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Litigation Finance: The 'Unicorn' of Uncorrelated Absolute Returns?

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Editor's note: Billionaire Peter Thiel's involvement in the infamous Gawker privacy case has renewed interest in litigation finance, an relatively esoteric corner of alternative investments that involves bankrolling lawsuits in return for a piece of any monetary judgements. As explained by Edward Truant, principal of commercial litigation finance specialist ***Balmoral Wood Litigation Finance****, the strategy can be an interesting source of return virtually uncorrelated with any other asset class.*

Is Commercial Litigation Finance the 'Unicorn' of Non-Correlated Absolute Returns?
By Edward Truant

It used to be the case that the word "litigation" would make the hair on the back of your head stand up straight. Today, litigation is a common occurrence in corporate America to the point that it is part of the corporate vernacular and for certain companies it has become a business tool. However, if you are a hedge fund manager, high net worth investor, family office or pension plan, litigation has recently taken on a different meaning – **non-correlated absolute returns**. And the source of those returns is 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, as a result of various judiciaries' responses to the ever increasing barriers preventing access to justice (mainly increasing litigation costs), the aforementioned doctrines are being set aside in an effort to ensure access to recourse for plaintiffs with meritorious cases.

In fact, one could argue that litigation finance has been in practice in the US for the last century, although its use has been the sole domain of lawyers willing to perform their services through a contingent fee arrangement. With the wider acceptance of commercial litigation finance, the returns inherent to this form of finance are now no longer limited to those practicing law.

In its current form, the industry started in Australia

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approximately 40 years ago in the context of corporate insolvency litigation and quickly developed to include personal injury, class action and commercial litigation. In 2013, the Jackson Reforms embraced litigation finance in the UK and the industry continued to expand. In the US, litigation finance started in earnest about a decade ago and is now accepted in most jurisdictions. Litigation finance is becoming a global business which is now permitted to varying degrees in a number of other countries including Germany, France, Canada, South Africa, Hong Kong, Singapore and New Zealand.

Demand

In commercial cases, the issue often at hand is that the proverbial 'David' has been harmed by the proverbial 'Goliath' and 'David' doesn't have sufficient capital to pursue his meritorious case to fruition. The justice systems in many countries have been grappling with how they deal with this unbalanced situation in the context of the existing common law doctrines and increasingly they are setting aside champerty and maintenance doctrines and allowing the practice of litigation finance. Litigation Finance is a tool that the business owner or manager now has at its disposal to monetize an asset that only has value with an appropriate level of investment.

Inherently, the real benefit of litigation finance lies in the fact that it effectively 'levels the playing field' such that both plaintiff and defendant are equally armed in terms of financing, forcing both parties to focus on the legal merits of the case as opposed to who has the bigger balance sheet. The result is that settlement discussions ensue more often than not and meritorious plaintiffs prevail. Justice has been served!

Corporate Perspective

Corporations have a real dilemma when it comes to considering litigation. On the one hand, if a corporation decides to pursue litigation the expenses that it incurs will result in a reduction in its EBITDA which, if sustained, has a negative effect on both its enterprise value and its balance sheet. In the event the corporation is successful in its litigation, its enterprise value does not benefit from the positive outcome because the award is considered a non-recurring item and is accounted for below the EBITDA line (although the balance sheet benefits from the cash award received). Accordingly, it often doesn't make sense for a corporation to finance its own litigation. For the same reason, it makes absolute sense for the corporation to finance the litigation using off balance sheet financing or litigation finance. In addition to avoiding the negative effects outlined above, litigation finance has the side benefit of providing the corporation with a 'second set of eyes' who can provide an unvarnished perspective of the probability of success. In this way, litigation finance can help plaintiffs focus on the potential winners and avoid potential losers. Accordingly, as litigation finance becomes better known in legal circles, corporations are being educated on its merits and increasingly availing themselves of this option.

