INVESTMENT FUNDS

What a fund manager should know about entering the litigation finance industry

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Introduction

The term "litigation finance" (also known as "litigation funding"), refers to several forms of funding transactions, some of which do not involve the actual funding of a specific litigation.

For an industry that, until recently, was little known in the legal and finance markets, litigation finance has grown sharply — not only due to broader acceptance but also because of the high potential returns and the uncorrelated nature of the investment. While private funds in 2018 were able to marginally outperform the S&P for the first time in a decade,[1] the returns for the industry have been generally inconsistent and lackluster for many private funds. Managers are seeking more unique asset classes.

Litigation finance offers the prospect of higher returns than traditional investment strategies and of being uncorrelated to equity market movements, both of which are particularly alluring during periods of market downturn and volatility.

Why do litigants seek financing?

Litigation finance can be seen as the "democratization" of a lawsuit whereby plaintiffs who historically have had fewer resources than the defendants can pursue a meritorious claim on an equal footing. Litigants seek financing for litigation claims for a variety of reasons, including to (i) increase their economic power (including higher-quality counsel) against counterparties, (ii) reduce the pressure to settle prematurely due to the high cost of litigation, (iii) provide for working capital for their business during litigation, (iv) de-risk their positions with another stakeholder and (v) refinance existing financial arrangements.

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Types of litigation finance

A litigation funder can finance any stage of a litigation to counterparties directly or indirectly involved in the litigation. An investment with the claim holder (e.g., the plaintiff) is arguably the purest form of litigation funding, and the types of lawsuits funded can range from mass torts and class actions (e.g., pharmaceutical products or medical devices), to patent infringement, matrimonial disputes, federal torts, arbitrations (including international) and commercial cases.

Litigation involves a binary outcome, and, in the event that a plaintiff loses a case, the funder will lose its investment. Therefore, transactions with plaintiffs are often non-recourse equity investments and not loans. In the event of a successful outcome, the funding arrangement provides for a distribution waterfall to allocate proceeds among the plaintiff, the attorneys (if applicable) and the funder.

Another common type of funding is financing to law firms. These financings are usually secured by attorneys' fees from a single or portfolio of cases. They can be full recourse, non-recourse or limited recourse transactions and can be entered at any stage of the litigation (including post-settlement). One of the advantages of this type of investment is that, when secured by a portfolio of cases, the funding can be cross-collateralized so that the return on investment is not solely dependent on the outcome of one case. One of the risks to consider when funding a law firm is that the law firm does not "own" the litigation, and the plaintiff can terminate its relationship with the law firm and seek other counsel. The structure of the transaction should also take into account the fact that the law firm represents the plaintiff and not the funder and has a duty to the plaintiff rather than the funder.

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Another form of litigation financing involves medical liens whereby advances are made to medical professionals who provided medical care to the plaintiffs and are entitled to be paid from recoveries in the related litigation or what are commonly called "pre-settlements," which are relatively small fundings provided directly to personal injury plaintiffs.

A final common area of litigation financing is in bankruptcy litigation to advance funds to debtors-in-possession, creditors' committees, liquidation/litigation trusts or Chapter 7 or 11 trustees, during the pendency of bankruptcy cases, post-confirmation or after the consummation of a Chapter 11 plan. Bankruptcy court approval is required for a debtor or trustee to obtain such financing.

In all funding arrangements, the funder does not have the right to control the litigation and, as stated earlier, ethics rules dictate that the plaintiff's lawyer is obligated to act in the best interests of the plaintiff.

Assets funded

The actual "asset" that is being financed can take many forms ranging from attorneys' fees, legal expenses, or other costs and expenses, with the prospect of proceeds from the lawsuit judgment or settlement serving as the collateral. The manager has discretion to decide what aspects of the litigation to finance, its valuation and the expected return on investment in the distributions.

For litigation that is in the pre-settlement stage, the funding can be used for court costs, expert witnesses, attorneys' fees, medical advances, arbitration fees, accountants or similar service providers.

In post-settlement stage litigation, funding is needed when the funded party is awaiting a distribution of proceeds. Recent examples where there was a lengthy delay between settlement and payment include the NFL concussion settlements and the Deepwater Horizon BP settlements.

One common form of litigation funding is "patent monetization," which often involves a patent infringement litigation, and can be a costly endeavor for middle-market businesses or individual inventors.

Structure of a litigation finance vehicle

Management

The founders of litigation finance investment firms are often litigators or other professionals with trial experience, who may not have previously managed a fund and may have directly funded litigation without using investment vehicles. Litigation finance vehicles are structured with most features used by private equity funds, including management fees and carried interest structures.

