

SRZ's Leading Litigation Finance Practice

Holistic expertise for a booming asset class

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Schulte Roth & Zabel's 27th Annual Private Investment Funds Seminar, held in January 2018 in New York City, covered a wide range of hot topics, including litigation finance, also known as litigation funding or third-party funding.

Litigation funding is democratic. It removes barriers to entry in litigation and levels the playing field. Consumers and companies, retail investors and institutional investors of all sizes and levels of financial resources — including those who cannot afford billable hours — and bankrupt entities can seek redress and financial compensation.

"The US has seen a tremendous rise in interest and activity in the litigation finance space. All transaction types have increased by leaps and bounds. They include patent infringement, breach of contract, mass torts, securities fraud and others. Loans to law firms are another important area as the huge, liquidity-starved, plaintiff's bar in the United States provides tremendous demand," says Boris Ziser, SRZ partner and co-head of the Structured Finance & Derivatives Group.

Most litigation funding supports plaintiffs. "On the plaintiff side, a win is a win with a clear monetary result to determine what success means and what you get. On the defendant side, it is trickier to figure out the economics and measure of success. A 'win' for the defence avoids the need to pay the claim but does not produce cash-flow, so some funding has to come out-of-pocket. Usually, a defendant is sued because they have deep pockets in the first place," explains Ziser.

The major jurisdictions for litigation finance are currently most 'common law' ones, and include the US, the UK, Australia, Canada, New Zealand, Hong Kong and Singapore. The UK is an important market. This year, a UK television celebrity is using a litigation financier to fund a case that seeks GBP 300 million of compensation

from a banking group, after a unit of the group was found to have defrauded some customers, including this particular UK celebrity.

Shareholder actions

Securities class actions can also be funded with litigation finance. The UK's largest pension fund was the lead plaintiff against a Brazilian company. That company has paid USD 3 billion, which is the largest securities class action settlement in a decade. Retail investors are also getting involved. Retail investors in a major UK bank recently received a GBP 200 million pay-out.

Emerging markets hedge fund strategies can make use of litigation funding. "In many cases there are opportunities for clients to finance litigation for distressed companies. We represented a fund that financed a Canadian company that invested several hundred million to start a gold mine in South America, which was expropriated just as it was ready to start operations. The company, with the client's financing, went to the international court of arbitration and obtained a judgement, which they are now trying to enforce against the government of that country," says Adam Harris, SRZ partner, chair of the Business Reorganisation Group and a member of the firm's Executive Committee.

Bondholder actions

Distressed debt hedge funds can also avail themselves of litigation funding. Litigation funding helped a bankrupt firm, Downey Financial Corporation, win a litigation against the FDIC over a USD 373.8 million tax refund from the US IRS in 2013. Bondholders earned a significant contingency fee in return for providing the financing. Four of SRZ's well-known event-driven hedge funds, who were bondholders in the case, financed the case, according to court documents. "Opportunities abound, limited only by the creativity of the financing source and the nature of the claims," adds Harris.

Various other companies, including hedge funds, may use litigation financing to keep costs off their own balance sheets. Most litigation finance comes from private sources, but it can come from the public sector. The UK government has been keen to foster the growth of the litigation finance market, partly to control the costs of government-funded legal aid programmes.

A growing asset class

Litigation finance is a growing asset class, or sub-strategy, with attractive returns. "Hedge funds, private equity funds and non-bank lenders are coming in as the economics are very attractive. There can be double digit, and sometimes even higher rates of return, for what might be perceived as not a lot of risk. Even settled cases command a premium, though unsettled cases can be riskier," says Ziser.

For settled cases where appeals are not possible, and the defendant has the wherewithal to pay up, litigation financiers are essentially bridging a time gap before payment of receivables.

The return stream from litigation finance should be generally uncorrelated with financial markets because court decisions and awards are rarely dependent on the performance of financial assets. Billions are flowing into the space. At least GBP 10 billion (USD 14 billion) has been raised in the UK alone by firms and the largest litigation fund in North America has raised USD 500 million. Many of these firms are active globally.

Though numerous private funds in the litigation finance space have put out press releases announcing amounts raised, some may not publicly report their assets, so the total amounts being managed in the space is likely to be larger.

The weight of money flowing into the space might compress returns in some of the more commoditised areas however. "For pre-

settlements, such as personal injury claims, where the law of large numbers governs returns, some compression is possible. New entrants may accept lower returns, so parties can shop around and get a better deal, as seen in private lending. But private equity and hedge fund investors stand firm on their target return profiles and may not be able to adjust if returns do not justify risks. So elsewhere, in areas such as securities fraud litigation, each risk is bespoke, with its own facts, court and plaintiff. So, analysis, risk and resulting returns are all very bespoke. Likewise, in patent cases, each one involves different damages, numbers of infringers and royalty rates. And unlike in the more commoditised areas, the influx of capital has been more limited," Ziser points out.

Schulte's comprehensive litigation finance practice

As more private funds look to invest in litigation finance, SRZ lawyers from across practice areas are advising clients with a full suite of litigation finance services counsel, including litigation risk/return assessment, structuring of the financing, monitoring and assisting with its resolution. The litigation finance practice at SRZ includes partners from the firm's business reorganisation, investment management, litigation, regulatory and compliance, structured finance and derivatives, and tax groups.

