The Hedge Fund Law Report
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Litigation Funding

In Turbulent Markets, Hedge Fund Managers Turn to Litigation Funding for Absolute, Uncorrelated Returns

By Jennifer Banzaca

As economic recovery lags and absolute, uncorrelated returns remain hard to come by, litigation funding – an investment strategy that has been popular in the U.K. and Australia for many years – is gaining traction among U.S. hedge funds. The strategy essentially involves advancing a portion of the costs of a lawsuit in exchange for a multiple of the investment paid out of any damages or settlement.

David Desser, Managing Director at litigation funding provider Juris Capital Corporation, explained the strategy as follows: "Our business resides in the gap that oftentimes exists between what the client is willing or able to pay for legal services and what the law firm expects to capture in the form of its hourly fee. We offer litigants and their counsel something they didn't know was available, which is third party capital that can bridge the gap between the bid and the ask between the client and law firm."

What is Litigation Funding?

Kenneth W. Bradt, CEO of litigation funding firm CaseFunding/Attorney Financial Services clarified that the funding advanced by litigation funding investors is not a loan, which generally obviates the need to comply with state usury laws. As third-party litigation funding providers, hedge funds are essentially buying an undivided interest in the outcome of litigation, with a defined cost for the use of the money.

While the litigation funding market in the U.K. and Australia is reasonably mature, the market in the U.S. is relatively new. Litigation funding started in the U.S. with lawyers providing funds for partners' clients, normally on a contingency basis. Richard Fields, CEO of Juridica Capital Management, noted that another risk-spreading strategy involved firms syndicating funding opportunities by organizing consortia of law firms to handle cases together.

But according to Desser, of Juris, litigation funding activity in the U.S. has caught up with, and perhaps surpassed, similar activity outside of the U.S. "My sense," he said, "is that although the business model may have been in practice longer in England and Australia, there's now more activity and more money being invested here in the States. A reason why it may have started earlier there is because those judicial systems have a loser pays model, so it's easier to invest in either party to a litigation. Because many corporate defendants in large commercial litigations are represented by larger law firms and have large legal bills, it creates an investment opportunity."

Fields, of Juridica, also noted that while litigation funding in the U.S. started in the personal injury and bankruptcy areas, it is now increasingly common in the corporate litigation context, "particularly given the cost of litigation. There is limited amount of capital available among law firms for that purpose. Right now there is a pretty large demand for this funding, but there is a restricted supply. As a consequence of that there is a real opportunity in this space."

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Finding Investment Opportunities – A "Relationship-Driven Business"

Litigation funding is generally a relationship-driven business. Bradt noted that much of his firm's business is generated from either referrals from lawyers or brokers, or simply potential clients or lawyers conducting Internet searches.

According to Desser, his firm relies on a network of contacts at law firms as well as recommendations from lawyers and companies with which his firm invested in the past.

Similarly, Fields noted that his firm relies on past business dealings to generate new opportunities. Having worked as an attorney for 25 years prior to the formation of Juridica, Fields uses his network of contacts to find new investments. With a combination of contacts, networking events, word-of-mouth and press attention, Fields noted that there is robust interest in litigation funding today, and his firm is seeing an increasing volume of opportunities.

Due Diligence

Like any investment strategy, to do litigation funding right requires a significant amount of thorough due diligence. But the due diligence in this context is of a very unique kind. Litigation funding investors generally need to assess the strength of a particular case, the creditworthiness of the defendant and the potential size of any damages or settlement. Firms must also consider any political and legislative changes that could affect the outcome of the case, or the "shadow" in which the case may settle. Funds typically retain outside attorneys to review the facts of the case and weigh in on relevant legal, legislative, political and social concerns.

CaseFunding's Bradt explained that funding decisions are based on an estimated value analysis, taking into account the likelihood of success of the claim and the magnitude of the possible award or settlement. Bradt said that his firm evaluates the merits of each case it considers funding with its staff of professional "underwriters" (which consists of lawyers and paralegals), and only funds cases that have a high likelihood of an appreciable award or settlement. "We advance funds to plaintiffs against a participation in their claim. The amount of the advance can represent from five percent to ten percent of the estimated claim value as determined by our expert third party underwriters (outside lawyers). There is a concern about not being able to collect on a judgment, but that gets factored into the analysis of a case. Another thing we look at is the time it will take to settle a case. If there's no history of that type of case being settled then we're less likely to do it."

