THE WESTFLEET INSIDER

2020 Litigation Finance Market Report

WESTFLEET ADVISORS

OVERVIEW

The past year was a unique one in our nation's history, and the litigation finance market was not spared. The year was marked by a global health crisis, cries for racial justice reform, and political turbulence. In the face of all this and following our publication of *The Westfleet Insider: 2019 Litigation Finance Report* a year ago, this report represents our second annual exercise in gathering intelligence on the state of the market and offering our analysis. Our findings this year are tempered by caution. Because of the aberrational nature of 2020, we must be wary of drawing sweeping conclusions about the trajectory of the market.

Some high-level conclusions, however, are immediately clear. For example, investors continue to be drawn to the industry, attracted by equity-like, non-correlated returns. New entrants included not only dedicated litigation funders but also so-called *ad hoc* players, such as hedge funds and family offices. Because we expect these *ad hoc* players' participation to be a major factor in the industry for years to come, we plan to measure their participation in our future research.

As detailed within this report, the number of litigation finance providers, their assets under management (AUM), and the dollars they have deployed to new financing deals all moved in a positive direction for the sector as a whole last year.

Notwithstanding the entry of new capital and funders, we observed that the pace of actual capital commitments to new funding deals was relatively modest, increasing by only 6% compared to the prior year.[1] There may be several reasons for this tepid growth rate, not the least of which is the arrival of the Covid-19 pandemic in the latter half of our data collection period. The disruptions to global business operations could easily have created a lag in the funders' investment processes, causing deals to extend just outside our collection period. Indeed, this phenomenon is consistent with our experience and has been verified by several leading funders. Time–and hopefully a rapidly approaching return to normalcy–will tell us more about the litigation finance industry's precise trajectory.

As part of Westfleet's continuing commitment to bringing transparency to the litigation finance industry, we broadened our data collection efforts this year to capture an even richer portrait of the industry. We have introduced several new metrics, including information on the average size of funding deals, whether deals

were client-directed or lawyer-directed, the use of funding proceeds, and the significance of patent litigation funding. We also looked more closely at BigLaw's utilization of funding. Funders requested many of these new metrics and areas of inquiry in the wake of our inaugural industry report, and we plan to continue to be responsive to their needs in subsequent iterations.

In addition to the activities of *ad hoc* funders, we have identified other financing activities that do not meet our definition of commercial litigation finance but are nonetheless worthwhile to track for future reports. These activities are perhaps best described as litigation-finance-adjacent. We are seeing more and more of these deals that have a claim or dispute component, which are frequently structured more as debt and priced significantly lower than the equity-like multiples common in litigation finance transactions. In our experience, the users of these alternative structures are larger, more sophisticated corporates, and the funding providers are well-equipped to underwrite these deals due to their expertise in evaluating litigation. While we believe it is appropriate to distinguish these types of deals from pure litigation finance, we intend to include them in future reports as they reflect innovation and the possibility to expand the universe of viable capital deployment opportunities for the litigation finance community.

We remain bullish on the U.S. commercial litigation finance industry and on the promise of funding itself. Every day our clients enjoy greater access to justice through litigation finance to pursue their meritorious claims. We also see myriad inefficiencies and opportunities for improvement across the industry, which should drive growth and innovation for a long time to come. We believe strongly that reasonable industry transparency serves to educate the public and increase comfort with, and ultimately utilization of, litigation finance. It is in this spirit that we present 2020's *The Westfleet Insider*.

[1] Collection period is July 1, 2019 through June 30, 2020.

