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LEVERAGING LITIGATION ASSETS TO OPTIMIZE COST-CUTTING IN THE FACE OF THE ECONOMIC DOWNTURN

How can corporate counsel think strategically and creatively to monetize high-value legal claims while simultaneously reducing costs?

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In-house legal departments face a conundrum. Confronted with the COVID-19 pandemic and the ensuing economic turmoil, companies of all sizes must decide how best to manage their expenditures and sources of liquidity. Solutions designed merely to staunch the bleeding have the potential to damage a company's long-term competitiveness and unnecessarily sacrifice potential future assets. Corporate legal departments have been tasked with triaging the various components of their budgets to minimize costs—at least for the near term—while preserving mission-critical legal functions for the company. In effect, they are facing the challenge of positioning themselves for the future while responsibly managing through the present.

What, then, is a company to do?

Certain legal expenses such as regulatory and transactional work supporting core business operations, as well as expenses incurred to reduce liability and defend litigation, will be the last parts of the legal budget that corporate counsel will be inclined to eliminate. Elective matters such as affirmative litigation, including litigation-in-progress, may seem to be the easiest matters to trim; especially since potential recoveries from plaintiff-side litigation are not reflected as assets on the company's balance

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sheet. As such, the true cost of foregoing these future revenues will not be apparent to most shareholders and may even seem unimportant to some senior management. The directive that many corporate counsels already hear or can anticipate hearing from the C-suite is, “I don't care what you think the case may be worth years from now, settle it for what you can now so we can stop pouring money into it.” For companies with valuable litigation assets, however, this approach to cost-cutting may not be the most prudent course and could even be subject to second-guessing when the crisis is over.

Meritorious litigation claims are valuable contingent assets that can be preserved even when legal departments consider belt-tightening measures. Indeed, the monetization of a company's litigation assets—using contingent fee arrangements and litigation funding to secure the services of a preferred litigation firm to pursue the claims—is a proven strategy that enables in-house legal departments to generate cash and reduce costs.

Companies can use contingent fee arrangements with law firms coupled with litigation financing arrangements with third-party funders to preserve their litigation assets without expending their own precious liquidity on plaintiff-side matters. Eliminating the expenses while preserving the upside is reason enough to explore these alternatives. Companies with high-value litigation assets also stand to gain additional benefits that may not be obvious at first glance.

CONTINGENT FEES CAN SOLVE CERTAIN BUDGETARY PRESSURES BUT THEIR AVAILABILITY AND IMPACT MAY BE LIMITED

For plaintiff-side matters that are already in progress, and for yet-uninitiated matters, your outside litigation counsel may be willing to offer a contingent fee through the completion of the matter, whereby the law firm would receive their legal fees if and when the matter resolves successfully. Although most firms will require a premium to accept the risks associated with revenue deferral and other risks of contingent fee representation, the benefit to the company is clear. Whereas a company typically must record expenses for legal fees as they are incurred, a contingent fee arrangement enables a company to defer these expenses until the case has resolved successfully. At that time, a concurrent

revenue event would also be recorded—the damages recovered in the litigation. In essence, the contingent fee is paid out of “found money”. The company can retain most of its potential upside in the litigation while relieving the burden of paying legal fees in the interim and having those expenses drag down its earnings.

And now to the limitations.

During the last few years, many law firms have enhanced their capitalization to accommodate more contingent fee litigation work. But even firms that had the foresight to shore up their balance sheets may not be able to meet near-term client demand for these arrangements during the economic downturn, especially in light of their own diminished revenue. A few larger firms, as well as many boutiques that have historically embraced a contingent fee model, are well-positioned to accommodate contingent fee requests. But if your preferred litigation firm is not able to offer these solutions, the cost of transitioning to another law firm would require careful consideration and may ultimately not be worthwhile.

Additionally, many of the law firms that will accept contingent fees are only able to offer partially contingent fees or hybrid hourly-contingent fee arrangements. And among those firms, even fewer are equipped to advance the hard costs (e.g., e-discovery, experts, travel, document printing, and other corollary litigation expenses). Any portion of the litigation budget that the law firm cannot absorb as part of its contingency would still fall to the company to fund using its cash.

Finally, while your law firm may be able to accommodate the full budgetary burden of a matter, including hard costs, it will not extend financing to the company outside the scope of that matter’s budget.

In the right situation, however, litigation finance can address all of these limitations.