Juridica's Fields explained that his firm also has a very deep due diligence process that takes into account the substantive merits of the lawsuit, the nature of the claim and the magnitude of potential damages, as well as risk factors beyond the substantive legal merits, such as the ability to collect, the potential for appeals and political influence. Fields also noted that Juridica evaluates the "fit" between the lawyers and the case: "We make sure the plaintiff has the right law firm for the job. We want to back lawyers who have litigated a similar case before and have a track record of success. We do due diligence on the case, the lawyers, the business, timing factors. We do quantitative modeling on expected returns and the timing. We're pretty selective. If we like a case and it meets our parameters, then we'll go outside and get a third law firm to rip the case apart and find the flaws. We're not afraid to walk away if we find problems. So, that due diligence process takes about 60 to 90 days."

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Moreover, before making an investment, Juridica also conducts a compliance and ethics review to ensure that the litigation funding agreement is in compliance with applicable legal ethics rules.

Like CaseFunding and Juridica, Juris also has a thorough due diligence process, taking into consideration macro level concerns – such as the law firm and the lawyers litigating the case, whether or not the plaintiff is a revenue-generating business and the creditworthiness of the defendant – and micro level concerns such as the legal claims in the case and applicable law and precedent. After gathering information about the case and following a review by one or more outside law firms, Desser said his firm then determines what they believe to be a reasonable settlement value for the litigation. If the legal due diligence checks out, the firm will then fund the litigation.

Both Desser and Fields noted that their firms get paid when the case settles, so their preference is to avoid cases that are likely to go to trial; trials, in their view – especially jury trials – introduce an element of unpredictability into a case.

Structuring the Deal

Fields said that his firm is not a lender. Rather, his firm in effect takes an equity stake in the claim, or in the ultimate recovery or settlement. In general, funding agreements need not be approved by the court.

In general, Desser noted, "we get paid after a litigation is resolved and the attorneys have received their fees. The remainder is paid to the client, always with the caveat that if the litigation doesn't generate sufficient proceeds, we may not receive our full (or conceivably any) return. It does happen, although not frequently. Our investment is not recourse to other assets of the litigant. So, if we invest $1 million in a litigation and the litigant recovers nothing, we are not owed anything and would have a $1 million loss. We typically don't receive other security beyond our purchased interest in the litigation, so we're at risk. It's risky capital and it gets priced that way."

Legal Concerns

Besides financial risk and the legal risk in the underlying cases, litigation funding in general implicates a number of recurring legal concerns. As Bradt explained, so-called "champerty" and "maintenance" are causes for concern and his firm has done research on these topics in all 50 U.S. states. "Basically, these are old, leftover issues from the past and they're going away by and large. There are still some states where these rules apply. We are aware of those and they are issues we factor into our decisions. Those issues primarily affect lawyers that are trying the cases, not so much us. We like to be aware of them so our clients don't have any problems."

Added Desser, "we're passive investors because we want to avoid the somewhat arcane legal prohibitions of champerty and maintenance. If we take a percentage of the litigation outcome, or are actively involved in the prosecution, it could be argued we are intermeddling in a lawsuit or promoting litigation. That's why we purchase an interest in proceeds expressed as a multiple of the amount invested. The multiples are usually between 1.5 and six times our money, but never a percentage of the litigation outcome."

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Champerty

Champerty is a bargain to divide the proceeds of litigation between the owner of the liquidated claim and a party supporting or pursuing the litigation. Where state law prohibits champerty, a stranger may not acquire a party's right to sue. Bradt explained that different states impose different rules with respect to champerty. "If we were to be found in violation of a state's champerty laws, it could have a material adverse effect on our results and operations," he said.

Juridica's Fields said his firm is also concerned about champerty issues and reviews the relevant laws in each jurisdiction. "There are a few states where it's crystal clear that it's not a problem, like New Jersey. Most states have cases on the books and in some states it's more of a risk than others. There are only a few states where champerty gives a defendant a defense. There are other states where it creates an issue of enforcement, so if a jurisdiction finds an agreement champertous, then your contract might not be enforceable. You don't want to be in a situation where you invest in a case but can't get paid."

Maintenance

CaseFunding's Bradt explained that maintenance prohibits the "maintaining, supporting, promoting or assisting of another person's lawsuit, with money or otherwise." Similarly, the bargain between a stranger and a party to a lawsuit, by which the stranger funds a portion of the party's claim in consideration of receipt of part of the proceeds of any judgment, may be deemed to be a form of "champerty" or "maintenance," and may be prohibited in some jurisdictions. "This is why funding agreements here in the United States are generally structured as fully collateralized loans or advances to law firms (with no equity stake in the underlying cases). Furthermore, fortunately, the application of the old world concepts of champerty and maintenance are waning," Bradt said.

