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Responsible Investing in Litigation Finance

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The litigation finance industry has been receiving an increasing amount of press over the last few years as it has gained traction throughout the legal and financial community. The term "litigation finance" refers to a myriad of different financing strategies and risk-reward profiles. However, it most commonly refers to a third party providing financing to the plaintiff in exchange for an interest in the financial outcome of the case, be it through settlement or court award (referred to herein as "equity investments").

The typical scenario is that a plaintiff has a meritorious claim but does not have the financial resources to pursue the claim, whereas the defendant often has the distinct advantages of time and money – a classic "David vs. Goliath" scenario. Historically, in common law based judicial systems litigation finance has been prevented through medieval doctrines called "champerty" and "maintenance", which judiciaries are increasingly deeming misaligned with the realities of the 21st century. Today, judiciaries are more focused on increasing access to justice and consequently have either set aside champerty and maintenance concerns or abolished the concepts entirely, which have been instrumental in creating the current litigation financing market.

While the main purpose of a justice system is to allow aggrieved parties to access justice, in the US the costs associated with doing so have been escalating at a rate of 8% per year for the past 50 years. This cost escalation has provided large corporations with a distinct competitive advantage in a system that was designed to be a 'level playing field'. In the US, the judiciary recognized the economic reality of litigation and decades ago provided a remedy by allowing contingent fee arrangements, where lawyers can put their fees 'at risk' in exchange for a percentage of the outcome, up to 50% of the proceeds derived from the case. As litigation costs continued to climb, including expensive out-of-pocket costs not typically funded by contingent law firms, judiciaries have adapted by allowing third parties to provide the necessary financing. The litigation finance market have begun to address the financing gap and continues to develop this emerging market through education, scale and innovation.

What are the attributes of the asset class?

The attributes of the asset class vary depending on the type of litigation financing. For the asset class in general, one attribute is consistent with every institutional investors' target list – namely 'non-correlation'. Non-correlation simply refers to the fact that the outcome of a case is solely a consequence of and idiosyncratic to the litigation and is generally not correlated with other factors such as the economy and the state of the capital markets. With the current level of global uncertainty, aging demography in the developed world and inflated asset value resulting from central bank policy, there is an increased focus on returns that are non-correlated. This is playing out with forward thinking institutions like endowments who are choosing to reduce their exposure to public markets and private equity and shifting allocations into more esoteric asset classes like litigation finance.

In the private market context, the asset class tends to be illiquid with liquidity resulting only when cases get resolved either through settlement or through a court award. However, relative to other comparable asset classes like private equity, the extent of illiquidity tends to be shorter with average case lengths targeted at 2-3 years (which can vary based on the case type and the stage of investment in the case). Publicly-listed litigation managers will provide the liquidity many investors require, but may turn an otherwise non-correlated asset class into a correlated stock price if the markets fail to properly value the stock, as previously evidenced through historical market corrections.

The other aspect of the asset class is "optionality". In fact, the asset class has been described as an "option on an installment plan". As a litigation manager, you make a commitment to fund a piece of litigation, but the litigation is typically funded over a period of time based on milestones. A fund manager may negotiate the option to withdraw funding to limit downside risk in the event that the circumstances of a case change or are inconsistent with the fundamentals of the original underwriting. This is one of the reasons that hedge fund managers like this asset class – the optionality of the asset class is very appealing, especially when you can minimize your downside risk by not being fully exposed at the start of the investment.

The other characteristic of the asset class that many people highlight is a reference to it being "binary" in nature – you either win or you lose. However, practically speaking cases have a large number of potential outcomes. In any given case, there is uncertainty at both the defendant and plaintiff level – this is the very nature of disputes. Where there is uncertainty there is opportunity for a myriad of different outcomes depending on how either side to the litigation views a number of issues, including the level of uncertainty inherent in their position, counterparty priorities, changing circumstances, the past behavior of the counterparties, length of litigation, level of expenditures, etc. The inherent uncertainty can result in a series of potential negotiated settlements that make the outcome of a case more than a simple "1" or "0", but rather a series of probability weighted outcomes that any good litigation manager, defendant and plaintiff and their respective lawyers assess on an ongoing basis and adjust their expectations accordingly. Outcomes will tend to become more binary when the parties decide to let a judiciary decide the outcome, which is in a small minority of litigation finance backed disputes.

An analysis of the asset class would not be complete without commenting on the returns inherent in the asset class. The asset class is relatively young and inefficient. With inefficiency comes an absolute return profile that is very compelling, which is the case with litigation financing. However, the nature of litigation outcomes referenced above means that a litigation manager underwriting an investment must take into account the possibility they will lose all of their money financing a specific case. Accordingly, their economics must reflect that reality and the financing is generally perceived as being expensive because of this risk. What makes the asset class compelling is when you layer on portfolio theory. Over a larger portfolio of cases, a good fund manager can achieve success rates greater than 75% and when those success rates are married with the underlying economics of a single case, the results can be exceptional. In addition, the asset class has the potential to achieve outside returns depending on the particulars of the case, the level of determined damages, settlement negotiations and the decisions of judiciaries. All in all, a very unique and compelling asset class.

As an investor, what are my investment options?

From an investor's perspective, there are many ways in which to invest in litigation finance, each of which has its own risks, rewards and timelines. Generally, the first level of segmentation in the industry is between "consumer" and "commercial" litigation finance. Consumer includes personal injury, family law and mass tort/class action litigation and generally is comprised of high volume, low dollar investments (with the exception of class actions which can be very large dollar investments with longer investment periods). The commercial segment involves any piece of litigation involving two commercial parties (including government entities) and also includes international arbitration cases which are increasing in popularity among litigation financiers. Some mass tort/class actions would also be considered commercial in nature.

The industry further breaks down across types of litigation finance – law firm loans, portfolio equity investments, single case equity investments, settlement financing, enforcement financing, etc. The options within litigation finance are only limited by the financier's imagination, and while many new products have been created in the last 5 years, we should expect to see a proliferation of new products in the future.

In addition to the types of litigation financing, there are also a number of different investment vehicles: publicly-listed companies (e.g. Burford and IMF Bentham), closed-end publicly listed funds (e.g. Juridica) and private funds (e.g. Gerchen Keller Capital) with private funds or private litigation managers representing the largest number of firms in the industry. While the publicly listed vehicles have the benefit of liquidity, the private vehicles provide direct exposure to non-correlated case outcomes and the proceeds derived therefrom.

Article 2 in this three part series will explore the perceptions and risks inherent in the litigation finance asset class

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