Investing in Litigation Finance

Schulte Roth&Zabel

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PRIVATE INVESTMENT FUNDS SEMINAR

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Litigation

Bankruptcy & Creditors' Rights Litigation

Complex Commercial Litigation

Insurance

Real Estate Litigation

Securities Litigation

William H. Gussman, Jr.

Bill focuses on complex commercial litigation, including securities fraud actions, fraudulent transfer actions, M&A litigation, private post-acquisition disputes and derivative actions. He advises leading hedge funds, private equity firms, major corporations, investment banks, prime brokers, lenders and individuals. Bill has substantial trial experience, having tried cases in federal and state courts throughout the United States and in a variety of alternative dispute resolution venues, including AAA, FINRA and JAMS arbitrations. Bill frequently litigates in bankruptcy court, often representing creditors in enterprise valuation and asset ownership disputes. He has broad experience representing both buyers and sellers in deal-related disputes, including in shareholder class actions. He has also assisted clients in connection with SEC investigations.

Bill's jury trial experience includes the successful defense of a leading prime broker in a $141.4-million fraudulent transfer action brought by the trustee of a defunct hedge fund. In that two-week federal trial, he helped to secure a unanimous verdict in favor of the prime broker. In addition, Bill successfully defended a former officer and director of Merck & Co. in a widely publicized securities class action and related cases concerning the painkiller Vioxx. That high-profile matter included the defense of federal and state securities law claims, breach of duty claims, product liability claims and other matters. Bill is ranked as a leading lawyer in *The Legal 500 US*. A recognized thought leader, Bill co-authored the "Market Manipulation" chapter in the leading treatise *Federal Securities Exchange Act of 1934*, published by Matthew Bender and the article "Extending *CalPERS v. ANZ* Securities To Exchange Act Cases," published in *Law360*.

Bill received his B.A., *summa cum laude*, from Dartmouth College, where he was Phi Beta Kappa, and his J.D. from Harvard Law School.

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Practices

Business Reorganization

Distressed Debt & Claims Trading

Distressed Investing

Energy

David J. Karp

David leads the firm's Distressed Debt & Claims Trading Group, which provides advice in connection with U.S., European and emerging market debt and claims trading matters. His practice focuses on special situations and distressed investments, and distressed mergers and acquisitions. David represents investment funds, private equity funds and broker-dealers in connection with the financing and trading of distressed, non-performing and esoteric assets across a wide range of issuers in jurisdictions around the globe. He is often called upon to develop secondary market risk transfer structures for illiquid assets and claims including oil and gas royalties, liquidating trusts, litigation claims and many other financial products.

Recognized as a leading lawyer by *New York Super Lawyers*, and by the founder of *Reorg Research* as "undoubtedly one of the best in the field at what he does best: making sure funds and their investments are protected when transacting and executing trades in distressed debt and claims," David is an active member of the American Bankruptcy Institute, Loan Market Association, Emerging Markets Trade Association, National Association of Royalty Owners and the Loan Syndications and Trading Association. He is a frequent author and speaker on distressed investing and oil and gas topics and recently wrote articles, including "Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations," "Structuring Winning Bids: European NPL Portfolio Transactions" and "Bank Debt Trading on the Modern Day Back of the Napkin."

David earned his J.D. from Fordham University School of Law, his B.S. from Cornell University and his Energy Finance and Management Certification from the University of Denver.

