May 16, 2016

Pre-settlement Loans - A Market-Based Solution to Predatory Lending

Chris Hackett[1]

A person who is the victim of an accident should not be further victimized by loan companies charging interest rates that are higher than the risks associated with the transaction.[2]

Preface

Money may be a fungible commodity, but the cost of credit is extraordinarily variable. The theoretical explanation for this is that riskier credits command premium interest rates in order to compensate lenders for the higher probability of default. Other factors affecting credit costs include the cost of making a loan in relation to the loan size (smaller loans may require as much work as larger loans) and the term of the loan. To illustrate the enormous range of interest rates charged on consumer loans, consider the following two examples. As of this writing, one type of common asset-backed loan, 30-year fixed mortgages in metropolitan New York, features interest rates from 3.78% – 4.02% with no closing fees.[3] A second type of asset-backed loan, referred to by its purveyors as *pre-settlement funding*, typically features interest rates of 58% - 120%, sometimes much higher.[4] The author became aware of pre-settlement funding through his brother, a personal injury attorney. While pre-settlement loans are inferior to 30-year mortgages on all three counts (default rates, cost of making the loan in relation to loan size and loan term), the extraordinary interest rates associated with pre-settlement funding have led many to call for regulation and legislation,[5] i.e., "there ought to be a law." To date, regulation of the pre-settlement funding industry has been *de minimis.* This paper summarizes the development of the pre-settlement loan industry, gives specific examples of terms and structure of pre-settlement loans and outlines an alternative to the high cost of pre-settlement funding: a market-based solution called The Grateful Loan.Org.

Recent estimates indicate that investments in lawsuits by non-lawyer / non-litigants exceed $1 billion.[6] These third-party financing arrangements may be divided into three categories:[7]

- **Loans to plaintiffs' law firms.** These are loans to support litigation; the loans are made to a law firm. A law firm makes use of this type of loan to finance litigation that is beyond a firm's capacity to prosecute a case, i.e., they serve as a way to share the litigation risk.

---

[1] For a brief career biography, please see the last page of this report.

[2] Fausone v. U.S. Claims, Inc., 915 So. p. 630 (Fla. 2d Dist. Ct. App. 2005) as cited by Lauren `J. Grous, *Causes of Action for Sale: The New Trend of Legal Gambling*, 61 U. Miami L. Rev. 203 (2006) p. 230. Available at: http://repository.law.miami.edu/umlr/vol61/iss1/6

[3] http://www.mortgagecalculator.org/mortgage-rates/5-year.php as of 4/3/2016.

[4] Hashway, Jenna Wims (2012) *Litigation Loansharks: A History of Litigation Lending and a Proposal to Bring Litigation Advances Within the Protection of Usury Laws*, Roger Williams University Law Review: Vol. 17: Iss. 3, Article 2, p. 757. Available at: http://docs.rwu.edu/rwu_LR/vol17/iss3/2

[5] Ibid.

[6] Appelbaum, Binyamin, Investors Put Money on Lawsuits to Get Payouts, New York Times, 11/14/2010.

[7] Garber, Steven. *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*. Santa Monica, CA: RAND Corporation, 2010. Available at http://www.rand.org/pubs/occasional_papers/OP306.html PDF p. 12.

- **Investment in commercial lawsuits.** These are loans to a business prosecuting a lawsuit against another business. Like loans to plaintiffs' law firms, these loans allow a business to share the litigation risk with a third party.

- **Consumer pre-settlement loans**. These are non-recourse loans to plaintiffs, typically involved in personal-injury cases. These loans do not support the lawsuit *per se* – they simply provide the plaintiff with a cash advance in exchange for a share of the proceeds from the lawsuit.

Note that consumer pre-settlement loans are distinct from the other two categories in that they are made to consumers and typically do not support the litigation at hand. This paper will focus on the consumer pre-settlement segment.

Contents

Section	**Page**
Pre-settlement Loan Definition: A Rose by Any Other Name	3
ABA rule 1.8	3
Champerty	4
Attorney-client Privilege	5
Christmas 1997: An Industry is Born	5
J.G. Wentworth (publicly available information)	5
American Legal Finance Association (ALFA)	7
Pre-settlement Loan Costs	7
Pre-settlement Loan Economics	9
A Modest Proposal: The Grateful Loan.Org	10

Pre-settlement Loan Definition: A Rose by Any Other Name

Several terms are used within the third party finance industry to describe pre-settlement loans including: *consumer legal funding*, *non-recourse funding*, *cash advances*, *legal funding*, *plaintiff funding* and *pre-settlement funding*.[8] In nearly all cases, the word "loan" is avoided; there are two reasons for this:

- **Purchased interests.** Pre-settlement loans are structured as purchased interests in pending cases, i.e., the financing company is not loaning money, rather, it is buying an interest in a lawsuit. Pre-settlement purchase contracts specify a range of terms and charges (discussed below). Contracts are non-recourse meaning that the finance company is repaid only to the extent that the plaintiff's attorney collects from the defendant (or, more typically, the defendant's insurance company).