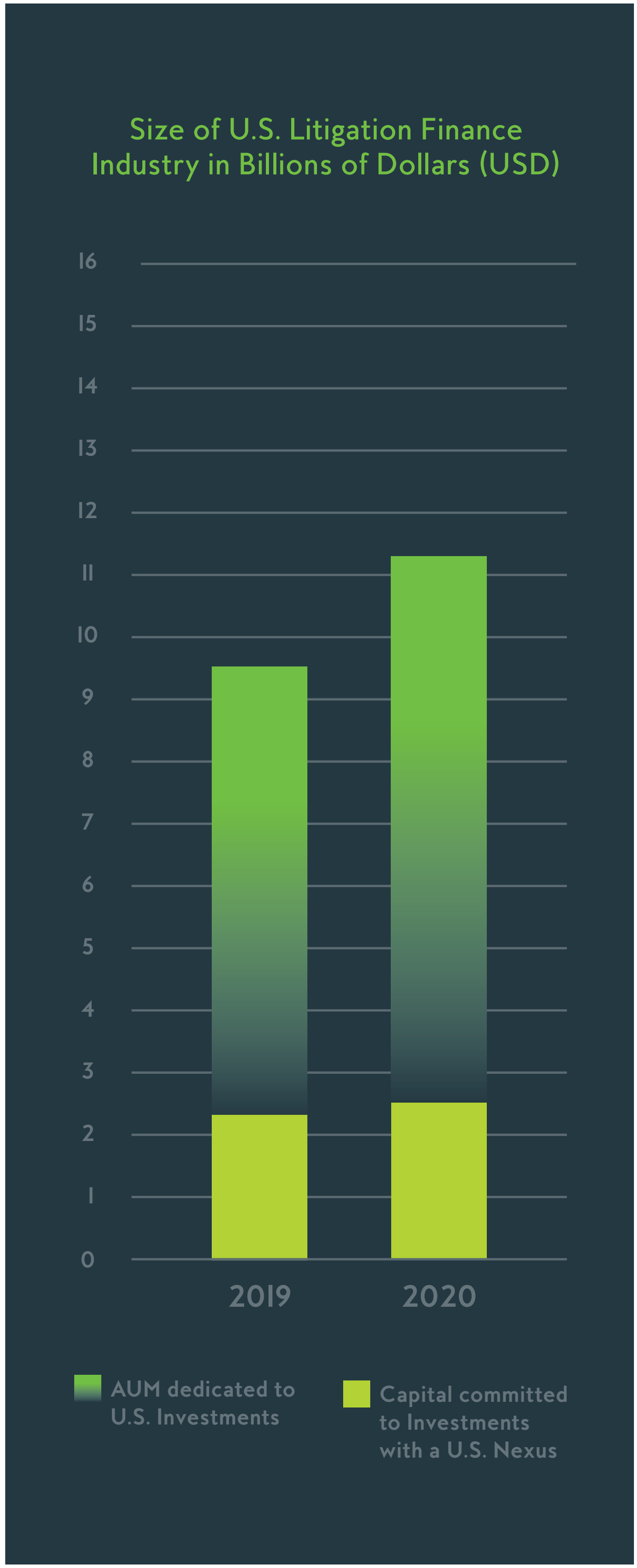
GENERAL MARKET INSIGHTS

The number of litigation funders active in the U.S. market grew from 41 in 2019 to 46 in 2020, according to our research. Those 46 funders had combined AUM of $11.3 billion, up $1.7 billion–more than 18%–from 2019. The 46 active funders closed 312 new U.S. litigation finance deals in total, committing $2.47 billion–a 6% increase from 2019.

The pandemic may have cast a shadow over these numbers. At minimum, it likely delayed the consummation of deals that would have normally closed in the second quarter of 2020, when courts around the country closed and litigation stalled indefinitely.

It remains to be seen whether the pandemic and the dramatic slowing of the U.S. economy that followed will be an intermediate-term boon to the litigation finance industry. Indeed, despite much speculation to the contrary at the onset of the pandemic, Covid-19 did not have an immediate positive impact on the U.S. litigation finance industry.

One potential opportunity for growth may arise from the fact that the rate at which funding applications are converted into financing deals is extremely low. Numerous funders have stated publicly that they close substantially less than 5% of their total funding applications. Such low approval rates, coupled with the fact that only 312 deals were consummated in the U.S. (the world's largest market for litigation finance) all last year, should cause the industry to question whether its underwriting and investment processes are truly optimized. Of course, it is impossible to determine whether funders are too selective based on these figures alone. Nonetheless, we expect to see a rise in the number of quality deals as capital flows into the market from new funding sources with varying risk appetites.



