5 Reasons Lawyers Often Fail To Secure Litigation Funding

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It's no secret that parties seeking litigation funding face steep odds in securing a deal.

How steep? According to my firm's research, more than 95% of commercial litigation funding deals presented to any particular funder never advance to closing.[1]

Experience tells me one of the overarching reasons the litigation finance deal closure rate is so low is that lawyers and their clients drastically underestimate the challenges and nuances of obtaining this specialized form of financing.

For many, the downside of trying and failing to secure funding is simply that – not obtaining the funding. So why not approach a few funders and see if one bites?

On the surface, this approach has appeal; in reality, it is fraught with hidden costs.

The litigation fundraising process can be extremely laborious, and the time sunk into an unsuccessful deal typically is not billable.

Each year, leading law firms squander millions of dollars in time alone seeking funding for deals that do not bear fruit.

Even more concerning, lawyers who are unsuccessful in obtaining funding for their clients almost always damage their credibility with the client.

The good news is that these challenges can be anticipated and, in many instances, overcome.

To overcome those challenges, however, it is important to also examine why so many parties fail to obtain litigation funding. Here are the top five reasons why.

1. Misunderstanding the Funders' Acceptance Standards

Funders reject the lion's share of deals that they are shown because most of them should never have been brought to the market in the first place.

My colleagues and I have seen that far too many lawyers and clients present litigation opportunities that make no sense to pursue, regardless of who is funding the case.

Nothing can be done to change the substance of the underlying matter, and short of committing fraud, you are not going to sneak into a funder's vault with a meritless deal.

The best – and only – advice for these weak opportunities is to avoid the litigation fundraising process altogether.

But we also see that funders also reject a significant number of matters that are meritorious and economically viable enough for experienced litigation counsel to be willing to risk their own legal fees on a successful outcome.

Why are these opportunities declined?

The reason – and it may not be a satisfactory one – is that a litigation funder's diligence process and investment criteria are generally more rigorous than that of most law firms.

Unless a lawyer has a great deal of experience with funding, this disparity can be jarring and more than a little ego-bruising, especially when clients or colleagues are watching.

To appreciate why the litigation funders' bar is set so high, it is helpful to consider the investment proposition from their perspective.

The funder must develop a high degree of confidence in a financially successful outcome of a legal dispute – usually involving complex subject matter – because it will only receive an investment return if the underlying matter resolves favorably.

As a purely passive investor, the funder also must structure the deal in a way that achieves alignment with both counsel and client, and often the economics of even the strongest of cases are insufficient to do so.

Further, unlike a venture capital fund that can accept high levels of losses because of their upside in successful investments, litigation funders' more modest returns are too low to subsidize VC-level loss rates.

Because most litigation funders are relatively new and have not yet established substantial track records, this dynamic fosters a stronger bias toward risk aversion within the industry.

A litigation funder's diligence process is designed to find reasons not to invest in an opportunity. It also tends to follow a leave-no-stone-unturned approach, which can be exhausting for the party seeking funding.

However, even the most discriminating funders' processes can be successfully navigated with proper preparation and analysis before approaching the funder.

What are the main challenges counsel will face in the litigation, and how will these be overcome? What is counsel's track record in similar matters? What level of financial risk is counsel prepared to assume?

These are just a few of the questions that parties should consider before approaching funders. Lawyers and their clients are well-served to anticipate these and other questions that a skeptical investor might ask, and be prepared with clear and thoughtful responses.

2. Failing to Approach the Most Suitable Funders for the Opportunity

Parties seeking funding often fail to approach the funders most likely to invest in their claim.

There are currently 46 active commercial litigation funders[2] in the U.S., each with different funding criteria, risk appetites, structuring preferences and return profiles.

Most parties seeking funding only present their opportunity to a few of these funders. This is a mistake, because even the largest funders in the world are not configured to accommodate every potential type of deal.

Without adequate knowledge of the market, it is difficult to know which funders are most suitable for a particular deal. It is critical to know what a funder's investment criteria are, including preferred deal size, type of litigation, jurisdictions and stage of litigation, among others.

Too often, parties meet resistance from funders that were never a good fit for the opportunity and elect to abandon the fundraising process altogether.

If they had only identified the right audience, they might have been able to secure funding.

3. Inadequately Packaging the Presentation of the Opportunity

First impressions matter, especially in litigation finance.

Our conversations with funders inform that the largest litigation funding firms see more than 1,000 opportunities a year and don't have the bandwidth to wade through poorly packaged opportunities.