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Tax

Distressed Investing

Energy

Mergers & Acquisitions

PIPEs

Private Equity

Vendor Finance

Real Estate Capital Markets & REITs

Kurt F. Rosell

Kurt focuses his practice on the tax aspects of mergers and acquisitions, leveraged buyouts and other private equity transactions; international transactions; the formation of private equity funds; executive compensation; and bankruptcy and workout transactions. With more than 30 years of experience in structuring acquisitions and sales of public and private companies and advising on all the tax aspects of the transaction, Kurt has handled acquisitions in a wide variety of industries, including government contracting, manufacturing, restaurants, media companies, supermarkets and other retail businesses and finance and leasing companies. He has represented both strategic and financial buyers and has handled exits and partial exits via sales, public offerings, leveraged recapitalizations and other methods. Kurt has also acted as tax counsel in connection with structuring private equity funds and representing both fund sponsors and investors in the fund formation and investment process. In addition, he has dealt extensively with corporations that possess valuable tax attributes, such as net operating losses. Both the NOL corporations themselves and investors in those corporations are subject to special tax rules. Kurt is recognized as a leading tax attorney in *The Best Lawyers in America*, *The Legal 500 US* and *New York Super Lawyers*.

Kurt received his J.D. from Columbia Law School, where he was a senior editor of the *Columbia Law Review* and a Harlan Fiske Stone Scholar, his LL.M. in Taxation from New York University School of Law, and his B.A., *magna cum laude* and Phi Beta Kappa, from Wake Forest University.

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Practices

Investment Management

Private Equity

Phyllis A. Schwartz

Phyllis focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning and the creation of internal investment and co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of private equity funds. Phyllis also advises private equity funds in connection with their investments in, and disposition of, portfolio companies and the establishment of capital call credit lines.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 US*, *The Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed compliance concerns for co-investments and issues related to fund restructuring and secondary transactions. Interviewed by *Private Funds Management* in the article "Ringing the Changes," Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject. In addition, she contributed to *Fund Formation and Incentives Report* (SRZ in association with Private Equity International) as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" in *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute).

Phyllis received her J.D. from Columbia University Law School and her A.B. from Smith College.

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Practices

Structured Finance & Derivatives

Boris Ziser

Boris is co-head of the Structured Finance & Derivatives Group. With over 20 years of experience across diverse asset classes, Boris focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation financing and cell towers, in addition to other esoteric asset classes such as intellectual property and other cash flow producing assets. He also represents investors, lenders, hedge funds, private equity funds and finance companies in purchases and dispositions of portfolios of assets and financings secured by those portfolios.

Recognized as a leading lawyer in the industry, Boris is ranked in *Chambers USA* and *The Legal 500 US* for his work in structured finance. He serves as outside general counsel to the Institutional Longevity Markets Association (ILMA) and he is a member of the Structured Finance Committee of the New York City Bar Association, the New York State Bar Association, and the Esoteric Assets Committee and Risk Retention Task Force of the Structured Finance Industry Group. A frequent speaker at securitization industry conferences, Boris has conducted various securitization and life settlement seminars in the United States and abroad. Most recently, he was interviewed for the article “Life Settlements and Longevity Swaps: Opportunities for Investors, Individuals, Insurers and Pension Funds,” published in *The Hedge Fund Journal.*

Boris earned his J.D. from the New York University School of Law and his B.A., *with honors*, from Oberlin College.

Investing in Litigation Finance

I. Introduction

A. What is litigation funding?

1. The term litigation funding is sometimes used to describe several forms of funding transactions, some of which do not involve the actual funding of a litigation.

2. The opportunity is to invest in an uncorrelated asset that, while complex, is not generally exposed to market volatility.

B. We represent clients that provide litigation funding. These clients generally are structured as private investment vehicles, but we also represent banking and similar institutions that are active in certain categories of litigation finance.

C. Litigation funding raises numerous issues under applicable laws and regulations, including regulations governing attorney conduct.

D. Tax issues vary depending on the party being financed (usually the plaintiff or the law firm), whether the financing will be treated as debt or equity for tax purposes and the presence of any investors who have special concerns, such as offshore investors and tax-exempts.

E. We coordinate with one another in creating vehicles that will provide litigation funding, negotiating transactions in which the funding is to be provided and identifying legal and regulatory issues affecting these transactions.

II. Types of Litigation Financings

A. Pre-Settlements

1. Advancing funds to personal injury litigation plaintiffs, who use the funds to pay medical expenses or for other purposes.

