Litigation Gamble

Law firms are willing to pay investors triple-digit returns.

Reported by Joanne Cleaver

Loans against lawsuits conjure the image of late-night television ads haranguing the luckless with offers of money now if they get lucky at the casino that is the court system. "Cash now, win later!" is the pitch.

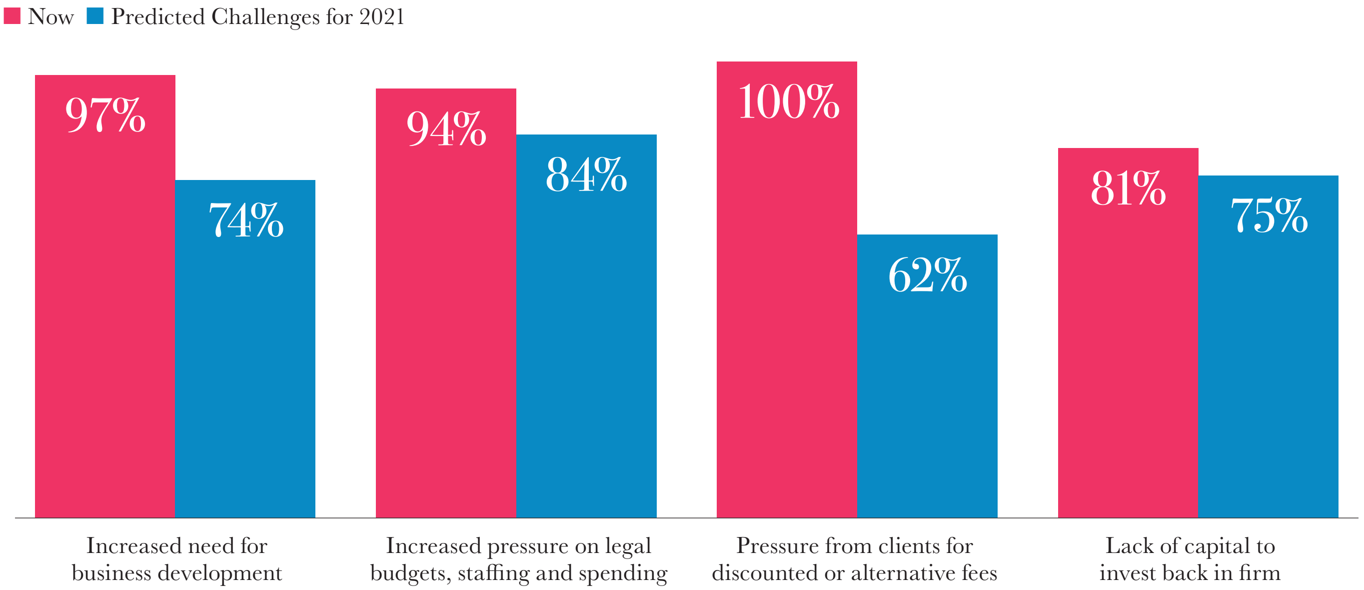
The same basic offer, considerably tidied and formalized, is catching the attention of asset managers interested in returns untethered to economic trends. The concept is simple, even when scaled up: it takes a lot of money to manage a complicated, high-stakes legal tussle between two huge companies. But at some point, one side or the other will win, or the matter will settle out of court. How and when the case concludes is only a matter of process and time… and law firms are willing to pay double-digit, even triple-digit, returns for investors to tide them over in the meantime.

The concept of litigation finance is long established in England and Australia, where the two largest publicly held litigation firms—Burford Capital and Bentham IMF—are respectively based. During the recession, litigation finance grew in the US as corporate law clients began to press for reduced fees and creative financing arrangements from big law firms. The recession faded, but clients haven't eased their demands for extracting more legal services for less money, or at least less money up front. The opportunity for investors lies in the gap between cash needed today and cash available if the suit wins.

Asset managers are rapidly building the infrastructure that enables investors to buy stakes in corporate litigation at various points in the process, and through several models, ranging from the equivalent of an equity stake to the equivalent of factoring. Documents filed with the Senate Judiciary Committee in 2015 indicate

Law Firms' Biggest Business Challenges

Capital and cash flow are ongoing headaches for law firms, according to the 2016 Burford Barometer Litigation Finance Survey. Burford is the largest publicly held litigation finance company and its reports are widely cited as the best and broadest industry indicators. Results are based on surveys completed in early 2016 by the largest law firms and in-house counsel in the U.S.



