Guide to

LITIGATION FINANCING

WESTFLEET
ADVISORS

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This Guide will help senior executives and their outside legal counsel understand their options regarding litigation financing. Some of the questions that are answered inside include:

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OVERVIEW OF LITIGATION FINANCING

Litigation financing can be an attractive tool for managing major expenditures for litigation and hedging the risk of an adverse outcome. Numerous companies and law firms have taken advantage of litigation financing as this relatively new form of capital has begun to enter the mainstream. However, while most lawyers and many business executives are aware of the concept, many misconceptions exist alongside a generally low level of substantive knowledge about this financial tool. This Guide is intended to help senior executives and their outside legal counsel determine whether litigation financing is right for their organizations.

WHAT IS LITIGATION FINANCING?

Litigation financing refers to a transaction in which a third party, that is neither a party to a legal claim nor their legal counsel, provides capital to a party to a legal claim (or their legal counsel) in exchange for a financial interest in the outcome of the legal claim. The signature feature of this form of capital is that repayment of the financing is contingent upon a successful outcome of the underlying legal claim.

In this Guide, the term *litigation financing* refers only to commercial litigation financing (as opposed to consumer litigation financing). An entirely separate area exists that deals with the financing of consumer claims (e.g., personal injury, medical malpractice, etc.). In the commercial litigation financing industry, larger transactions take place between sophisticated parties, where the subject matter of the underlying legal claims is usually commercial in nature (e.g., intellectual property infringement, antitrust, securities, breach of contact, fraud, business torts, etc.)

HOW CAN LITIGATION FINANCING BE USED?

In its classic application, litigation financing is a tool that enables companies—plaintiffs or defendants—facing large litigation budgets to defer these costs to the successful outcome of their case—and to avoid the costs entirely if the case resolves unsuccessfully. Companies can therefore tie their expenditures to their satisfaction with the result obtained, similar to engaging a law firm on a contingent fee basis, without requiring their preferred law firm to deviate significantly from its financial model.

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The uses and possible structures of litigation financing are myriad, limited mainly by the creativity of the financing providers and recipients. Indeed, financing is often used for working capital needs entirely unrelated to a claim.

BENEFITS OF FINANCING

- Limits exposure to uncontrollable, unpredictable expenditures;
- Minimizes adverse financial impact of litigation budget;
- Preserves capital for core business activities;
- Hedges against risk of adverse outcome; and
- Facilitates engagement of preferred legal counsel.

DOWNSIDES OF FINANCING

- Reduces claim's potential upside;
- Involves complex, time-consuming process;
- Requires specialized expertise in various legal and ethics issues;
- Requires disclosure of sensitive/ confidential information; and
- Involves counterparty risks.

WHAT ARE COMMON ELEMENTS OF FINANCING TRANSACTIONS?

In this specialized capital market, financing transactions are bespoke. Each transaction is negotiated, structured, and priced individually. However, common elements of financing transactions include:

- Financing provider's repayment is secured by and contingent upon a successful outcome of the claim;
- $500,000 to $10 million financing available for individual claims (larger amounts may be available for portfolios of claims);
- Financing may be a fixed amount or may be tied to other benchmarks such as legal fees and expenses actually incurred;
- Pricing may be based on the amount of capital provided, on the size of the recovery in the underlying claim, or some combination of the two; in most instances the pricing is graduated and increases in some fashion the longer the financing is outstanding;
- Capital may be available in a lump sum or may be drawn down over time; and
- Financing provider has passive role in management and decision-making in the legal claim, with strict prohibitions against interference with the representing lawyer's exercise of their independent professional judgment.

IS FINANCING ONLY AVAILABLE TO PLAINTIFFS?

Financing is available to both plaintiffs and defendants, although the market for defendant-side financing is still in the early stages of development. Plaintiff-side financing is much more common, largely because of the relative ease of defining "success" on the plaintiff-side. Defendant-side transactions are structured similarly to reverse contingent fees, whereby the capital provider receives an interest in the differential between a defendant's exposure and the amount of the claim that is ultimately paid.

WHAT TYPES OF CASES ARE FINANCED?

On the defendant-side, any type of claim is eligible. On the plaintiff-side, only cases involving commercial damages claims are eligible, for example:

- intellectual property infringement
- breach of contract
- business torts
- trade secrets
- domestic and international arbitration
- antitrust
- securities
- fraud
- employment
- bankruptcy and creditor's rights
- tax

IS LITIGATION FINANCING AN ALTERNATIVE TO CONTINGENT FEES?