TYPES OF LITIGATION FUNDERS

Litigation funders in the U.S. can be divided into three types: dedicated, multi-strategy, and ad hoc.

DEDICATED FUNDERS, as their name suggests, specialize in litigation finance. These funders account for most of the capital available, and most of the deals completed, in the litigation finance industry. Some dedicated funders enjoy full autonomy to invest in deals that fit their mandate. Others manage their investors' capital but with limited autonomy. For instance, investors may reserve veto authority over financing deals. Several entities that hold themselves out as dedicated litigation funders do not manage a dedicated pool of capital at all, but instead, approach investors on a deal-by-deal basis to raise capital on the fly.

Two of the funders in this category with significant US activities are publicly traded entities, while the balance of these funders are privately held.

MULTI-STRATEGY FUNDERS are entities–usually hedge funds–that invest in various markets and asset classes and have established a dedicated litigation finance area (or "desk"). This specific litigation finance area typically operates much like a dedicated funder, but these multi-strategy funders often have greater sensitivity to business conflicts and capital markets compliance issues due to the broader activities.

***AD HOC* FUNDERS** are entities like hedge funds or family offices that only occasionally participate in the litigation finance space and do not have dedicated litigation finance desks. *Ad hoc* funders have an appetite for litigation finance deals, but most do not publicize their participation in the market.

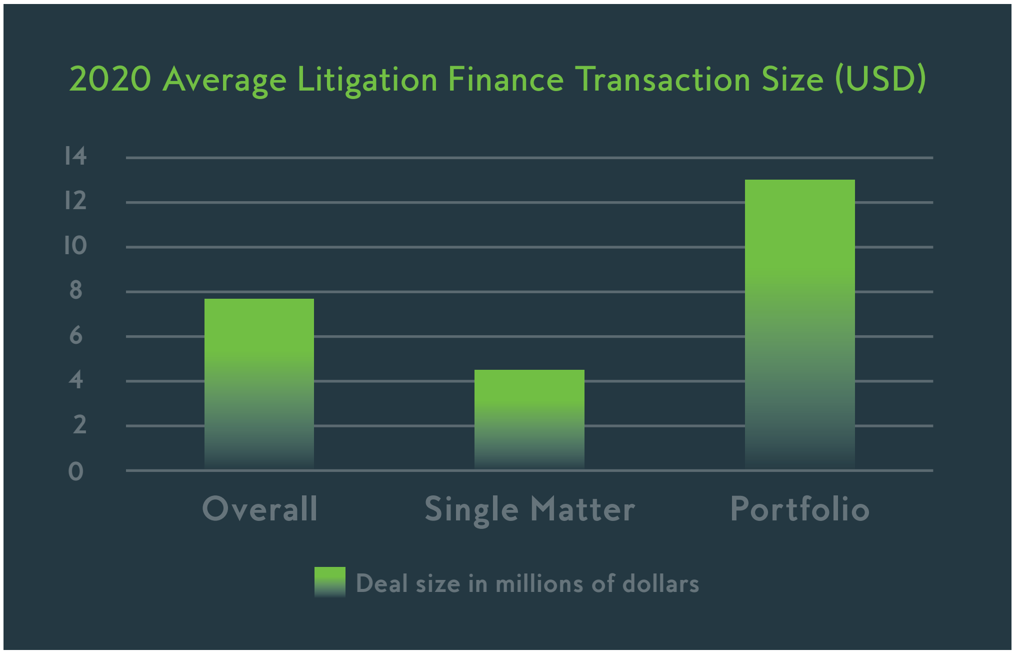
While our reports do not currently measure the activity of these *ad hoc* funders, our experience indicates they are increasing their focus on commercial litigation finance as the industry continues to produce positive investment returns. As such, they may become a significant force in the market in the near term. We have relationships with many of these *ad hoc* players and are exploring ways to include their activities in future surveys.