2. Each individual advance is fairly small, so pre-settlement companies originate a large number of fundings (hundreds or thousands).

3. Each advance will earn an accrual based on amount of time outstanding.

4. The risk is binary. The plaintiff is obligated to repay an advance only if there are proceeds from a judgment or settlement.

5. Funder does not have the right to control the litigation. The plaintiff's lawyer is obligated to do what is best for his or her client, which is the plaintiff.

B. Post-Settlements

1. As the name implies, these fundings are made after a settlement has been finalized and the funded party is awaiting distribution of proceeds.

2. The advances can be made to a plaintiff or to a law firm that's entitled to a contingency fee to be paid from the settlement proceeds.

3. One example of a type of post-settlement funding business is in the class action sector, such as the NFL concussion settlement. The settlement is final and is currently in the implementation stage.

4. Another example is the Deepwater Horizon BP settlement. The two settlements are good examples of how they can vary.

(a) The BP settlement requires a more complicated assessment of recovery entitlement.

(b) The NFL settlement is based on a grid.

C. Medical Liens (also known as Letter of Protection Fundings)

1. The advances are made to medical professionals.
2. Such medical professionals provided medical care to the plaintiffs and are entitled to be paid from recoveries under the related litigation.
3. "Letter of Protection" refers to the letter signed by the plaintiff's attorney acknowledging the entitlement to payment.

D. Loans to Law Firms

1. Can be secured by fees from one case or multiple cases.
2. Can be full recourse, non-recourse or limited recourse.
3. Can be a pre-settlement or a post-settlement.
4. Has often been done in the class action or other personal injury context, but can also be in commercial tort or other types of cases.

E. Investment in Cases

1. One might say this is the purest form of litigation funding.
2. Advancing money to a plaintiff to prosecute the litigation.
3. One well-publicized recent example was Hulk Hogan's case against Gawker.
4. This type of arrangement can be used in different types of cases (e.g., pharmaceutical, medical devices, patent infringement, matrimonial and others).
5. There is a waterfall for distributing proceeds among the plaintiff, the attorneys and the funder.
6. Some legal issues are usury and champerty.

F. Bankruptcy Litigation Funding

1. Advancing money to debtors-in-possession, creditors' committees, liquidation/litigation trusts, Chapter 7/11 trustees or liquidation trusts.
2. Types of litigation matters to be funded may include fraud/fraudulent transfer/preference actions, other avoidance or clawback actions and/or monetization of pre-bankruptcy or post-bankruptcy judgments.
3. Funding may be required during pendency of bankruptcy case (e.g., commencement of an adversary proceeding or continued prosecution of pre-bankruptcy litigation), post-confirmation or after consummation of a Chapter 11 plan.
4. Bankruptcy Code requires court approval for debtor or trustee to obtain credit outside ordinary course of business and approval of litigation financing is not a "slam dunk."

III. Why do Litigants Seek Funding?

Maximize value of litigation claims for benefit of:

A. War chest;

B. Reduce pressure to settle;

C. Working capital;

D. De-risking; and

E. Refinancing.

IV. Litigation Finance Investment Vehicles

A. Managers

1. The founders of litigation finance investment firms are often litigators or other professionals with trial experience, who may not have previously managed a fund. Some of our clients have directly funded litigation, other than through investment vehicles.

2. The litigation experience of the managers is likely to drive the particular litigation finance strategy.

B. General Structure of Investment Vehicles

1. Litigation finance vehicles are structured with most features used by private equity funds, including management fee and carried interest structures.

2. At least one well-recognized investment vehicle is a publicly registered entity.

3. Privately held litigation finance vehicles are allowed to finance new cases during an "investment period," and have a stated term (both of which are likely to be shorter than a typical five and five year investment/harvest period).

4. Litigation finance vehicles may leverage their investments.

5. Privately held litigation finance vehicles generally do not offer withdrawal rights, as they rely on the settlement or conclusion of the underlying litigation in order to be able to make distributions to investors. When a case settles and the fund receives its proceeds from the case, distributions are made to the investors in the fund, subject to a waterfall.

