisticated, high-net worth individuals. We think that the courts would be right in these cases to be skeptical of claims by plaintiffs that they could not bargain ex ante for the degree of control they optimally would have wished to retain.¹³⁴

ii. First-Party Insurance Bad Faith

There are important differences between third- and first-party bad faith breach in insurance law that explain why the breach of a litigation-investment contract should be remedied under contract law, not tort. One important difference concerns the insurer's promise to the insured. All so-called third-party bad faith cases involve the

131. See, e.g., Feinman, *supra* note 22, at 556 ("The relationship between an insurance company and its consumer policyholder is perhaps the best example of a relational contract of dependence and inequality."). Feinman acknowledges that the law of bad faith in insurance applies in commercial-insurance contexts as well, but chooses to describe the insurance contract entirely from the perspective of a consumer who lacks both power and sophistication. *Id.* at 556 n.14.

132. See, e.g., *Transp. Ins. Co. v. Post Express Co.*, 138 F.3d 1189, 1192 (7th Cir. 1998) (holding that duty by a business, as an insured, to settle was violated in bad faith because "[e]vidence in this case permitted a rational jury to conclude that Transport Insurance gambled with its client's money").

133. See 1-2 NEW APPLEMAN INSURANCE BAD FAITH LITIGATION § 2.03[1] ("Insurer Must Consider Insured's Interests") (discussing *Transp. Ins. Co. v. Post Express Co.*).

134. In liability insurance, for example, sophisticated counterparties have been able to contract for control, and courts have refused to extend bad faith-tort principles to cases where plaintiffs have alleged that the exercise of the control ceded to the insurer-caused injury. See Silver & Syverud, *supra* note 6, at 264-65 (reviewing "full coverage" cases).

breach of a promise to assist the insured if they are sued by a third party.¹³⁵ This contrasts with first-party cases in which the insurer promises to cover losses suffered by the insured for any reason specified in the contract, such as fire or accident. While both forms of insurance predated its rise, the bad faith tort was first developed in the context of third-party cases. The earliest case, *Hilker v. Western Automobile Insurance Co.*, established that an insurer's failure to pay for the insured's legal defense because it believed sincerely and incorrectly that the claim against the insured fell outside the contract was a violation of the covenant of good faith and fair dealing that sounded in negligence.¹³⁶ Other courts soon allowed for punitive damages when a litigant could prove that the insurer's refusal to defend was consciously wrongful.¹³⁷ California expanded third-party failure to perform to include not only the "duty to defend" but also the "duty to settle," which was the subject of the *Crisci* case, discussed above.¹³⁸

Only after *Crisci* did courts extend the tort principles developed in third-party bad faith cases to first-party cases. Here too, California took the lead, in *Gruenberg v. Aetna Insurance Co.*¹³⁹ Gruenberg's business, a cocktail lounge, burned down. He made a claim to his fire insurer, Aetna, who refused the claim because it believed that Gruenberg intentionally started the fire.¹⁴⁰ The court allowed Gruenberg to sue Aetna in tort, including for noneconomic damages for pain and suffering.¹⁴¹ The court based its extension of the tort from third- to first-party breaches of insurance contracts on the grounds that the promise to protect the insured against liability and the promise to protect the insured against fire losses "are merely two different aspects of the same duty [that establishes] . . . the obligation . . . under which the insurer must act fairly and in good faith in discharging its contractual responsibilities."¹⁴²

135. See Richmond, *supra* note 22, at 80 (outlining numerous cases regarding third-party bad faith litigation).

136. 231 N.W. 257, 261 (Wis. 1930).

137. Richard B. Graves III, Comment, *Bad-Faith Denial of Insurance Claims: Whose Faith, Whose Punishment? An Examination of Punitive Damages and Vicarious Liability*, 65 TUL. L. REV. 395, 397 (1990).

138. Richmond, *supra* note 22, at 78.

139. 510 P.2d 1032, 1037 (Cal. 1973).

140. An investigator hired by Aetna may have had some role in convincing the police that Gruenberg had committed arson, a charge which was dropped for lack of probable cause after a magistrate's hearing. *Id.* at 1035.

141. *Id.* at 1041.

142. *Id.* at 1037.