Litigation financing can be a very effective substitute for contingent fees primarily because capital providers have greater capacity and broader diversification than many law firms. These advantages often allow capital providers to price transactions more efficiently than law firms and to maintain more consistent appetites for these types of investments. However, litigation financing and contingent fees are not mutually exclusive. Litigation financing is used frequently in conjunction with a contingent fee or hybrid contingent fee engagement.

HOW CAN LAW FIRMS USE LITIGATION FINANCING?

Litigation financing can enable a law firm that seeks some exposure to contingent fee revenues to augment its capacity for these risk-sharing engagements. When a law firm engages on a contingent fee basis, it is making an investment of its unbilled time and often out-of-pocket expenses. Many firms are not ideally configured to make these types of investments because they dilute partner distributions and/or require the firm to take on debt. Litigation financing enables firms to hedge their exposure to these types of engagements individually and/or expand their portfolios of these engagements in a capital-neutral manner, thereby achieving lower aggregate risk through the added diversification.

WHAT CASES MAKE GOOD CANDIDATES FOR FINANCING?

This analysis is entirely dependent upon the situation. Any company would be attracted to the benefits of financing—avoiding expensive legal budgets unless and until they reach a favorable resolution of the claim—but both the benefits and downsides must be analyzed on a case-by-case basis. Good candidates for a litigation financing transaction often involve large (relative to the party's perspective) legal budgets where the case is strong and where a successful outcome has significant financial upside.

More objective criteria for financing include:

- Financing request in excess of $500,000
- Claim value in excess of $5,000,000
- Ratio of claim value to financing request in excess of 5:1

It is important to note that litigation financing is not always an "all or nothing" proposition. Often it makes sense to implement financing for a portion of the overall budget, and these types of transactions are common in today's market.The bottom line: for major cases, where a party is sensitive to the legal budget and/or outcome risks, or otherwise wishes to monetize a portion of the claim's contingent value, a financing scenario is probably worth exploring.

WHY SEEK FINANCING IF MY COMPANY HAS ADEQUATE RESOURCES?

Well-capitalized companies have many resources with which to finance legal budgets, but the ability to tie litigation expenditures to a successful outcome—to pay based on how satisfied they are with the results—is attractive to most business people, regardless of their company's size. And aside from contingent fee engagements, this feature is only available in the litigation financing market.

For legal matters that fall outside a company's routine legal budget, litigation financing enhances the ability to manage these extraordinary expenses and to hedge risk. When a company uses its own capital for these extraordinary expenses, it is foregoing some alternative use of that capital, where the alternative use is usually an investment in its core business. For most companies, litigation is a noncore area where risks are rewards are not well understood, and companies typically do not enjoy a relative informational advantage in making litigation investments versus investments in their core business.

WHEN IS THE RIGHT TIME TO SEEK FINANCING?

Financing is available at any stage in a case's lifecycle, from pre-complaint through the appellate process. Often it is desirable to arrange financing near the inception of a case when the budget and strategy are being formulated. However, financing is frequently obtained after the claim is well underway. Financing is only practically feasible after the party and their lawyers have performed a significant amount of research on the merits and financial viability of the assertion or defense of the claim.

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HOW DOES FINANCING IMPACT A COMPANY'S CREDIT RATING OR SHAREHOLDERS?

Litigation financing neither adversely impacts the credit rating of the company nor dilutes the company's shareholders. On the contrary, most creditors would view litigation financing's contingent-repayment feature as a net enhancement of the credit because a company's liquidity is preserved instead of being drained by an investment in litigation and any liability to repay the financing will be offset by a positive cash flow (on the plaintiff-side) or a savings relative to the company's exposure (on the defendant-side). Also, despite the equity-like risks assumed by the financing providers, existing shareholders are not diluted by litigation financing transactions.

WHAT IS THE ACCOUNTING TREATMENT OF LITIGATION FINANCING?

The answer can vary depending on how the transaction is structured. Litigation finance transactions are often structured off-balance-sheet, where financing proceeds are drawn directly to pay outside legal counsel. In that case, the portion of the legal budget that is financed does not appear as an expense in the company's financial statements (similarly to how these foregone expenditures would not be recognized if a company engaged a law firm on a contingent fee basis). Also, if structured properly, the financing proceeds would not be taxable as income. In terms of the repayment, on plaintiff-side financings, the repayment liability coincides with an as-yet-unrecognized inflow or revenue item (e.g., a recovery in the legal claim), so the liability to repay the financing provider would be offset by a surplus cash flow; on defendant-side financings, liability to repay the financing is often netted against the reserves already in place for the company's potential liability in the claim. This offsetting feature means that the sum of the legal budget financed plus the financing costs is significantly less acute than if a company had self-financed the entire legal budget. Of course, the more exotic the financing structure, the more complex the accounting and tax treatment is likely to be.