LITIGATION FINANCE USED IN PARALLEL WITH CONTINGENT FEES PROVIDES A MORE COMPLETE SOLUTION

Litigation finance enables corporate legal departments and their outside counsel to structure contingent fee arrangements where those arrangements may not otherwise be feasible. Indeed, nearly every litigation finance transaction involves some level of contingency stake or risk-sharing by the law firm litigating the case. As such, companies can derive the most complete set of benefits when using both of these options together. The benefits of using litigation finance (together with contingent-fee arrangements) to monetize litigation assets are considerable.

Although a law firm’s ability to offer contingent-fee arrangements is often limited, the supply of litigation finance capital is effectively boundless. In 2019, Westfleet Advisors performed a first-of-its-kind study of the supply and demand for commercial litigation finance in the U.S. market, and we determined that an oversupply of capital exists. To be sure, we expect demand for litigation finance to skyrocket given the current economic downturn. But notwithstanding increased demand, we know that litigation funders are still eager to deploy capital and have ample supply.

The accounting benefits of using litigation funding for a litigation budget are identical to using a contingent fee arrangement. There is a misconception that litigation funding simply adds debt to a company's balance sheet. On the contrary, a litigation funder commits to funding fees and expenses for the litigation, and the law firm submits drawdown requests (on behalf of the company) to cover fees and hard costs incurred. So, the funding proceeds for these budgets do not run through the company's accounts, nor do the expenses associated with the budget. The elimination of these expenses results in a commensurate boost to the company's earnings.

Other benefits associated with using funding include obtaining independent validation of the merits and value of claims, which can be useful in identifying claims that should not be pursued regardless of who is providing the financing. And although funders do not control or directly influence the strategy or disposition of the litigation, the presence of outside, professionally managed capital does serve to impose a certain discipline on the litigation process, particularly on adherence to budgets. Companies can and do benefit from an experienced group of professionals with skin in the game who are monitoring these areas.

Finally, companies with multiple plaintiff-side cases should consider portfolio structures, by which their multiple claims can be bundled together in a single litigation funding deal to secure more favorable pricing from funders. That these individual claims may be handled by different outside law firms does not bar a company from seeking a portfolio deal. A portfolio litigation funding structure can span all of these matters across the various outside counsel.

IMPORTANT, BUT LESS OBVIOUS, WAYS TO USE LITIGATION FINANCE TO OPTIMIZE COST-CUTTING

There are other less obvious—but equally important—benefits of using litigation finance that companies wanting to gain every possible advantage during these challenging times should consider.

Companies that elect to proceed with litigation-in-progress or to initiate new affirmative matters, especially when using funding to continue to pay legal fees to their outside litigation counsel, offer an increased volume of litigation work to the law firm, even as the law firm's other corporate clients may be drastically cutting their expenditures. This increased volume (again, requiring no additional outlays from the company) may provide the company with leverage to negotiate more favorable alternative fee arrangements. The increased volume of work for the law firm and more favorable pricing for the company is a win-win proposition for both parties.

For companies with individual claims or portfolios that are valuable enough to support litigation funding in excess of litigation budgets, additional capital infusions from the litigation funder may be used to offset other expenses within

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the legal budget or across the company's broader operations. This type of transaction enables a company to partially monetize a hidden asset (the litigation) that is not booked on the company's balance sheet, to generate working capital even before the underlying litigation has resolved.

The partial monetization of litigation claims is a frequently overlooked feature of working with a litigation funder that in-house counsel would be well-served to consider in today's environment. For example, companies may leverage litigation funding opportunities to fund settlements of their defense-side matters at extremely favorable valuations, particularly where the plaintiffs in those cases are themselves experiencing financial duress. Such dispositions not only eliminate continuing litigation expenses, but to the extent that the settlement amount is less than the reserves the company has previously taken to account for its potential liability, the release of any such reserves would also immediately increase company profitability.

CRYSTALIZING PLANS AND TAKING ACTION THAT CAN HAVE AN IMMEDIATE IMPACT

In these tumultuous times, corporate legal departments should consider how best to leverage the value of their litigation assets, to optimize their legal budgets. Leading law firms and litigation funding advisory firms (like Westfleet) can assist companies in exploring their specific options. We hope this article helps stimulate these discussions so that companies can take advantage of appropriate lifelines and emerge from the current economic downturn stronger and more nimble than ever.