The tort of bad faith did not gain the same widespread acceptance in first-party insurance contracts as in third-party insurance contracts.¹⁴³ However, the fact that about half the states have permitted claims for first-party bad faith, and that the tort has evoked very strong criticisms, suggests that it is important to see what risks might be present in the third-party context that are absent in the first-party context.¹⁴⁴ According to Powers, the main difference lies in the fact that in the first-party context, the insured and insurer merely disagree over the “requirements of the contract,” which is “something that could happen in any contract dispute.”¹⁴⁵ Leaving aside the question of why the insured and insurer are not also disagreeing over the “requirements of the contract” in third-party cases (especially in the duty to defend context), it is worth asking whether the counterparty interests the insurer risks in the first-party cases are different than those risked in the third-party cases, even if Powers’s description of the disagreement is correct. In fact, the risks are significantly different.

The risk of shirking is much more serious in terms of its effects in third-party insurance contracts compared to first-party insurance contracts. When the insurer refuses to pay the insured the money promised under the insurance contract in a property insurance case like *Gruenberg*, it is a form of “take the money and run,” but not in the same way as in a liability insurance case like *Crisci*. In both cases, the insurer takes the premiums and “runs off” with them without paying the expected cost of the indemnity for which they contracted. But in the third-party case, the value of the indemnity is not just the amount the insurer would have paid (the policy limits), but also the excess judgment the insured would have avoided. Shirking a liability insurance contract produces potentially huge externalities for the insured that far outweigh the gains for the insurer. The same is not true in a first-party insurance contract. While the loss of an expected indemnity will impose costs on the insured in first-party insurance,

143. “While third-party bad faith quickly gained acceptance and is now widely-recognized as an independent tort, courts have been less willing to apply tort principles to the first-party insurance relationship.” Richmond, *supra* note 22, at 104. In 1994, Henderson estimated that “at least” twenty-four states had adopted the *Gruenberg* principle, as well as five more that allowed for expanded damages under contract principles or statute. Henderson, *supra* note 18, at 1153–55.

144. For criticisms, see Powers, *supra* note 62, at 1230 (asserting that first-party insurance cases are no different from any normal contract dispute, thus not needing any special consideration); Sykes, *supra* note 22, at 406–08 (explaining that courts have split on the issue of whether to grant special remedies in first-party insurance cases and that those remedies may not be necessary, especially when the breach is unintentional).

145. Powers, *supra* note 62, at 1230.

the range of that loss is both limited and known in advance by the insured.¹⁴⁶

The difference between first- and third-party insurance contracts nicely illustrates the risk of foregoing an opportunity and entrusting it to another party. One of the reasons why the claim of an insured like Crisci sounds in tort rather than contract is that the interest that the insured contracted to protect—peace of mind in the face of a liability claim—is worth the cost of insurance not only because liability claims are potentially openended, but also because they are financial risks that are not homogenous over time. Litigation is a process with definite strategic decision points that are only partially under the control of the insured. At a certain point, the failure to accept a settlement means, for all intents and purposes, a commitment to go to trial.¹⁴⁷ In other words, settlement offers are opportunities that if foregone by the insured, may be lost and never regained. In first-party insurance contracts, there is no opportunity that is lost due to the failure to provide the promised coverage (except in special cases where the money was especially valuable at a specific point in time because of an opportunity that was time sensitive). If there is a risk arising from loss of an opportunity due to failure to perform the first-party insurance contract, it is homogenous throughout the performance of the contract. In third-party insurance, the value of the settlement opportunity is dynamic.

The risk of loss of control is much more significant in third-party insurance bad faith than first-party insurance bad faith. In first-party insurance contracts, the insured has no reason to value control other than the control over the payment of the money owed to her by the insurer, which is already captured by the risk she faces of the insurer shirking. On the other hand, loss of control is a central risk of the third-party insurance contract. The decision whether to settle, in addition to exposing the insured to potentially unlimited liability and removing from them a strategic decision point in the litigation, is also an example of control in its purest form. Especially for insureds who feel that any agreement with a plaintiff is like an admission of fault, the very fact of settlement may cut against their idea of what, ideally, litigation should achieve. The same cannot be said for the frustration an insured feels where the insurer wrongly—even intentionally

146. See Sykes, *supra* note 22, at 419–21 (suggesting possibilities for assessing damages related to the loss or delay of an expected indemnity).