Still, parties often fail to spend the time necessary to appropriately present an opportunity. The failure to properly present an opportunity often is the difference between a yes and a no.

What are the most common deficiencies in litigation fundraising presentations? Most lawyers are more than capable of presenting the legal merits of an opportunity; however, we have observed time and again that they tend to fall short in demonstrating a thorough approach to the economics, i.e., the damages model and the budget.

Lawyers and clients may also downplay or omit entirely a case's potential challenges, whereas a funder expects these downsides to be soberly acknowledged and addressed.

Another similar mistake is to leave too many analytical black boxes in the presentation, such as factual questions that could be investigated now but are proposed to be left for discovery, or assumptions underlying the damages model that have not been rigorously researched.

The negative impression left by these and many other deficiencies is difficult to overcome. Parties seeking funding should prepare a thoughtful and complete presentation of their financing opportunities.

4. Lacking Awareness of Norms That Guide Negotiations With Funders

A common misconception is that litigation funding deals are easy to negotiate and that funding agreements are relatively uniform.

In reality, these deals have several peculiarities and are governed by particular legal and ethical parameters.

Even parties with experience in other types of financing or business dealings struggle to extend their acumen to litigation financing deals.

Indeed, the process is guided by certain industry norms that outsiders may not necessarily appreciate or even be aware of. Parties that neglect to understand these nuances run a considerable risk of derailing the litigation fundraising process, sometimes after many months have been spent.

Each funder approaches the investment diligence and documentation processes differently.

For instance, some will provide parties a term sheet and, after the term sheet is executed, proceed to deeper diligence and final deal documents.

Other funders might have a three-phase negotiation process where the party is expected to execute a term sheet, a letter of intent and then a litigation funding agreement. Parties should be prepared to negotiate with the funder at each phase of the process.

Prior to closing, the last document to be negotiated is the definitive litigation funding agreement, or similarly named instrument.

While no two funding agreements are identical, most agreements have certain types of provisions that are essential to the funder, given the contingent-repayment, no-control nature of the investment.

Parties seeking funding should understand that these types of provisions are nonnegotiable and that pressing too hard can sour an otherwise fruitful closing process.

5. Prematurely Agreeing to Exclusivity With a Funder

Perhaps the most critical decision in the litigation fundraising process involves granting exclusivity to a funder.

Once a term sheet has been negotiated, a funder will nearly always require a period of exclusivity – sometimes more than 60 days – to complete its diligence and documentation of the transaction. After granting exclusivity, you are largely at the funder's mercy.

Parties seeking funding almost universally misread the significance of obtaining a term sheet from a funder, mistakenly believing that the probability of closing is far higher than it actually is.

Depending on the funder and the extent of its preliminary due diligence, the term sheet can merely be a hope certificate describing what a transaction might look like. Terms may be retraded or, as is often the case, the funder declines to proceed with the deal following a deeper dive into the opportunity.

Selecting the wrong funder for exclusivity may also hamper a party's future prospects of securing a deal with another funder, if negotiations with the original funder stall.

Funders will often assume that the deal with the original funder stalled because of a fatal flaw in the deal.

In an industry that is already risk-averse by nature, this kind of red flag in the middle of a fundraising process is extraordinarily difficult to overcome.

The key to avoiding this mistake – aside from refusing to grant exclusivity – is to understand the approach, process and track record of any funder requesting exclusivity.

The party seeking funding should also assess the extent of the funder's preliminary diligence and the degree to which the funder grasps the key issues.

Of course, ensuring that all material facts have been disclosed to the funder prior to exclusivity also helps avoid surprises. But candor may not be enough to avoid this pitfall.

Exclusivity is a necessary evil in the litigation finance industry – for now – and parties seeking funding should be extremely judicious in granting it.

Conclusion

While securing litigation funding may seem daunting, there are ways to beat those odds and maximize the chances of securing funding.

Parties that approach the market in a thoughtful and informed manner have a much higher likelihood of success and of avoiding wasteful dead ends.

As the market continues to mature, funders should innovate and improve their processes to make the experience more predictable and user-friendly.

Until then, experience in the market and knowledge of the funders and their approaches will remain the key to improving the odds of obtaining litigation financing.

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[1] https://advantage.westfleetadvisors.com/the-westfleet-insider-2020-litigation-finance-market-report.

[2] https://advantage.westfleetadvisors.com/the-westfleet-insider-2020-litigation-finance-market-report.

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