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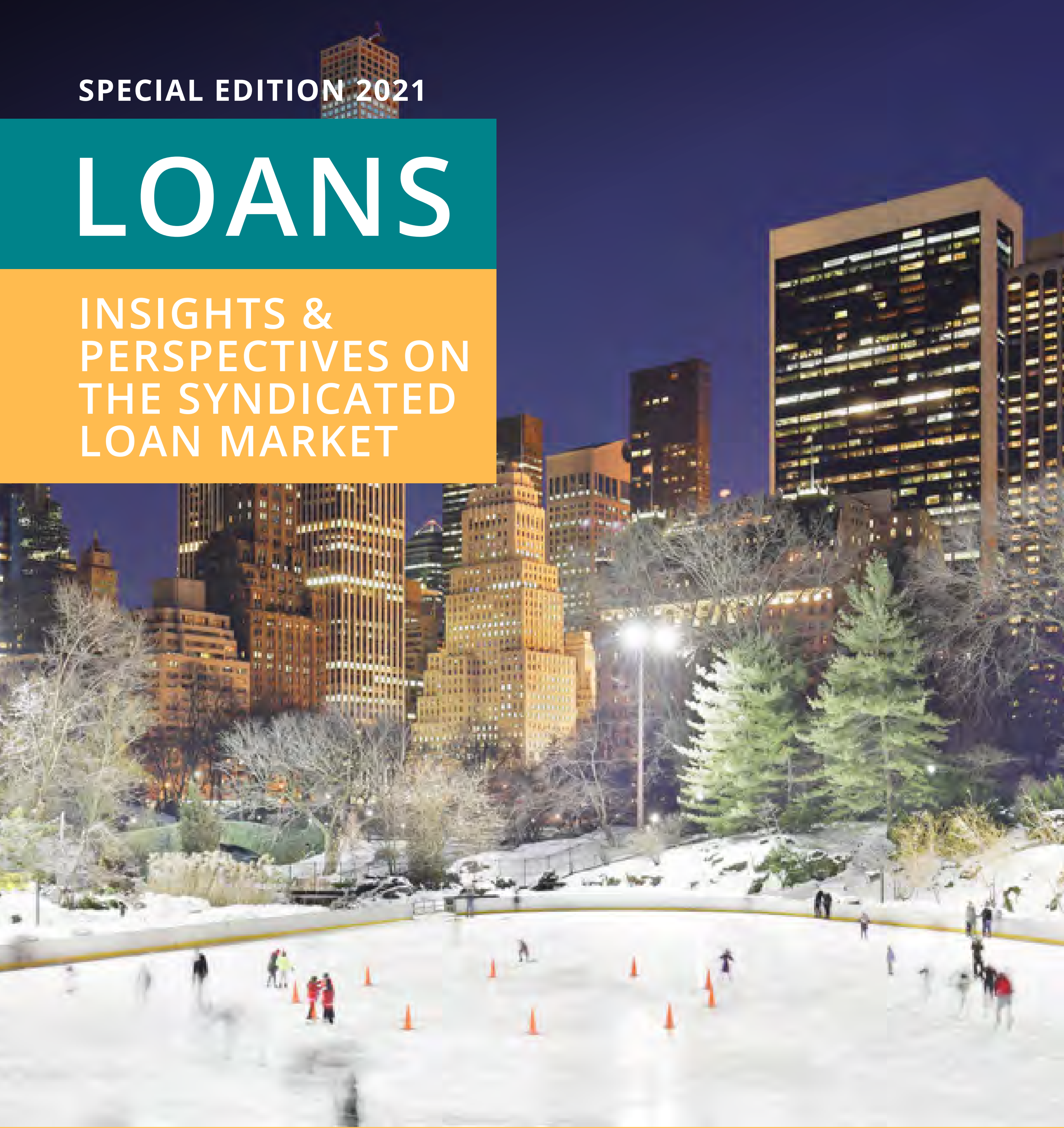
LOANS

INSIGHTS & PERSPECTIVES ON THE SYNDICATED LOAN MARKET



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RECENT TRENDS IN LITIGATION FINANCE

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The financing of commercial litigation has grown enormously since it first appeared on the scene in the U.S., about 15 years ago. While still small relative to the overall U.S. financial market, it is estimated that more than $11 billion has been invested in litigation finance alone. In essence, lenders (often referred to as "funders") provide commercial plaintiffs and law firms with the capital needed to prosecute expensive, hard-fought legal claims which the funders believe have a strong likelihood of success. Funders negotiate to receive a return upon a successful conclusion of the case commensurate with this large and potentially long-dated risk.

Because the investment returns in financing legal claims are uncorrelated with other more typical investment assets, litigation finance has become especially attractive in recent years to alternative lenders and multi-strategy funds looking to build diversified investment portfolios. While these funds have added litigation finance as a segment of their overall portfolios, they have been joined by an ever-growing number of specialty firms dedicated solely to litigation finance. Even among litigation finance firms, funders have sought to differentiate themselves from their competitors by specializing in specific categories of litigation, whether by case size, area of law, stage of litigation or the level of risk associated with the cases they fund. As a result of the maturing market for litigation finance, plaintiffs or law firms seeking funding now benefit by being able to access multiple bids to finance the prosecution of their legal opportunity. In addition, the increasing involvement of brokers and consultants specializing in this area has aided price discovery and created additional avenues for those seeking funding.