147. We are aware that cases may settle at any time, including after so-called final settlement offers are rejected, but it is also true that human dynamics can overtake the litigation process making the cost of rejecting a “final” settlement offer exponentially higher than the cost of rejecting the plaintiff’s first settlement offer.

wrongly—delays or denies the money owed under the insurance contract. As Sykes points out, to the extent that the expected value of the insurance settlement has market value, the insured can sell the claim (or borrow using the claim as security) and recapture the transaction costs through contract damages.¹⁴⁸ In this sense, Powers is correct: the delay and frustration felt by an insured who is denied money to which he has a contract right is no different than the delay and frustration felt by any creditor who is denied money to which he has a contract right.¹⁴⁹

B. Duties as a Matter of Contract Law

1. Introduction

Part III.A argued that tort doctrines marching under the banner of good faith are an inappropriate framework for regulating commercial litigation investments. The parties themselves are in a better position to perceive and safeguard against the possible risks of litigation investment than are courts, juries, administrative agencies, or other external decisionmakers. In a social and political system that values individual autonomy and liberty, people generally ought to be permitted to make decisions respecting their own welfare. (Default rules in contract law can be established with reference to what most people want, most of the time, thereby reducing bargaining costs.)¹⁵⁰ Tort law is best suited to situations in which there is good reason to believe that, systematically speaking, one party is incapable of protecting its interests effectively. In other cases, tort rights come with a built-in cost resulting from their open-ended nature and retrospective application to commercial relationships. Juries applying general norms of reasonableness systematically second-guess decisions made by parties who had an opportunity to allocate rights and duties among themselves. If there is no reason to believe the parties are not in a good position to determine what protection they need, there is no basis for substituting tort norms for those of contract.

Contract law is superior to tort as a means of mitigating the risks inherent in commercial litigation investment for several reasons. First, the intrusion of the tort system into economic relationships is justifiable only when there is reason to believe that there are affected third parties who are unable to bargain for an appropriate level of

148. Sykes, *supra* note 22, at 421.

149. Powers, *supra* note 62, at 1230.

150. Gillette, *supra* note 9, at 541–42 (describing idea of “majoritarian default rules”).

protection.¹⁵¹ If customers were frequently injured at amusement parks or poisoned at restaurants, they would stop patronizing those businesses. Because many commercial actors have a preexisting incentive to take precautions to protect their customers, courts applying the reasonable care standard in tort lawsuits should refer to the customary standard of care prevailing in these industries when applying the negligence standard. The paradigmatic example of this deference by courts is in medical malpractice cases, where the custom among physicians practicing in a particular area of specialization is dispositive of the standard of care. In commercial litigation-investment transactions, not only do the parties in theory have the ability to bargain over the terms of their relationship, but they almost certainly have *actually* bargained over even the finest points in the contract.

Second, contract law is much more sensitive to the specific risks that the parties face in a particular transaction; tort law applies a more one-size-fits-all approach to regulating conduct. Tort law relies on general standards of conduct, usually elaborations of the overarching reasonable care norm, which courts and juries apply retrospectively when there is a legally cognizable injury. Tort standards are ostensibly forward-looking—that is, a party is evaluated according to whether he did what a reasonable person would have done *at the time*—but the application of legal norms by decisionmakers is highly susceptible to hindsight bias.¹⁵² In contract law, by contrast, the standard itself is up for grabs; the parties determine what duties they owe to each other.

Contract doctrine reflects a commitment to the values of individuality, autonomy, consent, privacy, and voluntary assumption of duties.¹⁵³ As a result, the parties themselves, as opposed to judges and juries, make the decisions regarding the allocation of rights and duties and the remedies available in the case of default by the other. The parties can bargain for a liquidated-damages clause, for example, if they wish to price the risk of future breach. In the context of commercial litigation funding, the risks the parties face are highly specific to the terms of the deal the parties have reached. The risks of

151. See, e.g., Richard A. Epstein, *The Path to The T.J. Hooper: The Theory and History of Custom in the Law of Tort*, 21 J. LEGAL STUD. 1, 13–16 (1992) (discussing the use of the custom, usually a principle used in the tort system, in analyzing transactions within an industry).

152. See Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 572–73 (1998) (explaining how hindsight bias effects decisionmakers as they attempt to apply the reasonableness standard, already knowing that the defendant's conduct resulted in an injury).

153. Powers, *supra* note 62, at 1214.

litigation investment, such as information asymmetry and shirking, are categorical and general, meant only to suggest the specific types of problems the parties may anticipate. Where it is difficult to generalize *ex ante* about the specific form a risk will take and the best means of mitigating it, courts should rely on the terms of the parties' agreement, with general duties serving at most as default rules.¹⁵⁴

There may be a few categories of cases about which it is possible to generalize. Sometimes one party is dependent upon another for "natural reasons" relating to facts about the natural world. Parties may be in a "special relationship," as the common law labels it, of parent-child, innkeeper-guest, carrier-passenger, guardian-ward, and so on, which supports moral and sometimes legal duties to care for the party in a position of vulnerability. The common-law category of "special relationship" encompasses these relationships of natural dependency.¹⁵⁵ Where there is a natural dependency, there is a special relationship, and from this it follows that there may be duties as a matter of tort law.