HOW MUCH DOES FINANCING COST?

Financing costs are analyzed and negotiated on a case-by-case basis and are based upon a variety of factors, including a capital provider's perceived risk of an adverse outcome and length of time the financing may be outstanding. Since capital providers assume the risk of an adverse outcome, their profits on successful financings must be sufficient to offset their losses on unsuccessful ones. Capital providers strive to generate private equity-like returns (e.g., 20%-plus annualized returns) for their investors. In order to achieve these returns, providers are typically seeking multiples of their capital invested in successful cases ranging from 2x to 4x. So the financing costs for $1 million in financing outstanding might range from $1 million to $3 million, but the costs are really best viewed as a reduction in the upside (or the substantial savings) in a successful resolution of the claim. And, of course, a provider receives nothing in cases that are unsuccessful.

OVERVIEW OF LEGAL & ETHICAL ISSUES

Various commercial law and legal ethics issues may be implicated by litigation financing. Over the last decade, a significant body of law has developed concerning litigation financing, and several courts and ethical bodies have rendered opinions on this subject. Although this body of law continues to develop, these opinions offer guidance as to the parameters governing these transactions. If properly structured, litigation financing transactions are permissible and enforceable in every state. Those who are knowledgeable and experienced about the legal and ethical issues of litigation financing should be consulted in connection with any transaction. Generally, the issues which may be implicated are:

- Confidentiality and privilege waivers
- Champerty and related issues
- Legal ethics issues
    - Independence of professional judgment
    - Conflicts of interest
    - Confidentiality

WILL DISCLOSURES TO A FINANCING PROVIDER BE DISCOVERABLE?

As long as a nondisclosure agreement is in place prior to information that is protected by the work product doctrine being conveyed to a financing provider, that information should remain confidential and not be discoverable by the opposing party. However, disclosure of information that is confidential solely due to the attorney-client privilege (and not also the work product doctrine, which affords a broader and less easily waived protection) is likely to result in a waiver of the privilege. Reputable financing providers do not seek information that is confidential due solely to the attorney-client privilege.

Even though existing case law unanimously supports the position that work product protection extends to any information conveyed to a financing provider (or related third party) as long as an NDA is in place, some opposing parties may be inclined to attempt to obtain such information through discovery anyway, resulting in expenditures on a satellite discovery dispute. These expenses should simply be built into the legal budget and weighed against the benefits of financing.

IS THE COURT OR OPPOSING PARTY ENTITLED TO KNOW ABOUT FINANCING?

There is no affirmative duty to disclose the existence of a financing arrangement to the court or to the opposing party, although it should be noted that there is virtually no law directly on this subject yet. Any party seeking information about how a party's litigation budget is being financed would have to demonstrate that this information was relevant to the issues in the case. The mere fact that a party has provided financing does not make them a real party in interest in the litigation. Any provider of capital to a company—or for that matter, any party with any financial interest in the company—has a direct or indirect financial interest in the outcome of a major litigation matter.

WHAT DUTIES DOES MY LAWYER HAVE TO A FINANCING PROVIDER?

Lawyers have no professional obligations whatsoever to the financing provider and do not render legal services or provide opinions to them. Most financing agreements contain provisions in which the client instructs its legal counsel to provide routine information to the financing provider, so that the provider can monitor the status of its investment and compliance with the financing agreement.

WHAT CONTROL DOES A FINANCING PROVIDER HAVE OVER THE CASE?

Reputable financing providers do not control the management or decision making in the case, including decisions regarding settlement or disposition of the claim. Reputable financing providers explicitly state this lack of control in their financing documents.

WHAT IS CHAMPERTY?

Champerty is an ancient doctrine originating in medieval England that was designed to prevent feudal lords from waging their wars through the court system. Champerty involves an "officious intermeddler" paying the expenses of another's lawsuit in exchange for a portion of the recovery—at first glance, this may sound a bit like litigation financing. However, courts have applied champerty narrowly in the modern era, limiting it to situations in which frivolous litigation is instigated by a third party and/or where the third party is heavily involved in the management of the case; reputable litigation financing providers do neither. Many states have abolished champerty, drastically limited its scope, or never adopted it in the first place. Even for states where champerty laws are in effect, champerty is subject to a choice of law which provides structural latitude for avoiding champerty and related issues.

WHAT LEGAL ETHICS ISSUES SHOULD MY LAWYER CONSIDER?

More detailed information on these topics can be provided by experts in this area, however, the basic framework for lawyers is to ensure that they:

- Maintain their independence of professional judgment;
- Exercise reasonable caution to protect their clients' confidentiality; and
- Avoid (or adequately disclose) any conflicts of interest.