- **Regulatory issues.** Consumer lending is highly regulated. To the extent finance companies frame the transaction as a purchase contract, there is little to no regulation.

Technicalities aside, pre-settlement funding is not lending in the same way gaming is not gambling – a distinction without a difference.[9] In this paper, we use the terms pre-settlement funding and pre-settlement lending interchangeably.

ABA Rule 1.8

The desire and real need for plaintiffs to borrow money is not new, but the pre-settlement loan industry is less than two decades old. Common law has long prohibited lawyers from providing financial assistance to clients with limited exceptions, e.g., lawyers may advance court costs.[10] The concern is that providing financial assistance may encourage clients to pursue lawsuits of dubious merit. Perhaps more importantly, preventing lawyers from lending to clients prevents financial advances as a way of attracting and keeping clients. Here is the American Bar Association's (ABA) rule 1.8, section e: [11]

> (e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:
>
> > (1) a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and
> >
> > (2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

The ABA goes on to comment on rule 1.8 as follows:

> **Financial Assistance**[12]
>
> [10] Lawyers may not subsidize lawsuits or administrative proceedings brought on behalf of their clients, including making or guaranteeing loans to their clients for living expenses, because to do so would encourage clients to pursue lawsuits that might not otherwise be brought and because such assistance gives lawyers too great a financial stake in the litigation. These dangers do not warrant

---

[8] Garber, Steven. *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*. Santa Monica, CA: RAND Corporation, 2010. Available at http://www.rand.org/pubs/occasional_papers/OP306.html

[9] Hashway, Jenna Wims (2012) *Litigation Loansharks: A History of Litigation Lending and a Proposal to Bring Litigation Advances Within the Protection of Usury Laws*, Roger Williams University Law Review: Vol. 17: Iss. 3, Article 2, p. 784. Available at: http://docs.rwu.edu/rwu_LR/vol17/iss3/2

[10] Hageman, Alice L., Neither a Borrower, nor Lender Be, 12/2000, http://www.mass.gov/obcbbo/lender.htm

[11] http://www.americanbar.org see Rule 1.8: Current Clients: Specific Rules

[12] Ibid., comment on Rule 1.8

> a prohibition on a lawyer lending a client court costs and litigation expenses, including the expenses of medical examination and the costs of obtaining and presenting evidence, because these advances are virtually indistinguishable from contingent fees and help ensure access to the courts. Similarly, an exception allowing lawyers representing indigent clients to pay court costs and litigation expenses regardless of whether these funds will be repaid is warranted.

So if attorneys can't lend to clients, why not third parties?

Champerty

Historically, the doctrines of maintenance and champerty[13] discouraged the financing of lawsuits by non-litigants.[14] Until recently, the legal community assumed maintenance and champerty were prohibited under common law.[15] A shift in this thinking began to occur in the mid-twentieth century with the growing momentum of the civil rights movement, which served as a catalyst for changing public perceptions of litigation from necessary evil to a form of political expression.[16] For example, the NAACP Legal Defense and Educational Fund financed *Brown v. Board of Education*. In 1963, the Supreme Court held in *NAACP v. Button* that champerty "by nonprofit organizations that engage in litigation as 'a form of political expression' and 'political association' constitute []… conduct entitled to First Amendment protection."[17] The federal government does not regulate third party financing and only Maine, Ohio, Nebraska, Oklahoma and Tennessee directly regulate the industry.[18] Although New York does not directly regulate the industry, nine third party finance companies are subject to a 2005 agreement signed by the companies[19] and then Attorney General Elliot Spitzer. As of 2010, over half of the states explicitly permit non-lawyer financing of lawsuits[20] and courts in two-fifths of the states have overruled defenses based on maintenance and champerty doctrines. Though it is beyond the scope of this paper, the justification for prohibiting third party financing appears to be outweighed by the importance of promoting access to justice. Also, as mentioned above, pre-settlement loans are consumer loans and typically have little or no bearing on financing the related lawsuit, making them less susceptible to champerty challenges.

---

[13] "Maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome." U.S. Supreme Court, In re Primus, 436 U.S. 412, 424-25, n. 15(1978).

[14] *Third-Party Litigation Funding: Tipping the Scales of Justice for Profit*, National Association of Mutual insurance Companies, May 2011. PDF p. 5.

[15] Ibid. PDF p. 5.

[16] Robertson, Cassandra Burke, "The Impact of Third-Party Financing on Transnational Litigation" (2011). Faculty Publications. Paper 53, p.166. http://scholarlycommons.law.case.edu/faculty_publications/53

[17] Lyon, Jason, *Revolution in Progress: Third-Party Funding of American Litigation*, UCLA School of Law, 2011, p. 571.