Similarly, the *Crisci* case and other cases involving bad faith conduct by third-party liability insurers show that certain types of vulnerabilities are "baked in" to a liability insurance contract. It will always be the case that the insurer's downside will be capped at the policy limits. Thus, if a plaintiff makes an offer to settle at the policy limits, the insurer could decide to exercise its right to control the litigation to insist on going to trial, effectively gambling with the insured's money. The law imposes heightened obligations of good faith on insurers in these situations because of the structural, built-in vulnerability the liability insurance contract creates. In the great run of cases, however, parties become dependent upon one another only because they have agreed to make it so. If there is no natural dependency at the outset, but dependency has arisen in the relationship, the parties have presumably concluded that it is to their mutual advantage to structure their relationship in this way. The law must be cautious about interfering with dependencies of this type, because unwinding contractual relationships generally upsets an

154. See Gillette, *supra* note 9, at 544-45 (pointing out some flaws in using only default rules and suggesting that courts should turn to the written document and the prior conduct of the parties).

155. See RESTATEMENT (SECOND) OF TORTS § 314A (1965) (enumerating common-law categories). Numerous cases involve attempts by plaintiffs to expand these categories to include the relationship with the defendant so as to support affirmative duties to protect the plaintiff from harm. See, e.g., *Farwell v. Keaton*, 240 N.W.2d 217, 221-22 (Mich. 1976) (finding a special relationship where the plaintiff and defendant were "companions on a social venture"); *Harper v. Herman*, 499 N.W.2d 472, 474-75 (Minn. 1993) (distinguishing a social boating trip from common-law special-relationship categories).

agreed-upon set of rights and duties that the parties adopted for their own, autonomously chosen reasons.

Theorists tend to react very differently to the problem of how a legal relationship should adapt to changing circumstances depending on whether their sympathies lie generally with the institutions and procedures of the tort system—courts and juries as decisionmakers, applying open-ended standards of conduct—or with the bargaining over the terms of an agreement that characterize contract law. Consider the much-discussed issue of efficient breach of contract.¹⁵⁶ Economic theorists like Richard Posner see nothing wrong with one party breaking its promise to perform as long as it compensates the other party. The purpose of contract damages is to give the promisor an incentive to keep its promise *unless* the result would be an inefficient use of resources.¹⁵⁷ If the seller has promised to produce some part that is critical to the buyer's production process, but a third party comes along and offers a significant premium over the contract price to the seller, "there will be an incentive to commit a breach. But there should be."¹⁵⁸ The breaching party gains by taking advantage of the new opportunity, and the nonbreaching party, by receiving expectation damages, is placed in the same position it would have

156. See, e.g., Barry E. Adler, *Efficient Breach Theory Through the Looking Glass*, 83 N.Y.U. L. REV. 1679, 1679 (2008); David W. Barnes, *The Anatomy of Contract Damages and Efficient Breach Theory*, 6 S. CAL. INTERDISC. L.J. 397, 397 (1998); Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 630 (1988); Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1443–45 (1980); Farnsworth, *supra* note 21, at 1380; Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 1 (1989); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 557–58 (1977); Avery Katz, *Virtue Ethics and Efficient Breach*, 45 SUFFOLK U. L. REV. 777, 777 (2012); Gregory Klass, *To Perform or Pay Damages*, 98 VA. L. REV. 143, 143 (2012); Jody S. Kraus, *The Correspondence of Contract and Promise*, 109 COLUM. L. REV. 1603, 1605–06 (2009); Ian R. Macneil, *Efficient Breaches of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 947–50 (1982); Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1090–93 (2000); Steven Shavell, *Is Breach of Contract Immoral?*, 56 EMORY L.J. 439, 456–59 (2006); Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 729–33 (2007).

157. POSNER, *supra* note 25, § 4.10, at 150.

158. *Id.* at 133. Posner's example:

Suppose I sign a contract to deliver 100,000 custom-ground widgets at 10¢ apiece to A for use in his boiler factory. After I have delivered 10,000, B comes to me, explains that he desperately needs 25,000 custom-ground widgets at once since otherwise he will be forced to close his pianola factory at great cost, and offers me 15¢ apiece for them. I sell him the widgets and as a result do not complete timely delivery to A, causing him to lose \$1,000 in profits. Having obtained an additional profit of \$1,250 on the sale to B, I am better off even after reimbursing A for his loss, and B is also better off.