Investment period

While there are publicly traded litigation funders, most are private litigation finance vehicles that are allowed to finance new litigation cases during an "investment period," and have a stated term (both of which are likely to be shorter than a typical five-year investment period and five-year harvest period).

Withdrawals and distributions

Privately held litigation finance vehicles generally do not offer withdrawal rights to fund investors, as they rely on the settlement or conclusion of the underlying litigation in order to be able to make distributions to investors, the timing of which is uncertain. In other words, these assets are illiquid and absent extraordinary circumstances, investors stay invested through the life of the fund. When a lawsuit settles and the investment fund receives its proceeds from the lawsuit, distributions are made to the investors in the fund, subject to a waterfall set forth in the fund documents, and is the same waterfall for all incoming proceeds.

The waterfall between the fund manager and investors in the investment vehicle should not be confused with the waterfall in the transaction documents between the funder and a plaintiff or law firm.

Expenses

In addition to typical fund-related expenses, a litigation funding vehicle will often retain subject-matter or litigation strategy experts to assess the strength of a case prior to entering into a funding deal (even where the fund managers are also litigators) and may retain ethics consultants to advise on structuring and terms of transactions depending on the jurisdiction of the lawsuit.

In a traditional litigation funding transaction, the litigation finance vehicle will draw down capital as needed to cover fees and expenses covered under the agreement between the plaintiff (or law firm) and the investment vehicle. If an investment is made at a point when the plaintiff has funded a substantial amount of expenses, the investment vehicle may make a payment to the plaintiff and, therefore, require a larger initial capital call.

Information sharing

In order to assess the merits of funding a case and monitoring its progress during the pendency of litigation, the investment manager will rely on information provided by the plaintiff and its attorneys or that is publicly available. To protect attorney-client privilege in active litigation, information provided to the investment manager may be limited. Such limitations will also limit the information managers will be able to provide to their investors.

Courts are divided as to whether the common-interest doctrine will apply to third-party funders, and, therefore, investment managers should be aware of the limitations to which communications may be subject.

Tax issues

The tax analysis depends on the facts of the nature of the deal structure, the structure of the funding vehicle and the nature and location of the investors, which can vary dramatically from transaction to transaction. Tax issues vary depending on the whether a plaintiff or a law firm is being financed, whether the financing will be treated as debt or equity for tax purposes, and the presence of any investors in the fund who have special concerns, such as offshore investors and tax-exempt investors.

Regulatory requirements

Managers in litigation finance may be required to register as investment advisers if their investments are deemed to be securities. Such analysis will generally depend on the nature and structure of the investment and the roles of the various parties.

Other legal issues

Litigation financing raises numerous issues under applicable laws and regulations, which are not uniform across jurisdictions. As litigation finance increases in prominence, certain states have passed or are contemplating regulations to require the disclosure of litigation financing arrangements.[2] Courts are carefully reviewing disclosure obligations, with the U.S. District Court for the Northern District of California announcing a new rule for the automatic disclosure of third-party funding arrangements in proposed class-action lawsuits.[3]

While not law, the New York City Bar Association issued a formal, and often criticized, opinion in 2018 that non-recourse litigation funding to a law firm was considered "fee splitting" with a non-lawyer in violation of New York ethics rules to which New York lawyers are subject.[4] The bar association has since formed a working group to examine the practice.[5]

Conclusion

The market demand for litigation finance is not expected to wane in the coming years. Due to such demand and the mercurial application of regulations, bar associations and court opinions, a fund manager in this industry should be acutely cognizant of managing uncertainty through proper fund structuring, careful drafting of funding documents, active monitoring and transparency to investors.

1 Williams Watts, "Hedge Funds Lose Money in 2018 But Outperform S&P by a Whisker," *Market Watch* (Jan. 9, 2019), available here: https://www.marketwatch.com/story/hedge-funds-lose-money-in-2018-but-outperform-sp-500-by-a-whisker-2019-01-08

2 2017 Wis. Act 235.

3 Ben Hancock, "Northern District, First in Nations, Mandates Disclosure of Third-Party Funding in Class Actions," *The Recorder* (Jan. 23, 2017), available here: https://www.law.com/therecorder/almID/1202777487488/Northern-District-First-in-Nation-Mandates-Disclosure-of-ThirdParty-Funding-in-Class-Actions

4 *Formal Opinion 2018-5 Litigation Funders' Contingent Interest in Legal Fees*, nycbar.org, available here: https://s3.amazonaws.com/documents.nycbar.org/files/2018416-Litigation_Funding.pdf

5 *New York City Bar Association Forms Litigation Funding Working Group*, nycbar.org, available here: https://www.nycbar.org/media-listing/media/detail/new-york-city-bar-association-forms-litigation-funding-working-group