[18] J.G. Wentworth 10-K, 3/13/2015, PDF p. 10. Regulatory statutes regulating pre-settlement transactions in these states include certain rescission periods, mandated contract provisions, restrictions on funder activities, restrictions on advertising, prohibitions of attorney referral fees, mandated disclosures, acknowledgements by the attorney representing the litigant and prohibitions on the funder making any decisions with respect to the underlying legal claim.

[19] The nine signatory companies were: Plaintiff Support Services; Pre-settlement Finance; QuickCash, Magnolia Funding, BridgeFunds, Plaintiff Funding Corp. d/b/a as LawCash, Oasis Legal Finance; The Whitehaven Group; and New Amsterdam Capital doing d/b/a LawMax. As a result of the agreement with Spitzer, these companies formed the American Legal Finance Association (ALFA), a trade association of pre-settlement finance companies.

[20] Robertson, Cassandra Burke, "The Impact of Third-Party Financing on Transnational Litigation" (2011). Faculty Publications. Paper 53, p 167. http://scholarlycommons.law.case.edu/faculty_publications/53

Attorney-client Privilege

Another concern with third party financing is the possibility that by disclosing otherwise privileged information to a third party (the lender), the plaintiff may waive his/her attorney-client privilege[21] and/or protections afforded by the work product rule. While this has not been resolved, it is thought that communications with third-party litigation lenders are protected by the work product rule because the information exchanged and the calculations generated by the finance company are clearly created (a) for a party and (b) with litigation in mind.[22] It is thought that the plaintiff should limit communication with the finance company to only that information which is most essential to determination of the value of the claim to avoid inadvertent waver of attorney-client privilege.[23]

Christmas 1997: An Industry is Born

Perry Walton founded the pre-settlement lending industry in 1997 in Las Vegas.[24] Walton, described as a one-time rock musician and mobile-home developer in North Carolina, moved to Nevada in the early 1990s and established Wild West Funding, a payday lender. Wild West's collection practices ran afoul of Nevada law and in April 1997 Walton plead guilty to charges of extortionate debt collection. He was sentenced to 18 months probation. Later that year, Walton's housekeeper, who had recently been in a car accident, asked if she could borrow money to buy Christmas presents with the understanding that she would repay Walton when a lawsuit (related to the car accident) was settled.[25] "I realized there must be a million other people in the situation my housekeeper was in," commented Walton.[26] To capitalize on his insight, Walton established Future Settlement Funding Corp. and began approaching personal injury attorneys about his service. He also offered two-day seminars, for $12,500, where he taught an estimated 600 students how to establish a pre-settlement loan business. Walton quickly expanded into other types of legal finance and in 1999 advanced $200,000 to fund a sexual assault case brought against George Shinn, owner of the NBA's Charlotte Hornets. The plaintiff eventually lost the case and successfully sued Walton claiming that her contract with Walton caused her to turndown a $1 million settlement offer.[27] As a result of the suit, Walton was out of business, but the pre-settlement funding industry had taken root.

The J.G. Wentworth Company

To better understand the pre-settlement industry, a logical starting point is to study public companies that participate in the industry. There are three publicly held companies that are active in litigation finance;[28] however, none offer pre-settlement funding. A fourth public company, J.G. Wentworth Company (JGW on the New York Stock Exchange) offered pre-settlement funding (under their Peachtree brand) until April 2015 when they put that business into runoff. JGW is a tiny ($29 million market capitalization, $5 billion enterprise value) consumer finance firm based in Radnor, PA. The pre-settlement business was a small portion of JGW's overall business (e.g., on 12/31/2015, of their $5.1 billion in assets, $44.3 million were pre-settlement loans – less than 1%

---

[21] Lyon, Jason, *Revolution in Progress: Third-Party Funding of American Litigation*, UCLA School of Law, 2011, p. 604.
[22] Ibid., p. 605.
[23] Ibid., p. 605.
[24] Schmitt, Richard B., *Las Vegas man lends against lawsuits, forms and industry*, Las Vegas Sun, 9/15/2000.
[25] Maimon, Alan, *Litigation Finance Pioneer bet big then Lost*, Las Vegas Review Journal, 7/19/2010.
[26] Ibid.
[27] For a detailed synopsis of this case (Weaver, Bennett & Bland, P.A. v. Speedy Bucks, Inc.), see Martin, Susan Lorde, *The Litigation Financing Industry: The Wild West of Finance Should be Tamed, not Outlawed*, Fordham Journal of Corporate & Financial Law, Volume 10, Issue 1, Article 3, 2004.
[28] The three publicly traded companies are: Juridica Investments (JIL on the London Stock Exchange), Burford Capital (BUR on the London Stock Exchange) and IMF Bentham (IMF on the Australian Stock Exchange).

of total assets) and their disclosure regarding their pre-settlement business is parsimonious. The following table summarizes JGW's pre-settlement receivables by year of origination.