   The waterfall in the litigation financing vehicle should not be confused with the waterfall in the transaction documents between the funder and a plaintiff. In the transaction documents, proceeds from the case are also divided pursuant to a waterfall.

C. Joint Ventures

1. Litigation funding is a relatively new investment strategy. As a result, managers may not be able to arrange for capital sources on a committed basis, and will form "pledge" or "club" funds that pursue litigation funding.

2. If a club fund is set up to pursue litigation financing transactions, investors have the right to decide whether an underlying case will be financed and are likely to carry out their own diligence of that case.

D. Expenses of Investment Vehicles

In addition to typical fund-related expenses, a litigation funding vehicle will often retain outside experts to assess the strength of a case (even where the managers are also litigators).

E. Drawdowns of Capital From Investors

1. A litigation finance vehicle will draw down capital as needed to cover litigation expenses borne by the plaintiff pursuant to the agreement between the plaintiff and the investment vehicle.

2. 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 hence, a single capital call from investors.

3. As the manager assesses the progress of a case, the manager of the investment vehicle may determine to cease funding that case; in the event that the investment vehicle is set up as a joint venture, investors in the joint venture may have a say in whether the investment vehicle continues to fund the case.

F. Information-Sharing

1. In order to assess the case, the manager will rely on information provided by the plaintiff and its attorneys or that is publicly available. To protect attorney client privilege, such information is likely to be limited.

2. Information provided to investors in a litigation investment vehicle will accordingly be limited.

G. Tax Issues

1. The tax analysis depends on the facts, which can vary dramatically from transaction to transaction. The three principal variables are the identity of the party being funded, the treatment of the investment as debt or equity for tax purposes and the treatment of investors subject to special rules, such as tax-exempt and offshore investors.

2. Transactions structured as loans will generally produce returns characterized as interest or original issue discount, which are treated as ordinary income and taxed at marginal federal rates up to 40.8 percent plus any applicable state or local tax. In some cases, such as equity financings of plaintiffs, it is possible that some of the return could be treated as long-term capital gain, currently taxed at a maximum federal rate of 23.8 percent and state and local rates that vary by jurisdiction.

3. Offshore investors will generally be treated as engaged in a U.S. trade or business and thus will be required to file U.S. federal, and possibly state and local, net income tax returns. To avoid that result, such investors typically invest through "blocker" corporations so that the blocker, rather than the investor himself, files the U.S. tax returns. The good news is that the cost of investing through a blocker has been reduced by 40 percent as the U.S. corporate tax rate was recently reduced from 35 percent to 21 percent.

4. Tax-exempt investors may be subject to the tax on "unrelated business taxable income," depending on the structure of the investment and certain other factors.

5. The tax treatment of the party being financed can also be critical. In general, those parties desire to defer the inclusion of any item of income or gain until the receipt of settlement proceeds that they are entitled to retain.

H. Regulatory Issues

1. Managers may be required to register as investment advisers, depending in part on whether the investments are deemed to be securities

2. Litigation funding vehicles structured using a private equity fund format are unlikely to permit participation by ERISA investors to be 25 percent or more, as these vehicles could not meet the "VCOC" standards.

V. How to Become a Litigation Funder

A. Litigants or their counsel often will market the investment opportunity.

1. Established players in this field.

2. Investment firms interested in alternative investments/opportunities.

3. Attorney referrals.

4. Brokers/investment bankers.

B. In addition to diligence of the litigation, funders should assess additional factors such as:

1. Litigation expenditures (including volume of discovery);

2. Availability of insurance to defendant;

3. Jury vs. bench trials;
4. Likely duration;
5. Probability of one or more appeals;
6. Collection risk;
7. Ability to satisfy judgment;
8. Foreign enforcement risks;
9. Priority encumbrances; and
10. Potential bankruptcy filing.