As one would expect, the expanding market for litigation funding has spurred an increase in innovation and funding structures are now available in a variety of flavors. Funding for a litigation may be offered in the form of a single up-front payment or a draw-down facility. The funding may cover a single case or a portfolio of cases. And while litigation funders previously targeted small law firms working on a contingency basis as customers, we now see traditional white-shoe, "Wall Street" law firms growing more comfortable with this space, with some firms openly touting their partnerships with one or more litigation funders.

WHAT IS LITIGATION FINANCE?

By definition, traditional litigation finance is the practice whereby a third-party provides capital to a plaintiff or law firm to pay the costs and expenses associated with a litigation in exchange for a return of its initial investment as well as a profit. What distinguishes this area of finance from others is that, typically, it is non-recourse: meaning that if the litigation is unsuccessful, the funder receives little or nothing in return for its investment. The funder risks both its principal as well as its return. Funders mitigate this risk by conducting extensive due diligence on the underlying claim and the counterparty and by negotiating large upsides for when the litigation is successful.

Today, however, the term "litigation finance" is often used in a much broader sense to mean any investment of capital where the return is associated with the outcome of a litigation. This includes not only traditional litigation finance but also putting money to work in areas that look a lot less like lending. Examples include the purchase of litigation claims where the investor steps into the plaintiff's shoes and becomes the direct party to the litigation. This type of transaction, better characterized as an outright asset purchase, typically occurs for class action claims, but purchases of single plaintiff claims may also occur where the investor retains its own counsel to prosecute the claim and makes all strategic decisions as the plaintiff. Another investment strategy involves acquiring claims against a solvent or insolvent company where the overall value of the claims will be determined by, or is strongly correlated with, the outcome of a litigation either brought by or defended by the company. This article, however, focuses on the more narrow and traditional areas of litigation finance: non-recourse lending to a plaintiff or law firm for the purpose of funding the costs associated with a litigation.

IS IT REALLY A LOAN?

Litigation funding transactions can be structured in a myriad of ways. Although often styled as loans, the underlying economic arrangements may freely blend elements of an equity instrument with terms normally found in a loan. Litigation financing arrangements are typically non-recourse to the "borrower" and rarely have a fixed rate of interest or a maturity date. As a result, most funding arrangements are more accurately characterized as purchases of rights in an asset (proceeds of the underlying litigation claim or the right to a law firm's legal fees in connection with such litigation) rather than as extensions of credit. Nonetheless, funding agreements often have characteristics more commonly seen in the loan context, such as financial covenants and credit enhancements designed to ensure payment of the investment return upon a successful outcome of the litigation, including, the posting of collateral and the provision of limited third-party guarantees.

How the investment is characterized (as an asset purchase or a loan) can have important implications for how it will be treated under pertinent tax laws, state common law regarding champerty, state usury statutes, and state rules governing legal ethics. Most funders prefer to characterize their funding arrangements as asset purchases and not as loans. Because of the uncertainty as to how a court or regulator will actually view the transaction, a prudent investor must be comfortable with the "recharacterization risk" inherent in funding arrangements. A simple rule of thumb borne out by recent history is that if a court or regulatory authority deems the funding arrangement to be unfair or overreaching (especially in relation to individual consumers), it may seek to find a way to characterize the arrangement in the way least favorable to the funder.

THE WATERFALL

In most cases, traditional funding agreements include a "waterfall" which dictates how proceeds of the litigation (whether pursuant to a judgment, a settlement or otherwise) will be allocated. Typically, the funder is first in the waterfall and is entitled to a priority return of its initial capital investment before there is any sharing with the plaintiff or the plaintiff's law firm. After that, there may be sharing between the funder and the plaintiff or the law firm, with the funder typically receiving a preferred return (in addition to recovery of the funded amount), which may be expressed either as a percentage of the plaintiff's recovery or as a multiple of the amount invested. Usually the plaintiff or law firm will then receive 100% of any remaining proceeds after the funder has received its full return, but in certain cases the funder will continue to share in the upside.

COLLECTION RISK

Funders must not only handicap the merits of the underlying litigation and its duration, but the ability to collect from the plaintiff or the law firm after a successful outcome. As with any financing, funders conduct extensive diligence on the creditworthiness and character of their counterparty and may seek additional enhancements, such as the posting of collateral and personal guaranties. Even in cases where collateral is posted, the funding typically remains non-recourse, so the obligation of the counterparty to pay (and the corresponding right of the funder to foreclose on the collateral upon default) arises only upon, and to the extent of, a successful outcome to the litigation. In this context, the posting of collateral is designed to protect the funder against the misappropriation of litigation proceeds or other misconduct. Similarly, any personal guarantees provided by the principles of the counterparty are typically of a ”bad boy” nature: the funder has recourse against the guarantor only to the extent of such misappropriation or misconduct. In addition, many funding agreements now provide for a “full-recourse trigger” whereby a bad act or other material breach by the counterparty triggers the counterparty’s obligation losing its non-recourse character.

CONCLUSION.

In many ways, litigation finance as an asset class in the U.S. is rapidly evolving from an embryonic stage. As the market develops we will see new participants as well as new financial structures. Because litigation finance draws upon and incorporates concepts from so many legal and financial disciplines, including lending, asset purchases, litigation, claims trading, insurance, factoring, derivatives, etc., we should expect to see continuous integration of structures and techniques borrowed from these fields as litigation finance grows and becomes more widely accepted in the credit marketplace.

Fund managers and investors that are new to the area should understand that litigation finance can be complex. Investors must understand and appreciate several specialized categories of risk that are distinct from those associated with more traditional areas of investment. Not only must the investor evaluate the merits, cost and timing of the underlying litigation (a task foreign to most investors in corporate debt), but there are a number of legal, ethical and practical issues that must be addressed and managed carefully.