Source: Burford Barometer 2016 Litigation Finance Survey

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that asset management firms had channeled $3 billion to US large-scale, third-party litigation finance—triple the 2011 total.

The American Bar Association's Guide to Litigation Investing reports that investors expect annualized returns of at least 20%, and, "providers are typically seeking multiples of their capital invested in successful cases ranging from two times to four times." Law firms can actually return to investors more than the investors put in, but that's justified, says the ABA, when firms think of the financing as a 'reduction in the upside' of a successful suit rather than an out-of-pocket loss.

Allison Chock, chief investment officer of Bentham IMF, says that American litigation investments initially appealed to "small contingency boutiques that would normally be carrying costs for three to five years. Litigation funding can ease that and allow them to take on more cases." But as firms have continued to search for operational efficiencies, larger firms also started to see litigation funding as "an attractive bridge" that enables them to better the erratic cash flow of contingency cases.

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"It's a corporate finance or risk management tool," says Adam Gerchen, who became president of Burford Capital when it acquired Gerchen Keller Capital, his 4-year-old Chicago-based litigation finance firm, in December 2016. "There's growing comfort in the limited partner community with this asset class… it has matured quite quickly." University foundations and state pensions have invested through Burford.

One Bentham case illustrates how an infusion of capital resulted in the plaintiff's victory and a substantial payoff for investors. Joseph Radcliff, an Indiana roofing contractor, used funding provided by Bentham to beat an appeal brought by State Farm of a $14.5 million jury award Radcliff won in a defamation claim against the insurance company. His business in tatters from the defamation, Radcliff turned to Bentham for cash to fund a new business and to pay his lawyers to litigate the appeal. Eventually, the Indiana Supreme Court ruled in Radcliff's favor. With interest, State Farm had to pay Radcliff more than $17 million. Bentham made a $2.2 million profit on the investment.

Regulations prevent law firms from many forms of borrowing, so litigation finance must be meticulously structured. To date, the asset managers are roughly divided into two categories: those that have always specialized in litigation finance and those that are drawn to it through adjacent asset categories and related experience.

One thing the firms all claim is a forensic level of due diligence to understand the underpinnings of the cases they are betting on. The category of lending against suits appears relatively small; the real draw is buying an equity stake in the outcome. Inevitably, some of those outcomes are losses, and in those cases, there is no recourse for the investors. That's why the first and most important investigation must be, say asset managers, how the suits are deemed investment-worthy.

Alternative Platforms

Typically, say litigation asset managers, investors direct part of their high-risk allotment to litigation investments. Because each case has its own risk profile, one way to get acclimated to the category is to sort through individual cases available for investment.

LexShares is a Boston-based electronic platform that lets accredited investors do just that. "It's our job to vet the cases," says Jay Greenberg, LexShares co-founder and CEO. "We break down the legalese to show what actually occurred with the case."

As with many of the litigation finance firms, LexShares offers investors a chance to invest at several points in the legal process. Greenberg explains that a typical case that settles within 12 months of the investment might yield two times the investors' principal, while a recovery after 12 months might increase at a rate of 1x the investment annually.

Or, investors can simply buy a percentage of the gross recovery, for a return of, say, 20%. Since the firm launched in November 2014, six LexShares cases won or settled, providing a payoff to investors. One case was lost, resulting a loss to investors.

New York based Halcyon Capital Management, detected an opportunity in lawsuits as it managed portfolios of distressed assets, says John Greene, partner and managing principal.

Halcyon's expansion into corporate litigation investments evolved into two separate litigation funds of undisclosed size, he says. The key skill, Greene believes, is crafting each litigation opportunity on its own terms. "These are bespoke investments, driven by process and privately negotiated. We're buying into a situation, just as we do with other outcome-driven processes, whether that's bankruptcy or liquidation," he says. "Results are driven by process, not valuation. Think of them as small, middle-market private-equity deals. You can't do these in a broad way."

Another player grounded in private equity is Houston-based Virage Capital Management, founded in 2013 by Edward Ondarza. Ondarza is a serial entrepreneur and developed financial and other derivatives for Enron. He declined to comment for this article, but in 2015, told an asset managers' roundtable that Virage structures debt for law firms to use for expenses as they represent plaintiffs in third-party cases. At the roundtable, he said the return on the notes ranges from 18% to 24%. Virage is expanding into a variety of loans for lawyers leading large class-action suits. At the time of the presentation, he said Virage had $260 million of institutional capital, including pension funds, insurance companies, and endowments.

