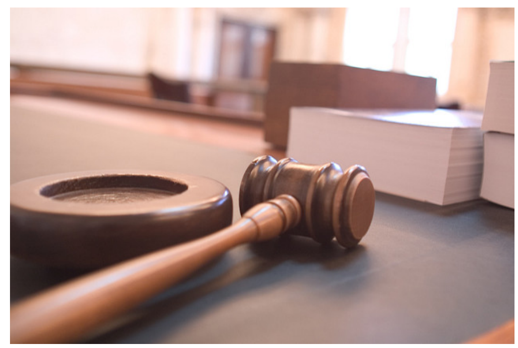
Where to invest in an increasingly uncertain world? Litigation, of course!

By Edward Truant on 2nd August 2016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As central banks head toward negative interest rates, the geo-political environment becomes increasingly unstable - witness Brexit, 'President' Trump and Turkey in lock-down - and capital markets become more volatile, where does one invest? Well, progressive investors are looking beyond traditional investment vehicles into more esoteric and non-correlated asset classes, such as litigation finance.

History

The business of litigation finance dates back to Roman times. However, it was brought to an end through old common law doctrines such as champerty, maintenance and barratry which have been in place since medieval times. Now, judiciaries have increasing concerns about access to justice and the aforementioned doctrines are being set aside in an effort to ensure access to recourse for plaintiffs with meritorious cases.

One could argue that litigation finance has been in practice for decades in markets that allow for conditional fee arrangements (i.e. contingency fees), although it has been the sole activity of the legal profession. With the wider acceptance of commercial litigation finance, the returns inherent in this form of finance are now no longer limited to those practicing law.

The Asset Class

Today, the asset class is multi-faceted providing investors with a number of different ways to invest with different risk/return profiles. The asset class is generally segmented between consumer finance such as personal injury and family law and commercial finance. This is any dispute between two commercial parties.

The asset class further segments between law firm loans, individual litigation loans, settlement/award factoring, litigation equity investments and derivatives thereof. There are also credit-type opportunities that derive from litigation but don't have associated litigation risk, which provide investors with different risk/reward outcomes.

The "why"

The real benefit of commercial litigation finance lies in the fact that it provides financing to corporations to allow them to effectively 'level the playing field' such that both plaintiff and defendant are equally armed in terms of financing. The result is that settlement discussions ensue more often than not and meritorious plaintiffs prevail.

The commercial litigation finance market has also started to evolve to include not only financing 'David vs. Goliath' cases, but has recently taken the form of off balance sheet financing for large corporations and investments in a law firm's contingent case portfolio to allow them to de-risk their portfolio by giving them the financial capacity to assume more cases.

Growing Demand, Growing Supply

The litigation finance market is in the early stage o ts l ycle and is exper encing rowth in both demand and supply. A w publicly listed litigation finance corporations have grown significantly since listing. However, the bulk of investing capital originates om private litigation finance managers dedicated exclusively to the sector (i.e. specialist private equity firms). Many market participants describe the market as inefficient, which is one o th reasons why it is an increasingly attractive asset class.

Increasing Litigation?

In the United States the detractors o the business, mainly the US Chamber o Commerce, suggest that litigation finance would give rise to many ivolous cases being pursued, resulting in clogging up already back-logged court systems and a net drag on gross domestic product. Given that the US Chamber o Commerce is a lobby group financially supported by large corporations, you can quickly see the inherent conflict.

The litigation finance industry's response to these claims is that nothing can be rther om the truth. Litigation finance is a third party to a case that is seeking to put real money solely behind meritorious claims that they believe will result in a "win". I litigation finance companies started investing in cases without merit, they would soon be out o business, which explains why so few cases get financed.

Litigation - the 'Ick' Factor

Actually, no. In terms o social responsibility, there are w sset classes that actually contribute to improving corporate behaviour. One o the reasons there is so much litigation applicable r litigation finance is a preponderance o ad corporate behaviour. Bad corporate be aviour stems om the ct that decision m kers un erstand the financial and legal leverage they have over their smaller counterparts and use this asymmetrical relationship to their financial advantage with ll knowledge that the harmed party has a low probability of seeking justice.

What if there was an asset class, the very existence o w ic would stop corporate executives in their tracks and make them think twice about the decisions they are about to make. This is exactly what litigation finance achieves. Accordingly, investors in the asset class can boast that they are contributing to an asset class that has the power to change corporate behaviour for the better.

The Business Model

The business model is relatively straight forward. The litigation manager, after reviewing the merits of the case (often assisted by a law firm working on a contingent fee arrangement which has conducted its own due diligence), determines whether and on what terms it wants to provide a commitment to fund the plaintiff and then enters into a funding contract to codify the arrangement.

Each funding contract is bespoke and specific to the circumstances, but generally involves an allocation of the damages that are either derived from a settlement (in the majority of cases) or a court award among the plaintiff, the litigation financier and the contingent law firm.

The litigation financier typically has priority in the proceeds waterfall, such that they are 'first money out' and often with a preferred return. An individual case typically provides a realization in 2-3 years and so the asset class cycles through capital much more rapidly than other alternative assets, such as private equity or venture capital.

It has been argued that litigation finance is an expensive source of capital, however one needs to consider that the possibility of a negative outcome on an individual case is real and pricing is reflective of that outcome. As a result of outcome risk on an individual case, the application of portfolio theory is critical to successfully investing in this asset class.

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