Table 1: JGW Pre-Settlement Receivables[29]

Year of origination	(000) 12/31/15	12/31/14	12/31/13
2009	1,229	2,618	4,578
2010	2,759	4,251	5,740
2011	5,597	6,938	10,915
2012	6,212	10,687	17,527
2013	6,772	11,335	17,549
2014	17,773	22,057	
2015	3,957		
Gross loans (year end)	**44,299**	**57,886**	**56,309**
New loans made during year	**10,763**	**27,155**	**22,300**
Loss reserves	(10,300)	(10,100)	(8,300)
Net loans (year end)	**33,999**	**47,786**	**48,009**
Reserves / (gross + new loans)	**19%**	**12%**	**11%**

Two observations standout when reviewing the data in the above table:

1. JGW's loss-reserves for pre-settlement loans are very high and growing; perhaps that is why they exited the business.

2. A large number of their pre-settlement loans appear to have terms in excess of one year (this is different than our experience – see below).

Until JGW put the business into runoff, they were making between $22 and $27 million of pre-settlement loans annually. The following chart summarizes JGW's pre-settlement loans issued and interest income earned on the outstanding pre-settlement loan balances.

Table 2: JGW Pre-settlement Loans made and Interest Charged[30]

(000)	12 ME 12/31/15	12 ME 12/31/14	12 ME 12/31/13
Interest income	9,117	10,439	
Pre-settlement loans made	10,763	27,155	22,300
Inferred interest rate charged	27%	22%	

It is important to note that interest income on pre-settlement loans is just one of several income streams associated with these loans, e.g., processing fees, maintenance fees; however JGW does not disclose the income from these other sources. JGW financed their pre-settlement portfolio with a combination of $45.1 million of fixed rate notes issued in 2011 (9.25% interest, $6.6 million outstanding as of 12/31/15) and a revolving credit facility with an effective interest rate of about 5%. JGW also did not treat their pre-settlement business as a separate business segment, so there is no way to infer the profitability of this business given their disclosure. However, given their very high loss reserves and the fact that they put the business into runoff, it is reasonable to conclude that their pre-settlement business was not profitable. Note that JGW created primary demand for pre-settlement loans through direct-to-consumer advertising (a very expensive customer acquisition strategy for one-off transactions).

[29] JGW 10-Ks, 3/13/2015 and 3/10/2016.
[30] JGW SEC filings, Hackett analysis.

American Legal Finance Association (ALFA)

Another avenue for learning about an industry is from the industry's trade associations. The American Legal Finance Association (ALFA), a trade association of pre-settlement finance companies, currently lists 35 members, all privately held.[31] ALFA got its start in 2005 as a response to an investigation conducted by then Attorney General of New York, Elliot Spitzer.[32] Spitzer's investigation was prompted by concerns that consumers could not understand the terms of the pre-settlement loan agreements they were signing. Nine pre-settlement companies formed ALFA and signed an Assurance of Discontinuance that specified that pre-settlement contracts would:

- Disclose annual percentage rate charges broken down in six-month increments. (Interestingly, this format systematically understates the effective interest rates charged on loans – see below for more on this subject).
- Include a five-day right to rescission.
- Be translated into the borrower's native language.
- Not require mandatory arbitration to resolve disputes.

The Assurance of Discontinuance also specified that the nine loan signatory companies reimburse New York State $45,000 for the cost of the investigation. Unlike trade associations in many industries, ALFA does not collect and distribute data on the pre-settlement industry; instead, ALFA's primary focus is to lobby state legislatures to leave the industry alone.[33]

Pre-settlement Loan Costs

With so little information available on the pre-settlement loan industry, we began conducting primary research to augment our understanding of the industry. A Google search turns up hundreds of firms[34] offering pre-settlement loans to personal injury claimants, all privately held. While there has been a proliferation of pre-settlement lenders, there is a dearth of data on the economics of pre-settlement loans. Here is what we have found:

1. Pre-settlement loans typically range from $1,500 to $4,500 with the largest loans approaching $20,000.[35]

2. Pre-settlement lenders typically advance less than 10% of a conservative estimate of the underlying legal claim. This has the positive effect of reducing the possibility that loan repayment interferes with the settlement process.[36]

3. Interest rates typically range from 3-5% monthly (43% - 80% annualized) though some companies offer interest rates of 2% monthly (27% annualized).[37] These interest rates

[31] http://americanlegalfin.com/alfa-membership/alfa-member-companies/

[32] Hashway, Jenna Wims (2012) *Litigation Loansharks: A History of Litigation Lending and a Proposal to Bring Litigation Advances Within the Protection of Usury Laws*, Roger Williams University Law Review: Vol. 17: Iss. 3, Article 2, Available at: http://docs.rwu.edu/rwu_LR/vol17/iss3/2 p. 774.

[33] Ibid., p. 783.

[34] Lyon, Jason, *Revolution in Progress: Third-Party Funding of American Litigation*, UCLA School of Law, 2011, p. 578.Try a Google search of "lawsuit loans," "pre-settlement funding," or "future settlement funding" – you are likely to find hundreds of thousands of hits.

[35] Garber, Steven. *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*. Santa Monica, CA: RAND Corporation, 2010. Available at http://www.rand.org/pubs/occasional_papers/OP306.html p. 12.

