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Overview

Profile of Litigation Funders

Michael Perich, Westfleet Advisors

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Contributed by Michael Perich, Westfleet Advisors

The growing field of litigation finance is drawing new entrants all the time. Many of these funding sources are not nearly as well known as the largest and most established litigation finance firms. While a litigant may know a big name or two in the space, without a consultant they are unlikely to be familiar with any family offices or small hedge funds open to investing in litigation assets. Litigants are also unlikely to understand the tradeoffs of working with each type of funder. Below, we have endeavored to identify the different sources of litigation funding available in the market, and the benefits and drawbacks to working with each of them.

Traditional Litigation Funders

The best-known litigation funders are traditional litigation finance companies. Traditional funders invest primarily in legal claims and have built up vast experience conducting diligence on cases, structuring agreements, and spotting issues that commonly crop up when investing in a claim or group of claims. These companies are often structured similar to hedge funds and invest capital on behalf of clients, though there are notable exceptions to this rule. For example, a company could be publicly traded and invest its own capital and that of its private investors.

Benefits

There are many benefits to using a traditional litigation funder. Most obviously, since they invest almost exclusively in litigation assets, they know how to structure a transaction and the various pitfalls to avoid. For example, a traditional litigation funder will almost always require a counterparty to enter an NDA before sharing documents or other information, in order to protect the confidentiality of any information shared. These funders also stay up-to-date on new rulings and developments in the litigation finance field. Finally, these funders will not include terms in their contracts designed to control litigation or settlement discussions.

Additionally, a traditional litigation funder provides the claimant and their attorney with an objective and well-informed assessment of the case. Each traditional litigation funder is staffed by former attorneys who perform thorough diligence on the cases they consider financing. While this process can be time-intensive, it provides a comprehensive review of the merits of a potential case. Even if the funder doesn't ultimately invest, the claimant leaves the process better off, having a clear understanding of the strengths and weaknesses of its case.

Finally, after an investment is made, traditional funders continue to monitor the litigation and, at the counterparty's request, help litigation counsel talk through various legal issues that arise. At the litigator's request, these funders may also moot arguments for the cases they fund and provide input on legal strategy. Importantly, since the funders do not control the litigation, they cannot direct legal strategy. Rather, these funders often fashion themselves like an outside litigation expert that can help the litigating attorneys work through issues they otherwise might not see.

Drawbacks

In addition to these benefits, litigants should also consider many of the drawbacks to working with traditional litigation funders. The biggest (and one that should be at the top of every users' mind) is the cost of their capital. Simply put, money obtained from traditional litigation finance companies is not cheap. Traditional litigation funders typically charge more for their financing than hedge fund or family office competitors, which often have greater pricing flexibility. In contrast to those providers, litigation funders are beholden to demanding investors. Indeed, when working with a funder, it is imperative to understand that the party seeking financing is not a client of the funder. Rather, the funder owes duties to its investors to get the best possible terms.

Another drawback relates to the financing process, which is not customer-friendly. The financing process is byzantine, overly complex, and opaque. Funders are often slow to respond and consistently need to secure internal approvals before providing terms, executing a term sheet, and agreeing on final terms. A simple transaction that should take a few weeks at most can often drag on for months due to these administrative issues. Additionally, given that funders are run primarily by lawyers, the underwriting process frequently gets bogged down in discussions about peripheral legal risks of the case, resulting in a robust back and forth between the funder and litigation counsel. This slows down the transaction and, if a case is not properly presented to a funder, can result in the rejection of a case that might otherwise be suitable for financing.

Hedge Funds

Another source of capital for litigation finance deals are traditional multi-strategy hedge funds. Over the past few years, as litigation finance has grown in popularity, multi-strategy hedge funds have begun operating in the litigation finance space with regularity. Indeed, many of these hedge funds have dedicated desk space to serve the litigation finance space.

Benefits

There are several notable advantages to working with a hedge fund that has a dedicated litigation finance desk. First, like a traditional litigation funder, these hedge funds will know the latest developments in the law and will make sure to enter into an NDA before reviewing documents. Second, hedge funds are generally substantially cheaper than a traditional litigation finance company. This is because the hedge fund can access many pools of capital that do not require set returns. Accordingly, unlike some traditional litigation finance providers, the hedge fund can match price to the overall risk of its investment. Finally, most hedge funds have a better litigation funding process—not requiring, for instance, multiple levels of approval before executing a term sheet or concluding a deal. Accordingly, they generally can execute a deal more quickly than a traditional litigation finance company.