C. In order to structure, negotiate and document the financing, the following factors should be considered:

1. Percentage recovery of litigation proceeds or multiple of amount invested;
2. Interest rate (if investment is structured as a loan or after some specified period of time);
3. Repayment terms, timing and process;
4. Maturity date, if any;
5. Budget (pre-approval by, or consultation with, funder); and
6. Notifications/updates.

VI. Certain Legal Issues

A. Legality of Transaction

1. Champerty

(a) Champerty is a common law doctrine, which has been codified in some states, aimed at precluding frivolous litigation by preventing the "commercialization of or trading in litigation." *Bluebird Partners v. First Fidelity Bank, N.A.*, 731 N.E.2d, 581, 582 (N.Y. 2000).

(b) New York is one of the states that has codified its prohibition against champerty. *See* New York Judiciary Law § 489(1): "… no corporation … shall solicit, buy or take an assignment of … a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon."

(i) New York's champerty statute has a safe harbor exception: New York Judiciary Law § 489(2): 489(1) "shall not apply … if such assignment, purchase or transfer … [has] an aggregate purchase price of at least five hundred thousand dollars … ."

(ii) However, this safe harbor would likely not cover the purchase of all legal claims, but would only exempt claims from Section 489 if they are debt-based claims that meet the threshold value and are "issued by or enforceable against the same obligor." N.Y. Jud. Law § 489(2).

(c) In most jurisdictions, litigation funding agreements are generally not considered champertous if there are limits on the funder's ability to:

(i) Influence/control the litigation and strategy;

(ii) Hire/terminate counsel; and

(iii) Make settlement decisions.

2. Usury

In addition to champerty concerns, litigation funders should be aware of state laws which may set limits on interest rates.

(a) It is not necessarily the case that litigation finance would be subject to usury laws. Some courts have adopted the view that litigation finance arrangements are not loans, since the repayment of the funds is contingent upon the outcome of the underlying lawsuit. *See Hamilton Capital VII LLC, I v. Khorrami, LLP*, 48 Misc.3d 1223(A), at *6 fn. 14 (Sup. Ct. N.Y. Cnty. 2015).

(b) Many states have safe harbors for their usury laws, which protect loans above a certain amount. In New York, loans made over $2.5 million are exempt from usury laws. N.Y. Gen. Oblig. Law § 5-501 (6) (b).

B. Ethical and Privilege Issues

1. Ethical Concerns

(a) Ethical canons in most jurisdictions prohibit attorneys from sharing, or splitting fees, with non-lawyers. Transactions, therefore, should generally be structured so that the plaintiff shares proceeds with the funder, rather than the plaintiff's attorney.

(b) In addition, funders must be mindful to not exert influence over the attorney's professional judgment and impede the party's attorney's ethical duties to his or her client. N.Y.C.B.A. Comm. on Prof'l Ethics, Formal Op. 2011-2 (2011) (discussing third-party litigation financing).

2. Privilege/Work Product/Confidentiality Issues

(a) There is a risk that sharing information with a third-party litigation funder waives attorney client privilege and work product protections.

(b) In addition, privilege concerns may result in a limit on the diligence that the funder can conduct. However, the funder can receive documents that are not privileged, will likely be disclosed to the adversary, and/or have already been disclosed to the adverse party. Funders may receive updates that are publicly available or that have already been disclosed to the adverse party.

C. Increased Regulation

1. As litigation finance becomes more popular, state and federal governments have begun to consider whether the process should be more regulated.

2. Agreement with the N.Y.A.G.

In 2005, the New York Attorney General and nine litigation finance companies entered into an agreement which imposed nine consumer-friendly requirements for future funding agreements, including providing translation into consumers' native languages and providing a disclosure statement. Bureau of Consumer Frauds and Protection, Attorney Gen. of the State of N.Y., Assurance of Discontinuance Pursuant to Executive Law § 63(15) 4-7 (2005). The agreement shows tacit approval of litigation finance arrangements.

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