Attorney-Client Privilege

In conducting initial due diligence on each case and in ongoing progress reports, litigation funding parties have to remain cognizant of attorney-client privilege issues.

As Fields noted, attorney-client privilege affects the due diligence process in that it can restrict access to pertinent information. "You like to have as much transparency as possible but very rarely are you able to get inside the attorney-client privilege. Normally you don't want to be because you're putting the case at risk. Once you're in, you're a passive investor. The way we set up our deals is the clients report to us and the lawyer reports to us but we don't get privileged information. That's why the due diligence itself is so important."

Added Juris' Desser, "in every conversation I have with a litigant or their counsel, we advise them not to share the information which is or may be subject to a privilege. We never ask for, nor do we receive, any privileged information that if disclosed to us might constitute a waiver of the attorney-client privilege. There are times our investment due diligence is limited as a result. If we can get comfortable without the privileged information then we'll make the investment. If not, we don't. We always conduct our due diligence subject to any limitations established by the litigant and their counsel."

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Avoidance of Influence

Many principals of firms providing litigation funding are former attorneys, so one would presume that such people would be tempted, from time to time, to provide legal guidance on cases in which they invest. However, both Desser and Fields said they remain assiduously passive investors and do not try to influence the cases in which they invest in any way.

"When we make an investment," Desser said, "we have only purchased a financial stake in the litigation. We have no control over the litigation whatsoever. We don't make any decisions regarding the case. In fact, in our purchase agreement we disclaim any opportunity to make decisions concerning the litigation. There are legal and ethical reasons that such a role is difficult for us. That's why developing trust in the litigant and their counsel is critically important – if we don't think interests are well aligned we are powerless to step in and fix things."

Fields added: "We try hard not to get involved in the cases. We're a passive investor. We have certain contractual rights to be kept informed, but we don't participate in the decision-making. But, if you're going to be a passive investor, you have to make sure you have the right type of deal structure to protect your interest. Once the deal is made, you can't make changes or try to get involved in the case if things are not going well."

Appeal of Litigation Funding

Bradt noted that for litigants, part of the attraction of litigation funding is the lack of funding from other sources, such as investment banks. "If you are a contingency-based firm, most banks don't lend to you because, in general, the banks don't like small, thinly capitalized service companies. Most of these companies dividend out their money at the end of the year, so it's not like they have a big balance sheet. Banks and other traditional lenders aren't geared up to evaluate the nuances of some of these contingency fee cases so it's a very, very interesting niche."

For investors, litigation funding offers two of the most sought-after elements in hedge fund strategies: returns that are absolute and uncorrelated. Moreover, the strategy is largely countercyclical, in that in bad times, there is generally more litigation, and that litigation is harder to pay for (on both the plaintiff and defendant sides).

"The economy has certainly created a lot of buzz for the business and we are busier than ever," Desser explained. "Many clients now really can't afford the fees that premier law firms charge and that's where we're able to provide a potential solution. Many firms are seeking our assistance to pursue alternate fee engagements."

He added, "the returns are very attractive, in excess of 20 percent to our investors. There are so few investors in commercial litigation that there is no price compression and very little competition; that creates opportunity for outsized returns."

In explaining the attractiveness of the strategy from the investor perspective, Fields emphasized the absence of correlation with other assets or strategies. "Interest rates, housing costs, inflation don't have much correlation with these assets. There's high demand and because of the limited capital supply there are also outsized returns. In our first year

our NAV was up 30 percent and our share price was up 24 percent and we paid about a 4.6 percent dividend. That gets people's attention."

Who Is Investing?

Desser noted that Juris has relationships with several hedge funds and is institutionally backed.

Fields stated Juridica is listed on the London Stock Exchange's AIM market, and that most shareholders are large U.K. institutional investors. He added that hedge funds have expressed interest in investing directly in Juridica, investing in the basket of cases in Juridica's portfolio or co-investing with the firm on certain deals.

Bradt noted that his firm gets a majority of its funding from high net worth individuals and its partners, although there is growing interest from hedge funds. "We are seeing more interest from hedge funds, although we saw a lot more involvement from hedge funds before the credit crisis. Given that these are relatively illiquid assets, it's not like you can trade them. A lot of the hedge funds that were involved in this space needed liquidity for redemptions so they ended up selling a lot more liquid paper, the effect of which was to make it more difficult for companies such as mine to raise funds from hedge funds. I suspect some hedge funds will get back into this space because it's a non-correlated asset with tremendous yields. So, no matter what the market does, the yields on this paper are very, very good."