Drawbacks

Nevertheless, there are some downsides to working with a hedge fund. First, the investment minimum for these hedge funds are generally substantially higher than a litigation finance firm. A hedge fund might want to invest a minimum of $15 million in a transaction, whereas a traditional funder is often willing to make a $1-2 million investment. Second, many of the hedge funds with dedicated litigation finance desks do not publicly advertise their existence, meaning that a claimholder cannot directly approach these hedge funds. Thus, a knowledgeable consultant may be necessary to mitigate this disadvantage. Finally, many hedge funds do not have teams of lawyers tasked with keeping tabs on the cases once the investment has been made. Therefore, the hedge fund will not be as involved as a traditional funder in helping to formulate legal arguments. As such, parties who view the funder as a partner in the litigation rather than a mere source of capital might be better off choosing a traditional funder, despite the significantly higher cost of capital.

Alternative Sources of Capital

Outside of the traditional litigation funders and hedge funds with dedicated litigation finance desks, there are some other alternative sources of capital. Generally speaking, these alternative sources are either wealthy individuals, family offices, or other hedge funds without a dedicated litigation finance desk. These alternative sources tend to be less sophisticated than the other options and far more diverse in their make-up.

Benefits

While it's difficult to generalize about this group, there are a few advantages to working with an alternative source of capital. First, they have varying minimums and maximums for litigation finance transactions. Those looking for funding on a smaller investment might have success looking at these ad hoc players. Second, they are open to different financing structures and have more flexibility on pricing, as many do not have a set return they are looking to obtain. Finally, they are, at times, quicker to close a litigation finance transaction than their more traditional counterparts, as they do not require multiple levels of approval to close.

Drawbacks

There are also drawbacks to dealing with an alternative source of capital. First, there is a concern that, in the event of negative case developments, they might decline to fund in order to "cut their losses." Second, these ad hoc sources of capital are generally not familiar with the funding process. Accordingly, before working with these sources of capital, attorneys and claimants need to make sure they enter into an NDA, are up to date on case law developments, and know the problematic terms a party seeking financing should avoid when entering into a litigation funding contract. Additionally, like hedge funds with dedicated desks, these ad hoc sources do not extensively monitor their investments, meaning that they will not offer the same input as a traditional litigation funder might on litigation strategy. Finally, these ad hoc sources do not advertise their existence, making them difficult to identify.

Conclusion

While the traditional litigation funders are well known, sources of litigation financing go well beyond dedicated litigation funders. There are many benefits to using the traditional litigation finance providers, which are often rooted in their knowledge of the market and their ability to conduct diligence on a case. Those same benefits can be obtained by working with someone knowledgeable about the litigation finance space. Given the rapidly expanding nature of the litigation finance space, one thing is clear: claimants and their attorneys have a wealth of options—pricey, confusing, and little-known as they may be—from which to choose.

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Overview

Litigation Finance Client Types

Charles Agee and Gretchen Lowe,
Westfleet Advisors

Litigation Finance Client Types

Contributed by Charles Agee and Gretchen Lowe, Westfleet Advisors

Litigation finance is an umbrella term that covers a wide variety of contractual arrangements. Those arrangements vary in any number of ways: in how much risk and reward the financier takes on, in the number of litigation matters covered, and in whether or how the funding is tranched.

One central variable in any litigation funding relationship is the type of client receiving the financing. This overview compares litigation funding relationships across three different client types: plaintiffs in litigation or arbitration, law firms, and defendants in litigation or arbitration.

Plaintiff Financing

What is it?

Plaintiff financing is a transaction in which a claimholder obtains financing that is usually used to satisfy the expense of bringing its claim in litigation or arbitration. It can also be used for other business purposes, or simply to monetize the claim in whole or in part. It is by far the most common form of commercial litigation finance.

Most commonly, law firms are the ones seeking financing for their clients' matters. The financier's repayment is secured by a financial interest in the outcome of one or more legal matters brought by the plaintiff. Funders may finance individual cases or portfolios of cases, which mitigates some risk through diversification.

Payment Obligations

All payment obligations to the financier (except in the event of a default by the funded party) are contingent upon a successful outcome in the underlying matter(s). If the funded litigation is unsuccessful for the plaintiff, the financier loses its investment.

Once a recovery is obtained, the financier typically enjoys seniority over distributions to the plaintiff or its counsel until repayment of its initial investment amount. Thereafter, the financier's return typically follows a waterfall structure in which the plaintiff and its counsel are entitled to receive distributions. This investment return may be structured as a percentage of the recovery, as a multiple of the financier's investment, or as a hybrid of the two methodologies.

