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# CLIENT ALERT

## Litigation Finance Following the COVID-19 Crisis

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Over the last several years, investors of all stripes had been flocking to the novel asset class of litigation finance. Litigation finance is the art of deploying capital today in order to benefit from a favorable litigation outcome in the future. The ability of litigation finance to generate high, non-market correlated returns during the recent period of record low interest rates and record high equity market values made the area especially appealing to investors and led to a large influx of capital. But much has changed in the past few months. This article discusses the current pandemic and the macroeconomic forces affecting the future of the litigation finance industry.

- **Increased litigation.** Several factors point to a marked increase in funding opportunities. Litigation is said to be counter-cyclical to the economy. Economic strife tends to result in defaults, general discord among market participants and inquiries into, and discovery of, fraud and malfeasance, all factors that increase the incidence of formal disputes. On the other hand, statistics from the 2008-2009 recession do not support an increase in the overall volume of litigation or litigation funding. Whether this was due to the nature of that recession (Wall Street vs Main Street) or whether the lack of widespread availability of litigation funding at that time (or the lack of general acceptance of litigation finance) is unclear.
- **Lack of Traditional Funding.** Another factor that may increase litigation funding opportunities in the near future is the sudden, pandemic-related reduction in the available credit (including bank financing) for law firms and businesses in need of resources to pursue litigation claims or for general corporate purposes. Should traditional sources of finance dry up or become prohibitively expensive, businesses and law firms may consider tapping litigation funding as an alternative in order to maintain or grow their operations. As businesses face liquidity problems, the prospect of monetizing litigation claims with little to no out of pocket cost to themselves, may be appealing. Likewise, law firms, which have been undergoing widespread staff and compensation reductions in recent weeks, may find the ability to monetize portfolios of ongoing cases to be an extremely useful tool to finance operations until client fees are realized at the end of a successfully prosecuted contingency case. Anecdotally, funders are already reporting a material increase in inquiries from those seeking funding.
- **Lack of Investment from Multi-Strategy Funds**. Despite the potential for increased litigation and increased capital needs, there are factors that may dampen the capital available for litigation finance. A large portion of the influx in capital over the past few years has come from multi-strategy investment funds that have made substantial investments in litigation finance alongside the traditional, dedicated litigation funders that made this type of credit available in the past. Multi-strategy funds allocated capital away from equities or distressed credit and into litigation finance when equity seemed over-valued and distressed opportunities were scarce. The question for litigation finance is whether these multi-strategy investment funds will “go back to their knitting” and exit the litigation funding strategy when equities seem cheap and distressed opportunities are abundant. While litigation finance served multi-strategy investment funds well when opportunities in their core strategies were few and far between, litigation finance requires hard analytical work and it may be difficult to favor investing in an illiquid and underwriting-intensive field when a

plethora of undervalued equities distressed investment opportunities are available. Should multi-strategy funds leave the market, it would, of course, reduce the total amount of capital available to fund litigation-related investment opportunities. While this may be bad news for plaintiffs and their law firms that are seeking funding, the decrease in available funds will likely benefit traditional litigation funders that may find fewer bidders (and less competition) for any given investment opportunity.

- **Long Term Cost and Availability of Capital.** Litigation funders will not, however, be insulated from this increase in the cost of investment capital if competition from other alternative investment spaces increases. Even funders with committed capital, will need to go to market at some point to replenish capital for new opportunities, at which time they will likely find a higher cost of funds. As such, litigation funding opportunities that were attractive at a time when interest rates were near zero may no longer be attractive. In order to make the math work, funders will require materially higher rates of returns on their funding transactions. Will the law firms and plaintiff businesses consuming litigation finance be willing to pay these higher rates? Perhaps they will and funding costs will rise along with all other financing costs. But if consumers of litigation finance are unwilling to pay higher rates, funders may need to focus on the higher yielding (albeit riskier) transactions in order to justify their higher costs of capital.

The field of litigation finance has grown enormously over the past several years and will likely continue to be a significant source of funding for law firms, in-house legal departments and businesses pursuing litigation claims. How the COVID-19 crisis will affect the industry exactly remains to be seen, but it is clear that the litigation financing industry will need to respond to a myriad of market forces over the next few years in order to remain successful.

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