[36] Ibid.

exclude a range of other charges typically associated with pre-settlement loans, e.g., origination fees, case servicing fees, document management fees, priority processing fees, and fees associated with expedited funds transfer.[38]

The following table summarizes the terms of pre-settlement contracts from four pre-settlement firms. The table format is based on the industry practice of providing contract payoff tables at six-month intervals.

Table 3: Four Examples of Pre-settlement Loan Costs

Annualized Percentage Fee (expressed as %) and Other Fees

From	To the end of	Peachtree	Oasis	LawCash	Covered Bridge
		$750	**$620**	**$1,000**	**$1,000**
Closing date	Month 6	202%	96%	65%	33%
Month 7	Month 12	100%	60%	45%	33%
Month 13	Month 18	67%	67%	37%	33%
Month 19	Month 24	50%	56%	33%	33%
Month 25	Month 30	40%	51%		33%
Month 31	Month 36	33%	45%		33%
Other fees (not included in the above interest rate calculations)					
Application fee		N/A	N/A	$150	$250
Delivery fee		N/A	N/A	N/A	$30
eSignature		N/A	$20	N/A	N/A
Servicing fee every 6 months		N/A	$35	N/A	N/A
Archival fee		N/A	$35	N/A	N/A
Subsequent case review fee		N/A	$20	N/A	N/A

While the interest rates appear to be quite high, **the table actually understates the effective interest rates imbedded in these contracts** for the following reasons:

- "Other fees" are not included in the calculation of annualized inferred interest charges. For instance, in the case of Covered Bridge, if we include their $250 application fee, their $30 delivery fee and the loan is repaid at the end of the first six months, the effective annual interest rate would be about 72%. In the case of Oasis, they charge $97 to send the money via Western Union (or to FedEx a check) for contracts up to $750. When this is included, this implies 125% annual interest on a $620 contract if it is repaid at the end of 6 months.

- Unless the contract is closed (loan repaid) on the last day of the time interval stated, the effective interest rate is higher than stated, sometimes much higher. For instance, if the LawCash loan were repaid on the last day of the first six-month period, the payoff amount would be $1,326 equating to 65% annual interest. However, if the same loan were repaid the following day (the first day of the month 7) the payoff amount would be $1,756, which equates to 145% annual interest.

---

[37] Garber, Steven. *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*. Santa Monica, CA: RAND Corporation, 2010. Available at http://www.rand.org/pubs/occasional_papers/OP306.html.

[38] Review of pre-settlement loan documentation produce by Oasis Legal Finance, LawCash, PeachTree Financial Solutions (a subsidiary of JGW) and Covered Bridge Capital.

Perhaps the high cost of pre-settlement funding reflects the economics of this particular type of lending; the fact that JGW exited the business may suggest these loans are not profitable. On the other hand, the above interest rates and fees are extraordinary, especially when one considers that pre-settlement loans are made to plaintiffs represented by lawyers who have taken their cases on contingency, i.e., the lawyer has already vetted the case and made an informed credit decision based on the economics of running a law firm. Below we propose a framework for thinking about the costs associated with making pre-settlement loans and then report on an experiment we are conducting to determine the economics of pre-settlement lending and lower the costs to borrowers.

Pre-settlement Loan Economics

From the perspective of the finance company, there are three components of costs associated with making pre-settlement loans:

- Funding costs (costs incurred to attract funds used to make the loans).
- Operating costs (marketing, loan underwriting, book-keeping).
- Default costs.

Beginning with funding costs, JGW's interest costs come to 42% of revenue – interest is their largest expense item. JGW funded their pre-settlement portfolio using a combination of notes that paid annual interest at 9.25% and a revolving line of credit that paid interest at about 5%. Based on this, we will assume that the funding of pre-settlement loans in today's market can be arranged at an interest rate of about 10% per year, perhaps a bit better.

Operating costs are more difficult to estimate. In a typical year,[39] JGW spends 15% of revenue on advertising and another 13% of revenue on compensation, general and administration (these categories would include loan underwriting and book-keeping costs). Because pre-settlement loans were such a small part of JGW's business, inferences made using their operating costs as a model are not likely to be reliable. There are also aspects of JGW's business model that look inefficient, e.g., they created primary demand for pre-settlement loans through advertising to consumers – since a consumer is not likely to make use of pre-settlement funding more than once, this is a very expensive customer acquisition method.

Regarding default costs, JGW had loss reserves ranging from 11% of gross pre-settlement funding in 2013 to 19% in 2015. This would suggest that the default rate on pre-settlement loans is very high. There are, however, irregularities with the JGW data. For instance, as discussed above, JGW had a large portion of pre-settlement loans that stretched over several years – this is in contrast to our experience (outlined below) regarding pre-settlement loan-term which suggests the loans are typically repaid between 6 and 12 months. An executive at LawCash was quoted as saying that their default rate runs "about 4%" and Michael Douglas, CEO of ExpertFunding.com, estimated that their pre-settlement loan default rate is 2%.[40]

To gain an appreciation for the impact on loan economics of different default rates, we built a model (available at www.GratefulLoan.Org, see "Loan Data" tab) that shows the required gross

---

[39] 2013 and 2014 were typical years for JGW; 2015 was not typical in that management restructured the business considerably.