OVERVIEW OF FINANCING PROCESS

The process for exploring and consummating financing is complex and can be time consuming. Due to the risks assumed by the capital provider and the sophistication of the subject matter, the process is very similar to raising capital in the venture capital or private equity market. While this process may seem daunting, careful preparation and alignment with knowledgeable partners can increase the chances of a successful transaction and significantly expedite the process.

WHAT IS THE PROCESS FOR EXPLORING AND CONSUMMATING FINANCING?

To consummate a litigation financing transaction, a company needs to prepare the appropriate documents, develop a targeted list of financing providers, schedule meetings with providers, and negotiate term sheets and financing documents. Companies should begin the process by assembling a synopsis of the financing opportunity it intends to offer. This synopsis should include a detailed memorandum discussing the legal claim (including strengths of the opposing party's position and how these will be refuted), financial projections for the budget and probable outcome(s), and a due diligence package (including legal and factual analyses, material documents and pleadings, expert reports, CVs and relevant experience of litigation counsel, parameters of engagement with counsel, et cetera). Next, the company needs to identify the financing providers likely to be suitable for the transaction based on case type, size of transaction, case status, jurisdiction, and intended transaction structure. Financing providers are inundated with low quality opportunities and may not prioritize review of an opportunity unless it is presented by a party with whom the provider has a relationship.

Through personal contacts, referrals, or a broker, the company would attempt to schedule initial meetings with potential litigation financing providers, usually over the phone or at the providers' offices. If the initial meeting is successful, more in-depth meetings will be scheduled, an NDA would be executed, and more detailed disclosures (such as the due diligence package) would be made to the potential financing providers. Depending on the content of the due diligence package, the potential providers may make additional due diligence requests. If a provider wishes to develop a transaction, it will provide a preliminary term sheet (typically non-binding) outlining the general terms of financing. The company and its advisors would then negotiate and execute the term sheet, which usually provides for financing subject to a more exhaustive due diligence review. Companies can save significant time and effort, and many more potential financing providers can be contacted, by using an experienced broker to manage this process.

WHAT IS THE TIME COMMITMENT REQUIRED TO EXPLORE AND CONSUMMATE FINANCING?

The entire process, from initial exploration to consummation of litigation financing, usually requires three to six months (especially if the process is not being managed by an experienced broker). Company executives involved in the litigation's management and their outside legal counsel should expect to be heavily engaged during this entire process, if a company attempts to manage the process itself. Using an experienced broker can cut management's and outside legal counsel's time commitment significantly and can compress the overall timetable to one to three months.

If the timeline is a primary point of sensitivity (more so than pricing or other financing terms), an experienced broker can arrange financing on a significantly shorter timetable (some transactions have been consummated inside of two weeks).

HOW DO FINANCING PROVIDERS CONDUCT THEIR DILIGENCE?

The diligence conducted resembles the vetting that an experienced law firm would perform prior to accepting an engagement on a contingent fee basis. They will review pleadings, document production and discovery, attorney work product, expert reports, damages models and other financial information relevant to the economic viability of the claim. They will interview litigation counsel and key executives with the company. Sometimes they will interview key fact witnesses.

WHAT ARE KEY FACTORS A FINANCING PROVIDER CONSIDERS?

Key factors include:

- strength and novelty of legal theory
- amount and demonstrability of damages claimed
- credibility of key fact and expert witnesses
- financial wherewithal of defendants to pay claim
- financial motivations of the parties (including legal counsel)
- adequacy and reasonability of legal budget
- jurisdictional factors such as the judge, jury pool, and appellate courts
- reasonability of the parties
- likelihood the parties will behave rationally
- "skin in the game" of both the company and its outside legal counsel.

CHARACTERISTICS OF THE FINANCING MARKET

The market for litigation financing is:

- **FRAGMENTED** – numerous providers operate in the market; some focus exclusively on this market while others are multi-strategy capital providers or ad hoc participants;
- **DIFFERENTIATED** – each provider has its own investment criteria, approach, and transactional preferences;
- **FLUID** – many new entries (and exits) occur each year, and providers' appetites for transactions vary depending on their capital raise/deployment cycles;
- **OPAQUE** – no publication of pricing or terms occurs and no centralized exchange exists; also, many providers maintain extremely low profiles, making their identification challenging; and
- **INEFFICIENT** – due to various structural reasons, most potential recipients do not negotiate simultaneously with multiple potential capital providers (unless they are working with an experienced broker); proposed terms can vary significantly from provider to provider, and absent a competitive environment, significant inefficiencies can occur.