Id. at 151.

been if the contract had been performed. The result is Pareto optimal. Granted, the seller could have attempted to renegotiate with the buyer, but this would have introduced transaction costs.¹⁵⁹ The efficient solution would be to let the seller unilaterally decide not to perform under the contract and to pay expectancy damages to the buyer. (Other remedies, such as specific performance, might be inefficient relative to this baseline unless renegotiation costs were low.) Contract remedies should not overdeter efficient breaches. There may be reputational or other reasons for the seller not to breach, but as long as the seller is willing to compensate the buyer for losing the expected value of the contract, there is no basis for using a remedy that would prevent the breach.

Even Posner, sometimes caricatured as “Mr. Efficient Breach” himself, recognizes an exception to the efficient breach doctrine for contracts in which performance is inherently sequential.¹⁶⁰ Performance is generally sequential in commercial litigation-investment contracts, but the transaction underlying those contracts is generally a one-shot purchase of a share in the claim in exchange for a contingent interest in a share of the proceeds. Posner goes so far as to say that “the fundamental function of contract law . . . is to deter people from behaving opportunistically toward their contracting parties.”¹⁶¹ Naturally, the question arises, “What does it mean to behave opportunistically?” Posner defines opportunistic behavior as trying to “tak[e] advantage of the vulnerabilities created by the sequential character of contractual performance.”¹⁶² For example, a sequentially performed contract often creates sunk costs in the form of transaction-specific investments.

The problem with Posner’s definition is that sometimes these very vulnerabilities are built into the design of the contract to serve as a bonding mechanism.¹⁶³ They may create incentives for opportunistic breaches of one sort, but they may deter breaches of another sort. For example, a loan agreement may provide that the lender has sole discretion to refuse to make further loans and to declare outstanding amounts payable immediately, as in the well-known case of *K.M.C. Co. v. Irving Trust Co.*¹⁶⁴ That way, if the lender concludes that the

159. Scott, *supra* note 8, at 2010 (“[B]argain theory ignores the significant barriers to renegotiation, or ex post bargaining, that exist in many contractual relationships.”).

160. POSNER, *supra* note 25, § 4.1, at 115–16.

161. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 438 (1987) (alteration in original).

162. See POSNER, *supra* note 25, § 4.1, at 115–16 (defining good faith as opposed to opportunistic behavior).

163. Fischel, *supra* note 13, at 139.

164. 757 F.2d 752, 754 (6th Cir. 1985).

borrower is misbehaving, perhaps by making risky investments or mismanaging the company, the lender can protect itself from further harm by refusing to extend more credit. The contract provision serves as a bond because it enables the party at risk—in this case, the lender—to protect itself without having to incur the transaction costs associated with suing for breach. However, if a court concludes, as the Sixth Circuit did in *K.M.C.*, that the lender acted in bad faith by denying the borrower an additional line of credit, the implied term of good faith would undercut the bonding effect of the sequenced lending structure.¹⁶⁵

The contract's design in *K.M.C.* seems to create either the risk of misbehavior by the borrower or the risk of opportunistic behavior by the lender; there does not appear to be a way to eliminate one of those risks without creating or exacerbating the other. Daniel Fischel uses *K.M.C.* and another important lender-liability case, *State National Bank of El Paso v. Farah Manufacturing Co.*,¹⁶⁶ to demonstrate the importance of relying on the terms of the parties' bargain when assessing good faith performance. In *Farah*, three banks that extended \$22 million in credit to a company were worried that the company's former CEO, who had caused the company substantial losses, would return to his former position.¹⁶⁷ Thus, they negotiated a clause providing that the company would be in default under the loan agreement if the former CEO returned.¹⁶⁸ When the former CEO returned after a proxy fight, the banks threatened to call the loan and accelerate the amount due.¹⁶⁹ The company sued for fraud, tortious interference with contract, and business coercion (economic duress).¹⁷⁰ Although not relying on the implied term of good faith, the court held that the banks acted unlawfully by asserting their right to call the loans in response to the former CEO's return.¹⁷¹ Fischel argues that the lenders in both *K.M.C.* and *Farah* did not behave opportunistically because they were merely seeking the protection of a contract provision meant to safeguard against the very risk that subsequently occurred—the deteriorating financial condition of the borrower in

165. Fischel, *supra* note 13, at 142 (“The strength of the bond, however, is weakened if the borrower can argue to a court that the exercise of discretion granted to the lender by the agreement was not done in good faith.”).