The Investment Opportunity

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

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segmented between consumer finance (personal injury, family law and class action) and commercial finance (any litigation involving two corporate entities, which includes breach of contract, partnership disputes, intellectual property, international arbitration, securities actions, etc.).

The asset class further segments between law firm loans, individual litigation loans, settlement/award factoring, litigation equity investments and derivatives thereof. This article focuses mainly on litigation equity investments which are non-recourse in nature, a critical element to avoid usury issues.

Inefficient Market

The litigation finance market is in the early stage of its life cycle and is experiencing growth in both demand and supply. A few publicly listed litigation finance corporations have grown significantly since listing. However, the bulk of investing capital originates from private litigation finance managers dedicated exclusively to the sector. One can also view these managers as specialist private equity firms managed by former litigators and finance executives. Many market participants describe the market as inefficient, which is one of the reasons why it is an attractive asset class. Where inefficiency resides so to do the opportunities for outsized returns.

The Debate

Detractors of the business, mainly the U.S. Chamber of Commerce, suggest that litigation finance would give rise to many frivolous cases being pursued, resulting in clogging up already back-logged court systems and a net drag on gross domestic product. Given that the U.S. Chamber of 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 further from 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". If litigation finance companies started investing in cases without merit, they would soon be out of business. Case in point, very few of the cases that are brought to litigation finance managers are ever pursued – their sole focus is on those cases with meritorious claims, where the proceeds can be received in a reasonably quick period of time (the average litigation finance cases realizes within about 2.5 years) and where collectability risk is low. Accordingly, there are relatively few cases that make the cut.

A 'Feel Good' Asset Class?

Increasingly, investment managers are being challenged to make investments that produce excellent returns while being socially responsible (witness the recent pressure on endowments to exit traditional energy investments). How does litigation finance help solve this investing conundrum? From a return perspective, the return profile of litigation finance is well documented by two large publicly-listed litigation managers that have been actively deploying capital for as long as 2 decades – IMF Bentham (ASX: IMF) and Burford Capital (AIM: BUR).

However, the problem with investing in the publicly listed managers is that the public structure effectively turns a non-correlated asset into a correlated asset, which offsets one of the major benefits of the asset class.

In terms of social responsibility, there are few asset classes that actually contribute to improving corporate behaviour. One of the reasons there is so much litigation applicable for litigation finance is a preponderance of bad corporate behaviour. Bad corporate behaviour stems from the fact that decision makers understand the financial and legal leverage they have over their smaller counterparts and use this asymmetrical relationship to their financial advantage with full knowledge that the harmed party has a low probability of seeking justice. What if there was an asset class, the very existence of which 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 provides a funding contract to codify the arrangement. While each funding contract is bespoke and specific to the circumstances, to provide a theoretical example a case outcome could result in the plaintiff receiving 40%, the contingent law firm receiving 30% and the litigation financier receiving 30% of the damages that are either derived from a settlement (in the majority of cases) or a court award. The litigation funder usually has priority in the proceeds waterfall, such that they are ‘first money out’.

Litigation funders typically underwrite to a multiple of capital if they are getting involved in the early stages of a case and a lower multiple if they are getting involved in the later stages of a case. An example of the latter would be an appeals process where the merits of the case have been established but the case is being appealed due to an issue of law. One might argue that is a high price to pay to access justice, but the possibility of a negative outcome on an individual case is real and pricing is reflective of that outcome. In theory that risk is somewhat mitigated when enough cases are compiled into a fund, as long as the fund and the fund manager’s strategy is not concentrated, which is easier said than done.

Summary

Litigation finance is an asset class that is experiencing continued growth in both existing and new jurisdictions. At the same time, it has the opportunity to influence corporate behaviour for the better by leveling the playing field between plaintiffs and “Goliath” defendants. Unicorn or not, the asset class is here to stay and investors will benefit handsomely from exposure to the asset class when approached in a manner that addresses the asset class’ inherent risks.

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