BREAKDOWN OF CAPITAL DEPLOYED

Portfolio transactions comprised the majority of new capital commitments in 2020, although single-case matters increased slightly as a relative percentage of overall commitments. Single-matter transactions made up 44% of all capital commitments in 2020, compared with 38% in 2019. Portfolio transactions, on the other hand, declined by 6% in 2020, to 56% from 62%.

AVERAGE DEAL SIZE

New to this year's report is data on the average litigation funding deal size, which we will update in future reports to provide important historical perspective. For 2020, the average dollar value of the transactions we analyzed was $7.8 million. Single-matter deals averaged $4.5 million, while portfolio transactions averaged $12.8 million. The level of these averages supports the frequently cited contention that funders prefer larger deals and tend to shy away from deals where the financing amount is smaller than seven-figures.

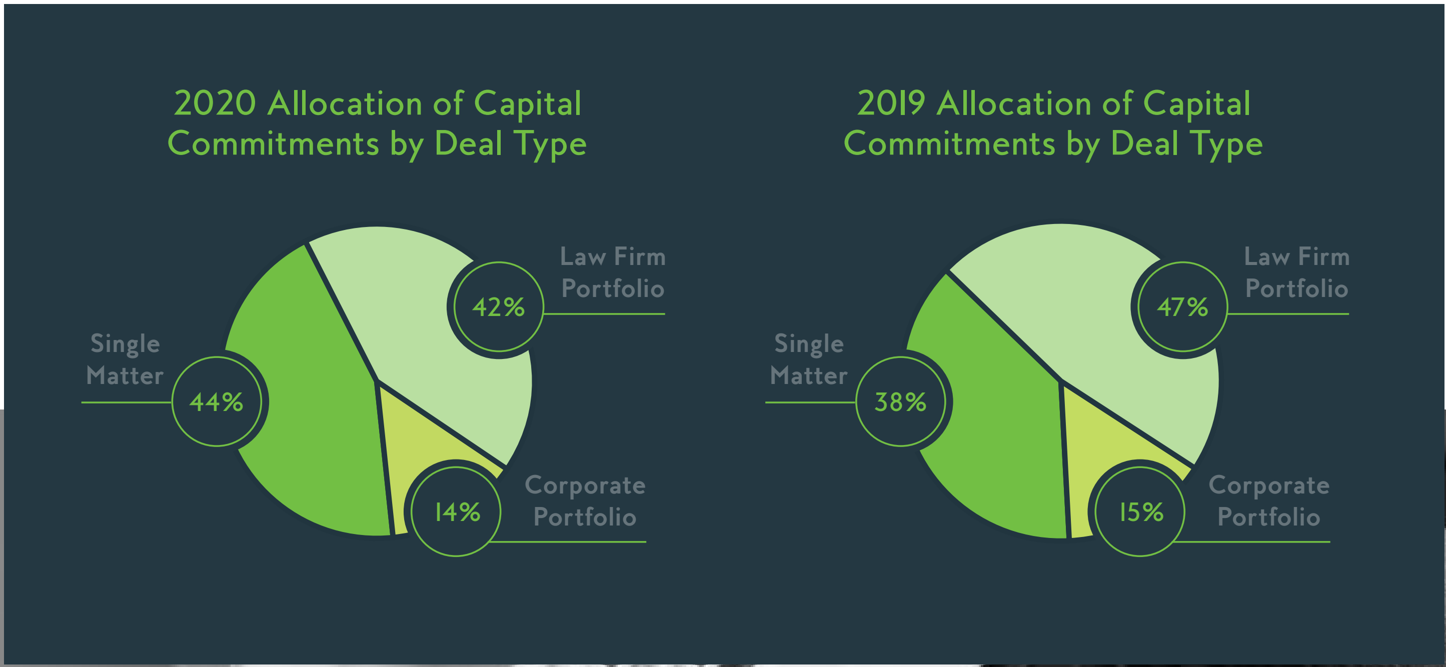


LAW FIRMS REMAIN THE PRINCIPAL USERS OF PORTFOLIO FINANCING

Within the portfolio category, the distribution of deals between law firms and corporations remained relatively constant from 2019 to 2020–an interesting data point, given our belief expressed last year that corporate portfolio deals were an area ripe for growth:

> *"For corporates and other entities such as universities, portfolio structures are only beginning to be utilized, but these transactions already account for 15% of the total capital commitments."*

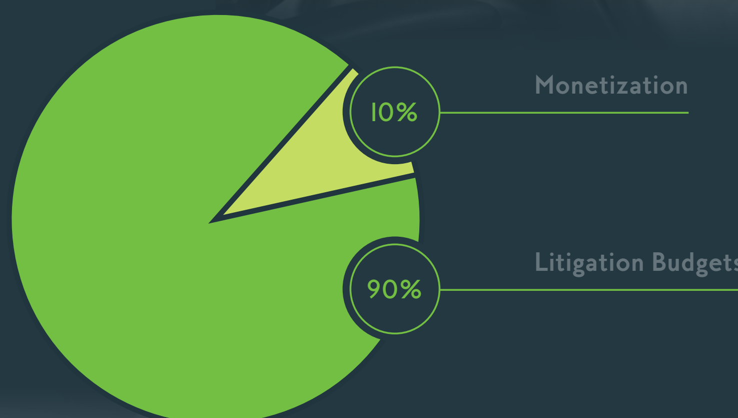
Stagnant growth in corporate portfolio investments may be attributed to the pandemic-induced recession, which prompted many corporations to focus on existential business issues and temporarily suspend exploration of litigation finance as a risk management and legal cost control tool. Many corporate legal departments consequently tabled or reined in affirmative recovery programs (designed to identify and pursue legal claims). We continue to believe corporate portfolios represent a significant area for development and growth, as we discussed in our Leveraging Litigation Assets white paper at the onset of the pandemic last year.

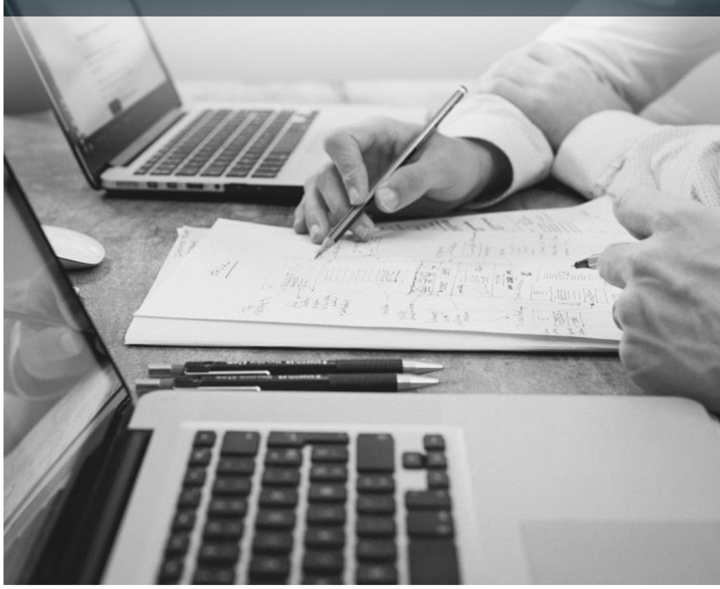


CLAIMS MONETIZATION REMAINS A GROWTH AREA

Many funders have touted their completion of "monetization" deals; that is, deals in which parties use financing to monetize the value of their legal claims, as opposed to simply financing attorneys' fees and other expenses needed to bring the litigation. Transactions that parties use to monetize claims (in lieu of, or in addition to, funding the legal budget) are an area of significant potential growth. To date, however, that market remains nascent. In 2020, 90% of all funding proceeds were used to support legal budgets, while only 10% were used purely for monetization purposes.