166. 678 S.W.2d 661, 661–99 (Tex. App. 1984).

167. *Id.* at 666–67.

168. *Id.* at 667.

169. *Id.*

170. *Id.* at 668.

171. *Id.* at 669.

K.M.C. and the return of the former CEO in *Farah*.¹⁷² The courts erred, according to Fischel, by relying on extracontractual fiduciary duties or contractual duties of good faith that did not use the terms of the parties' bargain as a starting point.

2. Bad Faith Breach of Contract

The hypothetical in Part II contains numerous actions that could be characterized as bad faith dealing. Owner had private information regarding his risk preferences that he did not disclose to Investor. Owner promised to use the funds invested in the claim to pay the expenses of litigation but dissipated half of the funds on a luxury vacation.¹⁷³ Investor delayed responding to Partner's settlement offer in order to capture an increase in the rate due under the contract. Finally, Investor knew that Owner needed funds to continue the litigation but refused to provide them when Owner declined to accept a settlement offer with financial terms that were advantageous to Investor (and, arguably, to Owner as well). Because we have established that the idea of bad faith conduct should not be given substance using tort doctrines, we now must articulate how it should be understood in terms of contract law.¹⁷⁴ As a matter of the theory of the tort-contract border, the specific question will be how to

172. Fischel, *supra* note 13, at 143, 145–46.

173. Several commentators have argued that the example is unrealistic here because no sensible party in the position of Investor would have failed to protect itself against this risk by using a different transactional structure—e.g., paying the funds directly to the law firm. We have elected to leave in this feature of the hypothetical, however unrealistic, to illustrate another risk in contractual relationships, namely, that of a simple mistake or oversight by one of the parties. Moreover, Owner in the hypothetical did agree to use the invested funds solely for the purpose of litigation. One's attitude toward contracts is revealed by the intuition that Owner's promise alone is an inadequate protection for Investor's interest in not having the funds dissipated on nonlitigation expenses.

174. See, e.g., Burton, *supra* note 28, at 369 (arguing that bad faith occurs "when discretion is used to recapture foregone opportunities"); E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 666–70 (1963) (discussing the concept of good faith as it appears in the UCC and how it relates to the concept of commercial reasonableness); Robert A. Hillman, *Contract Modification Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 680, 686 (1982) (discussing the concept of good faith as it relates and applies to contract modification); Robert A. Hillman, *Policing Contract Modifications Under the UCC: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849, 856–57 (1979) (discussing bad faith as it relates to contract modification and unconscionability); Robert S. Summers, *The General Duty of Good Faith – Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 810–12 (1982) (documenting the development of good faith and its inclusion in the Restatement (Second) of Contracts); Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 195–99 (1968) (discussing solutions within the law to the problem of bad faith).

develop a bad faith norm in contract law without collapsing a contract-law remedy into the disfavored tort action for bad faith.

To take one example from our hypothetical contract, the investment agreement gives Investor discretion to make further contributions in exchange for an increased share of the recovery. As the litigation continued, and after Owner improvidently blew some of the money, Investor found it advantageous to deny further contributions and pressure Owner to settle, while Owner preferred a second infusion of cash so that he could proceed to trial in the hopes of obtaining an injunction. Investor clearly knew that refusing the second round of funding would greatly increase the financial pressure on Owner and probably force a settlement to which Owner otherwise would not agree. Did Investor act in bad faith by declining to fund the second tranche, knowing of Owner's financial predicament? Or, should a court find no breach here because Owner could have protected himself by securing a promise at the time of contract formation that Investor would be obligated to fund subsequent tranches? Conversely, and analogizing to the *K.M.C.* and *Farah* cases, should the Investor's right to decline to make further contributions be understood as a bonding mechanism that offered protection against foolish or self-interested behavior by Owner?

Notice that this question does not pertain solely to the remedies available for breach. Many of the tort bad faith cases involve a clear breach of the contract and a promisee who seeks consequential damages, not only expectation damages. Consider the *Seaman's* case discussed in Part III.A.2,¹⁷⁵ for example, where it is perfectly clear that Standard Oil breached the contract; the question in that case was whether the plaintiff could recover consequential and punitive damages. In our hypothetical, however, Investor has no obligation to continue funding the litigation. The parties had an opportunity to bargain for an obligation to make future contributions (or perhaps a contingent obligation, depending on the occurrence of certain conditions specified ex ante), but did not do so. Labeling Investor's conduct as bad faith in relation to the contract would effectively amend the contract to incorporate extracontractual norms of ex post fairness. It may be the case that Owner is in a position of dependency or vulnerability with regard to Investor, which may rise to the level of de facto control by Investor over the Owner's litigation conduct.¹⁷⁶ But,

175. *Seaman's Direct Buying Serv., Inc. v. Standard Oil Co.*, 686 P.2d 1158, 1158-77 (Cal. 1984).