[40] Hashway, Jenna Wims (2012) *Litigation Loansharks: A History of Litigation Lending and a Proposal to Bring Litigation Advances Within the Protection of Usury Laws*, Roger Williams University Law Review: Vol. 17: Iss. 3, Article 2, Available at: http://docs.rwu.edu/rwu_LR/vol17/iss3/2 p. 759.

interest rate[41] in order to generate a given return on capital at varying default rates. For instance, if we assume that the average loan size is $1,000, average loan term is six months,[42] the fee to process the loan (to cover marketing, under-writing, book keeping) is $100, zero recovery on defaults and that the cost of capital is 10%, the following table summarizes the gross interest rate which must be charged on the loans at varying default rates.

Table 4: Cost of Default- Model Output

Default rate	Required gross interest rate
2.0%	24.0%
4.0%	28.0%
6.0%	32.0%
8.0%	36.0%
10.0%	40.0%
12.0%	44.0%
14.0%	48.0%

Note that the gross interest rate required to cover all expenses of providing the loan based on the assumptions entered is not directly comparable to the average percentage figures included in the Table 3 on page 8 because:

- The interest rates in Table 4 include all charges to the borrower – there are no additional fees. The interest rates in Table 3 exclude a range of extra charges.

- The interest rates in Table 4 do not assume cliffs at six month intervals, i.e., Table 4 interest rates are the effective interest rates which need to be charged in order to generate the desired return of capital to investors (in this case we have assumed 10%) and cover the costs of making running the service (in this case, we have assumed $100 of costs per loan). As discussed above, the effective interest rates in Table 3 are higher than they appear because loans are not typically repaid on the last day of the six-month interval.

It is surprising how high interest rates must be for pre-settlement loans to be economic. The explanation for this is the combination of small loan size ($100 assumed cost of marketing, under-writing and book keeping represents 10% of a $1,000 loan) and the short-term nature of pre-settlement loans (in making the above table, we assumed six months as the average term). The loan term plays a significant role in the required interest rate because, in order to compensate for defaulted loans, a loan of short duration must generate as much interest (over a shorter period of time) as a loan with a longer term, all other assumptions equal.[43] The data in Table 3 reflect these phenomena: note that as the term of the loans is extended, the effective rates, high as they are, decline.

A Modest Proposal: The Grateful Loan.Org

[41] "Required gross interest rate" is the interest rate that is needed to cover all the costs associated with the loan, e.g., cost of funds, marketing, underwriting, book-keeping, and default costs.
[42] Of the 18 loans made as of this writing, our mean loan size is $1,009. Of the six loans that have been repaid, the average term was 162 days. The mean interest charge (inclusive of all fees) for repaid loans was 30.6%. We are not aware of any publicly available data regarding pre-settlement loans other than the JGW data.
[43] We have not found reliable data on the average term of pre-settlement loans so we are developing the data ourselves (see below).

The author's brother, a personal injury attorney, brought to our attention the extraordinary costs associated with pre-settlement loans and asked what could be done. As we began studying the industry, we too were struck by the high costs associated with pre-settlement loans as well as the scarcity of information about the industry and its economics. To rectify this, we organized an experimental enterprise in June 2015, The Grateful Loan.Org. The Grateful Loan.Org is organized to use market mechanisms to lower pre-settlement loan costs and to develop and share cost data associated with making these loans. Its operations are based on the following principles:

Founding Principles

1. **Lower costs**. The Grateful Loan.Org experiments with ways to lower the costs of pre-settlement lending, then passes-on the savings to borrowers. Here are three cost savings initiatives we are implementing:

    a. Reduce defaults to as close to zero as possible – we ask that law firms only refer cases with excellent prospects of repayment. Eventually, we hope to tailor loan costs to each law firms' track record.
    b. Creative use of technology to automate loan processing and bookkeeping.
    c. Marketing based on word of mouth / referrals.

2. **Improve Service.** The Grateful Loan.Org seeks to improve the service experience for both law firm personnel and borrowers. Examples include the use of eChecks drawn on bank accounts located close to borrowers. This allows borrowers to receive funds in a few minutes at no extra charge. Unbanked borrowers may cash our checks without using expensive check-cashing services.

3. **Radical Transparency**. The Grateful Loan.Org is organized around the principle of radical transparency. It documents and publishes (on its website) all data related to the economics of pre-settlement lending, e.g., cost of capital, details on each loan, default rates, the effective interest rate charged on each loan, etc.