To the extent that a portfolio of claims is used to secure the financing, the financier would typically be cross-collateralized such that a recovery in any one of the claims would trigger a payment obligation to the financier.

Success

Success in a matter financed by litigation funding is nearly always defined as a monetary recovery.

Success can also be defined by non-monetary metrics, but they can be difficult to define in advance. For example, the litigation strategy might be obtaining an injunction in the United States International Trade Commission to prevent the infringing product from being imported into the United States. This can be a significant value to the company, but there is no "monetary" recovery after the injunction is implemented. In situations like these, the litigation finance agreement will contemplate how the funder is to receive its investment return if the plaintiff obtains the injunction.

When is it Used?

Plaintiff financing is appropriate in any situation in which the plaintiff would like to take advantage of "contingency economics"—that is, letting another party absorb the financial burden of the litigation in exchange for an interest in any eventual recovery. Reasons this may be attractive to a plaintiff include:

- A lack of funds sufficient to pursue the case with its preferred counsel;
- A desire to limit the impact of litigation expense on company financial statements during the pendency of litigation (litigation financing is usually "off balance sheet");

- A desire to hedge risks associated with an adverse outcome in the litigation by partially monetizing the claim at the outset of the litigation; and
- The desire to generate liquidity for some working capital need by leveraging an asset (a legal claim) not reflected on the plaintiff's balance sheet.

Law Firm Financing

What is it?

Another common type of litigation finance, known as law firm financing, involves a transaction in which a law firm with one or more contingent fee engagements obtains financing. In this situation, the financier's repayment is secured by an interest in the firm's recovery on those contingent fee engagement(s).

In this structure, proceeds are often used to fund or to hedge the firm's investment in its contingent fee cases, which includes costs such as third-party experts, document preparation, travel, and of course lawyer time.

Payment Obligations

Except in cases of default by a financed law firm, all payment obligations to the funder are contingent on a successful outcome in the underlying engagement(s). Once a recovery is obtained, the financier enjoys seniority over distributions to the law firm up to the amount of its initial investment. Thereafter, its investment return typically follows a waterfall structure in which the law firm is entitled to receive distributions. This investment return may be structured as a percentage of the recovery, as a multiple of the financier's investment, or as a hybrid of these two methodologies.

Many funders are reluctant to structure their returns as a percentage of the firm's fees due to concerns about fee-sharing prohibitions. To the extent that a portfolio of claims is used to secure the financing, the financier would typically be cross-collateralized such that a recovery in any one of the claims would trigger a payment obligation to the financier.

Success

In law firm financing, “success” is defined as a monetary recovery.

When is it Used?

Law firm financing transactions are typically used where a law firm seeks to expand or to de-risk its contingency caseload, or where a firm has obtained a large judgment for a client and wishes to monetize a portion of its contingent fee in order to avoid continued deferral of liquidity and to mitigate the risk of reversal on appeal.

Consider this example: a law firm has a portfolio of contingency fee cases but has been waiting for those cases to resolve for a long time. While the law firm knows that it will eventually recover on these cases, it wants to unlock some of its expected fee now rather than waiting for the cases to resolve. Such a law firm could use litigation finance to de-risk some of its contingency fee and advance the payment of a portion of its expected fee award.

Similarly, the law firm that would like to take a case on contingency but has met its internal threshold for taking on contingency cases could use litigation finance as a tool to help the law firm expand its contingency fee practice when it otherwise would not have had the risk tolerance to do so.

Defendant Financing

What is it?

It is important to note that while defendant financing does exist, it is exceedingly rare. While there are a few different types of defense-side financing, we will discuss “pure” defense-side financing. This occurs in cases where the funder is purely financing the defense of the case; there are no counterclaims present that a funder could secure its investment against. Notably, there are cases where the defendant has a strong counterclaim and seeks litigation financing for prosecuting that counterclaim and defending against the plaintiff's allegations. Given the similarities between this type of financing and plaintiff-side financing, we did not want to discuss it in-depth here.

In this scenario, defendant financing relates to the potential exposure the defendant faces from the litigation. It involves a transaction where the defendant obtains financing to defend itself in a legal action and the financier's payment is secured by a financial interest in the defendant's outcome in one or more legal matters. This type of financing is meant to replicate a law firm's reverse contingency fee arrangement. Much like a reverse contingency fee agreement, the funder's recovery is based on the difference between the amount the plaintiff demands from a lawyer's client (the defendant), and the amount ultimately obtained from that client, whether by settlement or judgment.