"We are a one stop shop," says Harris. "We can help firms to assess the probabilities, price the risk and decide if they want to get involved. For years, SRZ has done all of this via various practices as we are one of a handful of law firms with the capacity and expertise to provide this level of service," he adds.

SRZ litigation partner William Gussman adds, "The bespoke nature of claims means that we assess the merits of the specific claims at issue, as well as examine potential collection issues with respect to the claims. As the market gets more competitive, these assessments become more and more important. At the structuring phase, we often have to evaluate esoteric legal issues, such as champerty, maintenance and usury, that can vary widely by jurisdiction. We can usually structure around these issues. But there can also be ethical issues, such as

prohibitions against attorneys sharing fees with non-lawyers, which arises sometimes in the context of loans to lawyers."

Litigation funding trade associations have sprung up and developed their own codes of conduct, which many market participants like to observe.

"Later on, we are also involved in monitoring and in facilitating prosecution or settlement as well," commented SRZ litigation partner Alan Glickman.

Types of litigation finance

Types of litigation finance include pre-settlement, post-settlement, commercial torts, mass torts, breaches of contract, antitrust and appraisal cases and loans to law firms, among others. Funding for out-of-court arbitration is a related area. In addition, litigation finance needs not always await the end game of a judgement. Claims can be traded before resolution.

Some litigation finance involves single cases while others fund portfolios of cases or even take on all litigation from a particular company, as well as corporate portfolio cases.

Litigation finance investment vehicles

"Some funds are set up from the get-go as dedicated litigation funds, raising funds specifically for litigation finance. Other funds get involved more situationally and opportunistically," says Ziser. Funds may be run by those who are already plaintiffs' lawyers, by lenders or investors in the space, or as joint ventures with intermediaries or law firms. Many ways are used to originate or source the business.

Many funds are private, but some public vehicles exist. There are now even multi-manager products in the space; funds of litigation finance funds. Some funds have an open-ended, private equity structure, while others are closed ended. "The duration of cases is not entirely predictable. It is not uncommon to have an accumulation of cases that take two or three years, then three or four years to

resolve them. With appeals, it could be much longer," explains Ziser.

Unique legal issues

"The UK is well ahead of the US on litigation financing, but the US is catching up. Prohibitions on litigation financing are not adopted by some states, are being less and less enforced and have even been overturned by others. But some states have embraced them. These rules must be assessed, state by state," stresses Glickman.

The concepts of champerty, maintenance and usury should be heeded as they could invalidate cases in some situations. Champerty and maintenance involve one or more of a disinterested party funding or intermeddling litigation, while champerty involves profiting from it. But financing, or profiting from, litigation is not always a sufficient condition for champerty or maintenance; other criteria must usually be met, and they vary by state.

"Defendants who discover litigation financing may be able to raise an affirmative defence to dismiss a case because it was brought in a [champertous] manner. This is an additional reason to make sure it is structured correctly," warns Gussman.

It is risky to assume that litigation finance can remain unbeknownst to defendants throughout a case. Gussman explains that "mandatory disclosure of litigation financing has been discussed for many years, with a federal rules committee discussing the issue. But it has not yet materialised, and any rules would take years to work through the system. Though no federal rule requires disclosure at the outset, facts regarding litigation funding might be discoverable during the underlying litigation, hence the need for careful structuring."

Moreover, though the concept of champerty may be less widely observed in recent years, it cannot be dismissed as archaic or obsolete. "Some aspects of the doctrine are valid. For instance, you cannot control the litigation and that affects the discovery and facts," Gussman points out.

Usury — where laws vary by US states — could be relevant if litigation finance is deemed to be a form of loan. As most litigation finance is non-recourse equity and no interest is charged, it seems to be intuitively outside the concept of a loan but might be legally classified as a loan in some jurisdictions. Once again, careful structuring is paramount.

Litigation finance models

Rarely are litigation funders solely financing lawyers' fees. "Expert's fees and other costs are also involved. Fee models include percentages of all expenses; sharing of costs between funder and plaintiffs; caps on fees or disbursements or both, or ceilings on one but not the other. It is most common to fund both legal fees and other expenses," explains Ziser.

There can also be advances by law firms. In "no win, no fee" cases, where attorneys are working on purely contingent fees, and only get paid upon resolution of the case in favour of plaintiffs, the plaintiff may not need funding. But the contingency fee attorneys can be the

ones using the litigation funding. "A purely contingent fee is more common on the mass tort side. There are also hybrid cases, where lawyers take partial fees and partial contingency fees," observes Ziser.

Trends in 2018

In 2018, Ziser expects to see more jurisdictions become more open to litigation financing, as the general trend is to be more accepting. Already the Cayman Islands has, in 2017, decided to allow litigation funding, while Hong Kong and Singapore have permitted it for international arbitration and related court, enforcement or mediation proceedings. There are hopes that either or both of these Asian jurisdictions might in the future also allow third-party funding for domestic court disputes in a wider range of circumstances than the limited exceptions currently applying. In terms of types of cases, Ziser expects to see "cases around securities, commercial breaches and more matrimonial cases, though divorces need to involve big amounts of assets to make the funding worthwhile." **THFJ**

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