4. **Public Benefit Company**. The Grateful Loan.Org was initially organized as a subsidiary of a privately held business. As the experiment (business) grows, it will be spun-out into a Public Benefit Corporation, i.e., instead of being organized to maximize gain for its shareholders, it is organized to be a self-funding organization with the mandate of reducing the costs of pre-settlement loans and publishing data related to consumer micro-lending costs.

5. **Law Firm affiliation.** The Grateful Loan's affiliation is to law firms, not borrowers. We do not create demand for pre-settlement loans nor do we encourage borrowers to borrow.

6. **Alternative.** The Grateful Loan is organized to be an alternative to the existing pre-settlement loan industry. Its broader mandate is to end predatory lending.

As we began making loans, we came across a number of service issues that made life difficult for borrowers. For instance, borrowers want the money from the loan immediately. The existing industry has responded to this desire by adding fees for expedited processing, overnighting checks via FedEx or wiring money using Western Union. These fees are paid later with proceeds from the legal settlement and often the fee costs are added to the loan principal. Borrowers pay scant attention to the cost of these fees; however the costs are often substantial in relation to the size of the loan. Our first thought was to use PayPal to transfer money to borrowers, but PayPal requires a checking account, and many pre-settlement borrowers are unbanked and/or

technologically inept. Researching the subject, we found a service offered by Deluxe Corporation called eChecks. This service allows us, for about the price of a postage stamp, to send an eCheck via email to any email account in the world. The borrower prints the check (or someone at the law firm representing the borrower prints the check) and can cash or deposit it as he/she desires.

After resolving how to get the check to borrowers, we then discovered the difficulty that unbanked borrowers have cashing checks. This issue was fixed by establishing checking accounts with banks that are local to the borrowers. As a result, an unbanked borrower can take the check to our bank and it can be cashed for a nominal fee (typically $5) in lieu of the $45 typically charged by check cashing services (not to mention poor service often encountered at such enterprises).

To streamline the lending process and reduce costs, all paperwork is handled via email and we recently started using eSignatures on our documents. An eSignature eliminates the need for the attorney and the borrower to print the contract, sign the contract, re-digitize the contract and return it to us. We are also in the process of simplifying our contract so that clients can more easily read and make sense of it. At the recommendation of one of the law firms we are working with, we added a clause to our contract that prevents the borrower from further borrowing without a waiver from us. The idea is to put the attorney in greater control of his/her client's borrowing against the case.

We are pushing most of the credit decision down to the law firm. This should work because the law firms have already made one credit decision, i.e., to take the case. Eventually, we will price loans based on each law firm's track record. This will require a seasoning period with each firm as well as raising the firm's awareness of the different economic characteristics of pre-settlement loans when compared to a retainer on a personal injury case, e.g., the pre-settlement loan upside is capitated (the loan is repaid) and the downside is 100% loss of the money advanced.

With no experience and no publicly available default rate data, we began pricing loans so that they carry interest rates that approximate what one would expect to pay on credit card debt. As we gain experience, we will make adjustments to the interest rates accordingly. Like credit card debt, we have introduced a thirty-day grace period, i.e., if the loan is repaid within thirty days, no fee will be charged.

Of the loans that have been repaid, our average annualized interest charge (inclusive of all fees) was 30.6%. After obtaining feedback on a preliminary draft of this paper, we switched to a flat interest rate (20% per year, compounded daily, calculated to the day we receive full payment)[44] plus a separate onetime charge for making and administering the loans (10% of the principal. The fee becomes part of the loan but interest is not charged on the fee). Interest is now charged to the day: no six-month cliffs. We post our contact worksheet (used to calculate the contract / loan value, i.e., the amount owed on a given day) to the website under the tab "Loan Data." We don't know if these charges are economic, but they are a starting point. The math indicates that 20% interest charged on a portfolio of loans (excluding the cost of making the loan) with an average term of six months could withstand a 5% default rate while earning investors a 10%[45] return on

[44] This method of calculating the interest is consistent with how most credit card companies in the U.S. calculate interest extended to middle-class cardholders. For a more detailed discussion on credit card interest calculations, please see https://en.wikipedia.org/wiki/Credit_card_interest Here is a link to the model we are using make this calculation (posted to www.GratefulLoan.org under the tab "Loan Data": www.GratefulLoan.org/GL-Loan-worksheet.xlsx

[45] We don't know if a 10% return is what will be required to attract funding to a socially beneficial cause, it is simply a starting point. As of this writing, funding for the Grateful Loan.org has been provided by the author and a friend of the author's who works in the software industry. In order to eliminate any potential conflict of interest, no funding will be accepted from attorneys.

capital invested in loans. To the extent the loan portfolio's term lengthens and /or the default rate is below 5%, the interest rate may be lowered to achieve the theoretical goal of a 10% return on capital invested.[46] Over time, the interest charge will be customized to the track record of each law firm, based on the firm's historical default rate and the term of its loans. The goal is to build a self-sustaining enterprise that can loan money at the lowest possible rates while covering its costs.

Table 5 summarizes loans made to date. The first six loans (highlighted in pale green) have been repaid and are closed. The loans in the table are the result of work with four law firms in two states.