176. See Burton, *supra* note 28, at 380-83 (discussing cases where norms of good faith are enforced because one party is dependent upon the other).

notice that Investor and Owner found themselves in a strong and weak position, respectively, at a future time only because of decisions they made *at the time the contract was formed*. The terms of the parties' contract, not some feature of their extracontractual relationship, created the dependency.

From the point of view of contract law, the theoretical risk is that an open-ended good faith doctrine may permit a court to deem Investor's decision a breach of an implied term of the contract even though the express terms of the contract grant Investor the privilege (correlative with Owner's no-right) to refuse further funding. Doing so would collapse bad faith as a matter of contract law into tort bad faith, with all of the attendant problems that led California and most other jurisdictions to abandon the freestanding bad faith tort.¹⁷⁷

To avoid the collapse into tort, contract-law theorists have attempted to ground the standard for determining bad faith in some aspect of the contract itself. Steven Burton, for example, has argued that a party acts in bad faith if it uses discretion conferred by the contract in order to recapture opportunities that were foregone at the time of formation: "A reasonable person . . . would enter a contract that confers discretion on the other party only on the belief that the discretion will not be used to recapture forgone opportunities."¹⁷⁸ Contracts with an open price or quantity term, for example, might have been deemed unenforceable for lack of definiteness, but the implied term of good faith provided an obligation that was sufficiently clear to permit courts to enforce these contracts.¹⁷⁹

In the hypothetical, Investor's opportunity costs in this transaction include the foregone opportunity to invest the initial \$500,000 contribution in other cases—that much is clear. But Investor would argue that it did not forego the opportunity to direct its assets to transactions with parties other than Owner; it did not precommit to making subsequent investments, thereby incurring additional opportunity costs. Burton's test is a mixed subjective-objective inquiry. Subjectively, it matters whether Investor acted in order to recapture a foregone opportunity; objectively, the reasonable expectation of the parties *ex ante* determine the identity of the foregone opportunity.¹⁸⁰ Alternatively, the objective standard can be elaborated in terms of commercial norms based on the decency, fairness, or reasonableness of

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

178. Burton, *supra* note 28, at 387.

179. *Id.* at 388–89.

180. *Id.* at 390–91.

the commercial community of which the parties are members.¹⁸¹ Finally, one could give a Coasean account of the duty of good faith, in which the parties' duties approximate the bargain they would have reached if they were able to bargain without costs, either at the outset of the relationship or when changed circumstances arose.¹⁸²

Whether the standard for assessing contract good faith turns on the opportunities (objectively) foregone by the parties or the terms of a hypothetical bargain, a great deal depends on assumptions about the parties' ability to forecast and plan for the occurrence of events in the future.

Any attempt to decipher the parties' intent from a written document may reflect a certain fetish regarding the ability and practice of commercial parties to form intentions about the full scope of their relationship at its initial stages. It suggests to a potentially unrealistic degree that parties can recognize their intentions and draft documents that embody those intentions in a manner comprehensible to trading partners and courts.¹⁸³

We do not rely on unrealistic assumptions about the rationality or prescience of the parties in arguing for an essentially contract-centered approach to good faith. Nor do we assume that the long-term nature of a litigation-investment relationship necessarily means that the parties are acting altruistically. Investor and Owner in our hypothetical are both motivated by their own interests; they merely realize that a contractual relationship will enable both of them to realize these interests.

When one party takes advantage of an event that occurs subsequent to the contract's completion, the question is whether this constitutes defection from the prior agreement to cooperate in pursuit of joint ends or, on the other hand, whether the other party bargained away the right to insist on not seizing that opportunity.¹⁸⁴ "[C]ooperation," in the words of Clayton Gillette, "is not the only way to deal with unallocated risks."¹⁸⁵ Investor presumably has funded a diversified portfolio of cases so that a loss on one is made up for by gains on another. Owner may similarly hedge by negotiating a discounted fee with Law Firm or, perhaps, a contingent fee agreement. But this analysis assumes that a risk is unallocated. The parties' agreement may reveal instead that they contemplated a particular

181. Farnsworth, *supra* note 174, at 671–72.

182. Fischel, *supra* note 13, at 147.

183. Gillette, *supra* note 9, at 544 n.34.

184. *Id.* at 548.