WHO ARE THE FINANCING PROVIDERS?

The management teams of most litigation financing providers are composed of former commercial litigators who are sometimes complemented by financial executives. Generally, these teams are highly credentialed professionals, often with prestigious law firm and/or Wall Street pedigrees.

PROVIDERS LIKE "SKIN IN THE GAME"

Litigation financing providers prefer to see both companies and their outside legal counsel have a significant stake in the outcome of the claim to ensure strong alignment of incentives. Providers understand that their purpose is largely to limit companies' exposure to these expenditures. They tend to view a company's stake in the ultimate outcome as ample financial interest, especially when the company's resources are limited with respect to its legal budget. However, few factors are more persuasive to a provider of litigation financing than a risk-sharing or performance-based engagement with the representing law firm

HOW DO FINANCING PROVIDERS OPERATE?

Litigation financing providers earn a profit by selecting cases that are likely to result in a successful outcome such that the profits earned on successful cases more than offset capital invested in unsuccessful cases. These financing providers usually act as the general partner of a fund that invests capital on behalf of investors (typically, institutional investors and family offices) who are the fund's limited partners.

A provider typically charges its limited partners an annual management fee based on the capital invested or committed to the fund (usually 1-2%) plus a performance fee equal to a percentage (usually 20%) of the profits earned by investing the fund's capital. Most funds' organizational documents have clear parameters that dictate the types of investments the general partner may make with the fund's assets, often placing restrictions on the case types, case stages, or financing structures in which the fund may invest. Also, a fund usually has a limited deployment period in which the fund's capital may be invested in new financing opportunities, after which time the provider begins returning investors' capital as the cases that were financed mature. Financing providers often feel significant pressure to deploy capital in a new fund and then experience a diminished appetite for new transactions as they approach full deployment.

CAVEAT EMPTOR: COUNTERPARTY RISK

Unfortunately, even at this stage in the development of the litigation financing market, certain "capital providers" present themselves to prospective financing recipients as if they have ample financial resources, when, in fact, they do not. If they are presented with an opportunity, they will attempt to raise capital to finance it—sometimes from legitimate litigation financing providers—without ever disclosing their lack of capital adequacy to the prospective financing recipient. These bad actors subject their counterparties to unreasonable fundraise and execution risks by not being candid about their financial resources. It is therefore critical to understand the reputation, experience, and financial resources of any prospective capital provider.

USING A BROKER TO OBTAIN FINANCING

WHY WORK WITH A BROKER TO PURSUE FINANCING?

Pursuing a litigation financing transaction without the advice of an independent expert places a company at significant risk of an inefficient, protracted, and ultimately unsuccessful financing process. An experienced broker will be familiar with the information a provider will expect to receive and will present it in a manner that will both resonate with the potential providers and streamline the entire process. Also, a broker can bring more potential providers into the discussions and create a competitive environment for the transaction, which increases the chances of consummating a transaction and obtaining the most favorable financing terms. Using a broker will also substantially reduce the time that company representatives and outside legal counsel must spend pursuing financing and can eliminate unnecessary delays and inefficiencies in the process. A broker can also provide valuable insights into the legal and ethical parameters that govern these transactions and protect a company from agreeing to onerous terms that can limit its flexibility and autonomy to manage its case. Litigation financing transactions are highly sensitive, consequential transactions, and there is simply no substitute for experience.

WILL FINANCING PROVIDERS PURSUE OPPORTUNITIES THAT INVOLVE A BROKER?

All credible litigation financing providers will participate in quality opportunities that are marketed by an experienced broker. Generally, providers derive significant benefits from the efficiencies that an experienced broker brings to the process, even though the process subjects them to competitive pressures. Financing providers do not wish to work with inexperienced brokers who add little value to the process due to their lack of expertise in litigation financing and/or their lack of attention to vetting opportunities before presenting them to the market.

HOW MUCH DOES IT COST TO ENGAGE A BROKER?

Pursuing litigation financing through a broker is very cost effective. The vast majority of a broker’s fees (roughly 90%-95%) are payable only upon successful consummation of a transaction. These fees usually range from 4%-7% of the financing proceeds and are paid directly out of the proceeds, so the company does not incur substantial out-of-pocket costs. The remainder of the fees is paid as a nominal retainer.

Westfleet Advisors provides advisory and brokerage services to prospective recipients of commercial litigation financing.

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Westfleet Advisors is composed of an experienced team of litigation financing professionals. As former capital providers, our team has participated in the financing of more than 1,000 complex litigation matters. We are committed to delivering transparency and efficiency in order to increase the utility of the emerging litigation financing market.

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