Table 5: Summary of Loans Made through May 13

Loan	Contract date	Repaid Date	Contract amount	Repaid amount	Capital cost	GL fees	Inferred APF
1	06/17/15	01/13/16	750.00	877.77	73.39	54.38	29.6%
2	06/24/15	07/05/15	500.00	500.00	-	-	0.0%
3	07/02/15	01/13/16	500.00	602.00	57.00	45.00	38.2%
4	08/17/15	03/21/16	1,000.00	1,193.25	113.25	80.00	32.5%
5	09/18/15	01/13/16	750.00	877.77	73.39	54.38	53.1%
6	09/24/15	04/30/16	1,100.00	1,300.75	123.75	77.00	30.4%
7	09/30/15	05/13/16	1,000.00	1,182.50	112.50	70.00	29.5%
8	10/01/15	05/13/16	1,000.00	1,182.50	112.50	70.00	29.6%
9	10/07/15	05/13/16	1,000.00	1,184.15	114.15	70.00	30.7%
10	11/04/15	05/13/16	1,000.00	1,130.00	55.00	75.00	24.8%
11	01/08/16	05/13/16	1,000.00	1,130.00	55.00	75.00	37.7%
12	01/26/16	05/13/16	1,500.00	1,695.00	82.50	112.50	43.9%
13	01/28/16	05/13/16	600.00	678.00	33.00	45.00	44.8%
14	02/10/16	05/13/16	3,000.00	3,315.00	146.25	168.75	41.2%
15	02/26/16	05/13/16	700.00	776.00	34.75	41.25	51.5%
16	04/02/16	05/13/16	750.00	822.50	38.00	34.50	86.1%
17	05/05/16	05/13/16	1,000.00	1,000.00	-	-	0.0%
18	05/13/16	05/13/16	750.00	750.00	-	-	0.0%
		Totals	**17,900.00**	**20,197.19**	**1,224.43**	**1,072.76**	

The data in Table 5 is updated regularly and published to our website (www.GratefulLoan.Org). Inferred annual percentage fee (APF) for loans 7 through 18 assume the loans were repaid on 5/13/16 (the date the table was prepared). No fees were charged to loans two, 17 and 18 because they fell within the 30-day grace period. Here are our preliminary observations and inferences from the above data:

[46] Please see the model worksheet, posted to www.GratefulLoan.org under the tab "Loan Data," www.GratefulLoan.org/Loan-Loss-Math.xlsx

Preliminary Observations

1. No defaults to date.

2. The mean loan size is $1009 and the mean term for closed contracts was 162 days. The mean term for all contracts was 141 days.

3. Quoting loan costs in six-month intervals systematically understates the effective annual percentage fees assed to loans. The annual percentage fee for loans that have been repaid was 30.6% (slightly higher than typical credit card rates) and the annual percentage fee for all loans outstanding was 37.8%. The 31% effective cost of borrowing we assed to our closed contracts suggests that a portfolio of these loans could withstand a default rate of about 5% and still be able to pay investors a 10% return on their capital. At this point, we don't know if the GL fees assessed will be sufficient to cover costs (excluding default costs) associated with making the loans nor have enough data to estimate a default rate for any given law firm. Assuming random samples from each firm, statistical analysis suggests it will take about 20 loans per firm to make such an estimate.

4. As the loans mature, the annual percentage fee (expressed in percentage terms) declines. This is because loan-processing costs are effectively amortized over a longer period. Due to the short-term nature of pre-settlement loans, it is imperative to drive-down default and processing costs to make the economics work at low borrowing costs.

5. Total loans made since inception is $17,900; total loans outstanding is $13,300.

6. Remarkably, based on the terms of traditional pre-settlement funding companies (as outlined in Table 3), The Grateful Loan.Org **saved pre-settlement borrowers between $8,443 and $15,600 on the $17,900 loans made to date**.

Presently, we are experimenting with ways to efficiently develop relationships with personal injury law firms. Our message is straight forward: when a client comes to your office insisting he/she sign an irrevocable letter of direction for a small loan, we offer a reasonable alternative dedicated to lowering the cost, improving the service and publishing the economics of these loans.

Biography

Chris Hackett founded The Grateful Loan.Org in 2015 to end predatory lending in a unique way: provide a fair alternative. Chris continues to manage the investment research business he founded in 2001, Greenwich Investment Research.[47] Prior to this, Chris worked as a research associate for Professor Thomas Eisenmann at Harvard Business School, co-authoring cases on *Qwest Communications* and *Net Market Makers*. Earlier in his career, Chris worked for Access Industries, an investment company which acquired Russian businesses; return on investment was extraordinary. Access became the second largest aluminum producer in Russia and the sixth largest in the world. Chris earned a B.A. from Albion College in 1982 and an M.B.A. from Harvard Business School in 1990.

Questions, suggestions, referrals and speaking requests are welcome.

[47] Greenwich Investment Research produces research for professional investors.