185. *Id.* at 551.

risk and decided that one of them should bear it. Returning to Fischel's point about bonding,¹⁸⁶ Investor may have worried that Owner would not use the invested funds wisely, so Investor protected itself by refusing to agree to a duty to make subsequent contributions. It would be an erroneous application of the good faith doctrine to permit Owner to recapture the opportunity to secure a commitment to make subsequent investments when it had bargained away that right, perhaps in exchange for a larger initial contribution or some other advantage. The analysis may be different if one party had induced the other to make a substantial, contract-specific investment,¹⁸⁷ but in this case money is fungible, and neither party is enabled to engage in strategic behavior simply due to the prior investment.

Much of the relational contracting literature deals with circumstances that the parties did not anticipate at the time the initial contract was drafted or with unanticipated barriers to renegotiation.¹⁸⁸ The risk created by asymmetric information is therefore a potentially significant barrier to an efficient bargain. Allocating this risk to the party who possesses the information can dampen its effects.¹⁸⁹ In a relational contract, the parties desire to preserve their ongoing relationship and to harmonize conflict whenever possible;¹⁹⁰ but because they are also mutually exposed to risks, they desire contract rules that mitigate those risks. An information-forcing rule may have the effect of creating conflict, but it may be constructive conflict. Such a rule could create just enough of an opposition of interests that the party who would ordinarily be disinclined to share information is required to disclose it.

Sometimes, contract rules work at crosspurposes with other rules. In the lingo of relational contracting theory, the norm of "presentation"—that the contracting parties ought to foresee future contingencies and incorporate them into their agreement—is in tension with the norm of flexibility and may also threaten the goals of

186. See Fischel *supra* notes 166–72 and accompanying text (arguing that sometimes vulnerabilities associated with the sequential nature of contracts are built into the agreements in order to alleviate having to incur costs associated with litigation).

187. See Scott, *supra* note 8, at 2011 (noting that specialized, contract-specific investment can make one party vulnerable to strategic behavior by the other party).

188. See, e.g., *id.* at 2011–12 (discussing Aluminum Co. of Am. v. Essex Grp., Inc., 499 F. Supp. 53 (W.D. Pa. 1980)); Victor Goldberg, *Price Adjustments in Long-Term Contracts*, 1985 WIS. L. REV. 527, 527 (discussing price-adjustment mechanisms in contracts and the incentives for using such mechanisms in long-term relationships).

189. See Ian Ayres, *Default Rules for Incomplete Contracts*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter Newman ed., 2002).

190. See Macneil, *Internal and External*, *supra* note 9, at 350–51 (stating that relational norms affect common contract norms and sometimes come into partial conflict with them).

preserving the relationship and harmonizing conflict.¹⁹¹ Similarly, a strong prohibition on exiting the relationship, as in the decision in *K.M.C.* holding the lender liable for winding up the loan agreement, diminishes the usefulness of the threat of exit as a means to deter breaches by the other party.

IV. CONCLUSION

Our proposal is that the law should rely on bargained-for agreements among the parties to mitigate the bilateral risks associated with investment in commercial litigation (i.e., third-party financing involving sophisticated parties and negotiated investment agreements). In a commercial litigation-investment contract, it is unlikely that either party will be in a position of vulnerability prior to the bargaining process. The reasons supporting fiduciary duties in the third-party insurance context, moreover, do not apply to litigation-investment contracts. Contract law is therefore better suited than regulation or tort liability to minimize both parties' risks inherent in litigation investment. The contract-law good faith duty does not prevent the parties from contracting around various default rules, which is to say that extracontractual norms should play relatively little role in regulating commercial litigation investment. If one party becomes vulnerable because of an improvident bargain, that is just the risk sophisticated parties run when they enter into contracts. The parties' bargain, however, may be interpreted in light of the course of dealing between the parties and, perhaps, trade custom, as long as courts are attempting to understand the agreement itself, not applying freestanding norms of reasonableness or good faith. The duties of good faith owed by the parties to each other are defined in relation to the agreement of the parties; they are not free-floating tort-type duties that arise as a matter of law.

191. See Macneil, *supra* note 27, at 58–601 (explaining the term, “presentation” and explaining high amounts of presentation are more likely in short-term, discrete transactions rather than lasting relationships).