Success

In these structures, "success" is less tangible than in plaintiff financing, in which a monetary recovery is typically made. Here, success is defined by the differential between a benchmark of the defendant's exposure in the litigation (that is, an initial estimate of what the litigation will cost the defendant) and the actual amount paid by the defendant to resolve the claim through settlement or judgment.

For example: a defendant has been sued by a plaintiff for allegedly breaching a contract to manufacture television screens. The plaintiff seeks to recoup the amount it paid under the contract, $10 million, and an additional $40 million in lost profits.

While the defendant can pay for the defense of the case and the ultimate award, it does not want to due to current budget restrictions. Moreover, since the lawsuit is only for breach of contract, there is no insurance coverage available.

In this case, the defendant could seek financing from a litigation finance company to pay for the defense of the case. At the outset, the funder and defendant agree that "success" is defined to mean only repayment of the $10 million under the contract. The parties also agree that, if the plaintiff recovers any lost profits, then the litigation was not "successful." The parties determine that, if the lawsuit is successful, then the defendant must pay the funder two times the investment amount plus 25% of the difference between the amount actually paid by the defendant to the plaintiff, and the parties' definition of success, which is a payment of $10 million.

Payment Obligations

All payment obligations to the financier (again, except in the event of a default by the funded party) are contingent upon a successful outcome in the underlying matter(s). That is, the financier will only be paid if the actual cost to the defendant is less than the initial cost estimate or benchmark. If the outcome is unsuccessful, the financier loses its investment and the defendant will have effectively avoided the legal costs typically associated with an unsuccessful defense.

In this situation, once the underlying claim is resolved, the repayment of the financier's investment plus its return typically follows the same waterfall structure as in plaintiff financing. That is, the financier's return increases along with the differential between the defendant's actual payout and its pre-defined exposure in the case. This investment return may be structured as a percentage of this differential, as a multiple of the invested amounts, or a hybrid of these two methodologies.

Using the example above, assume the financier pays $2 million in defense costs. Ultimately, the case goes to trial and the defendant is only required to pay $2 million. Under this scenario, the defendant would owe the financing company $6 million (two times the $2 million investment, plus 25% of $8 million, which was the difference between the definition of success and the $2 million owed to the plaintiff) at the successful conclusion of the litigation. If, however, the defendant were required to pay $11 million to the plaintiff at the end of the litigation, then it would be considered unsuccessful, and the defendant would not have to repay the $2 million expended by the financier in defending the lawsuit.

When is it Used?

As we have already discussed, defendant financing is rarely used (though that may change in the coming years as new metrics for measuring success are developed). Theoretically, it may be used in any situation in which the defendant prefers to tie its expenditures to defend a claim to an agreed-upon level of success achieved in that defense.

What Else Is Out There?

There is currently much discussion throughout the litigation finance industry of corporate plaintiff portfolios, which operate very similarly to plaintiff financing, but on a larger scale. The difference is that corporate legal departments are the ones seeking funding for their own matters, rather than going through their outside law firms. It operates as a tool for corporations to generate consistent revenue from pending pieces of litigation rather than receiving all of the proceeds from a piece of litigation at one time. This can result in significant benefits for a corporation's balance sheet.

There is also talk throughout the industry about the introduction of sophisticated insurance products for parties who seek the risk-management benefits attendant to litigation financing but do not need liquidity and do not want to bear the costs associated with obtaining it.

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Comparison Table

Benefits & Risks of Litigation Finance Client Types

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BENEFITS	**Plaintiff Financing**	**Law Firm Financing**	**Defense Financing**
Minimizes financial impact of litigation budgets.	X	X	X
Expands counsel selection pool, bridging the gap between a client's willingness to pay and a firm's appetite for contingency risk.	X		
Firm is able to open up its client base by serving clients that can't or don't want to pay their full rates.		X	
Hedges risk.	X	X	X
Having a claim vetted by an independent, professional financier (an often-overlooked benefit of using third-party financing).	X	X	X

RISKS	**Plaintiff Financing**	**Law Firm Financing**	**Defense Financing**
High financing costs.	X	X	X
Potential for ancillary disputes in the litigation related to confidentiality waivers, discovery, and standing issues, among others. Most experts consider these risks to be remote.	X	X	X
Time-consuming and cumbersome process to procure financing, though industry advisors can mitigate this challenge.	X	X	X
Reporting and accountability to the financier despite the financier's passive role in the litigation.	X	X	X
Potential for difficulty in defining "success."			X