Breakdown of Funding Deployed by Use of Proceeds





PATENT LITIGATION IS KING

Patent infringement litigation is considered by most funders to deserve its own classification – separate from any other type of commercial litigation. Eighteen percent of all capital deployed last year was for patent litigation matters, and 80% of client-directed portfolio transactions involved patent infringement litigation. Patent litigation's suitability for litigation funding, relative to other types of litigation, makes sense because of the risk, expense, and disparity of resources between the parties in these types of disputes.

BIGLAW USES LITIGATION FUNDING PRIMARILY FOR INDIVIDUAL MATTERS

In our inaugural report, we found that financing deals with AmLaw 200 law firms represented just 30% of all capital commitments. We considered this a "striking number," given the sheer volume of litigation handled by the nation's largest firms. It was, perhaps, unsurprising, however, given that firms outside the AmLaw 200 tend to rely on litigation finance portfolio deals to fund firm operations or expansion initiatives.

For this year's report, we dug deeper into law firm use of litigation funding, focusing on what we view as a largely untapped BigLaw market. In doing so, we found that:

Litigation funding deployments to AmLaw200 firms remained consistent year-over-year, falling slightly from 30% to 28%.

Only 9% of law firm portfolio funding transactions were executed with AmLaw200 firms.

43% of client-directed, single-case fundings were executed with AmLaw200 firms.

These data points reflect a BigLaw culture that is slower to embrace the buildout of robust contingent fee practice areas, which could be augmented by portfolio financing, than smaller firms. Nonetheless, BigLaw accounts for nearly half of client-directed, single-case capital commitments. Whether BigLaw will continue to prefer to use litigation finance on a case-by-case basis (for their clients) or whether legal market conditions–including those resulting from the pandemic–will drive substantially increased utilization of portfolios and other more complex funding solutions remains to be seen. Regardless, our takeaway is that enormous opportunity remains for the AmLaw200 to leverage the benefits of litigation finance (and for funders to create products that cater to the unique needs of BigLaw clients).

WESTFLEET'S METHODOLOGY

This report would not have been possible without the participation of most of the major litigation funders, which provided thoughtful responses to our requests for information, and, through a third party, submitted confidential information from which we aggregated a complete picture of the industry's size and scope. By design, that third party shared no attributable data with anyone, even with Westfleet, which was only provided the aggregated information found in this report.

Further, much of the data relating to transactional volume and AUM is available online for the publicly traded entities, as these firms are required to adhere to a certain level of transparency in their operations. The more granular data included in our report was only gathered from those funders that directly participated in our survey. Nonetheless, based on the scope and composition of these participants, we believe these more granular data points accurately reflect the broader industry's activities.

The methodology used in this guide was as follows:

» Funder data was included in this report if the organization had substantial participation in the U.S. commercial litigation finance market as of the report's publication.

» The transaction data we collected relates to the 12 months from July 1, 2019, to June 30, 2020.

» As used in this report, "litigation finance" refers only to commercial litigation finance, which we define as transactions between commercial entities in which the financier's repayment is contingent upon the outcome of one or more legal matters. Other forms of finance–including consumer litigation finance, full-recourse law firm finance, receivables factoring, and other legal finance in which repayment is not contingent on the outcome of legal matters–are excluded from consideration in this report.

» Only commercial litigation finance activities with a nexus to the U.S. (i.e., transactions that involve a U.S. law firm as lead counsel, a U.S. counterparty, and/or U.S. litigation or arbitration or related proceedings) are included in this report.

» Law firm portfolio transactions are included even where the underlying cases may contain cases that are not commercial (e.g., cases involving bodily injuries) if the nature of the law firm's repayment obligations are contingent upon recoveries in the underlying cases.

» Some funders manage capital that is not exclusively dedicated to U.S. commercial litigation finance. For these funders, we have adjusted to exclude any capital not dedicated or allocated to U.S. commercial litigation finance from our estimate of industry-wide AUM ($11.3b).

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