Too Small for Comfort?

Precisely because litigation investments are so complex and idiosyncratic, it might be beyond the scope of a CIO's office to invest in specific suits, say litigation investment managers. An essential due

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diligence step is to confirm the litigation investment firm's process of choosing suits for direct investment or to include in portfolios. Another way is to invest at arm's length in one of the few publicly held companies that specialize in this category.

Gerchen says that he realized early on that the usual investment analysis didn't apply to these cases. As he built his namesake firm, he concentrated on the back-office operation because deep analysis of the law, trends, and legal logic was the only way to identify likely payoffs. "It's different from investment analytics," he says. "Process and portfolio construction is how you overcome the unique risk of individual bets."

That deep knowledge of the cases and their likely trajectory is how firms identify the right moments for maximum return.

"Each step of litigation is an inflection point where we can bring in investments or capital for the first time," says Gerchen. Over the typical 18 months to four years that a case is active, opportunities emerge in the earliest stage in deals that resemble equity, he explains. Later, if the law firm wants to finance the case mid-stage to free up capital for new cases, and the case looks strong, "we can accelerate the receipt of those funds for a lower return," he says.

Settlements are good news for litigation investors because they signal money on the table but even settlements offer a moment to invest if the payment is delayed by legal appeal or other complications. Such deals resemble old-fashioned factoring. "We'll buy the settlement at a discount and ultimately receive the payments when they flow," says Gerchen.

Bentham tends to invest in either single cases, putting in a set amount of money that clients can use to cover legal fees or as working capital, or in portfolios of cases handled by law firms, construct portfolio funds for categories of cases, explains Chock. Bentham also provides early-stage funding for new law firms.

The downside of litigation investing is that timing is erratic and unpredictable. Managing results over portfolios of cases help ease the 'lumpiness' of returns to investors, says Chock.

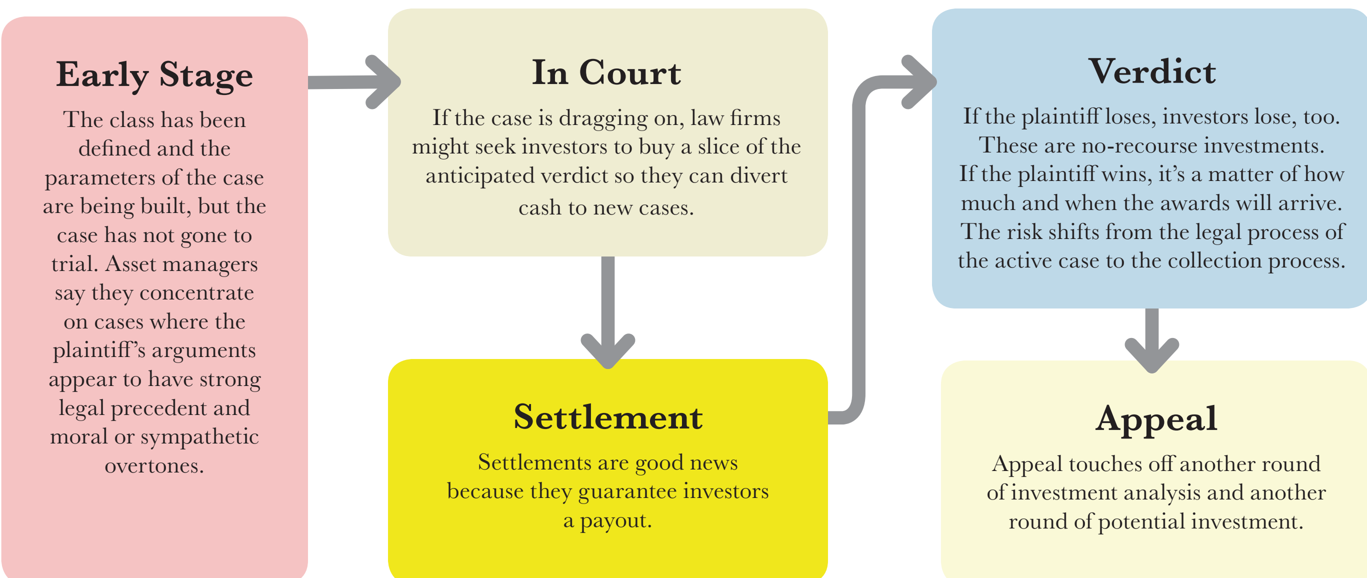
Because the industry is still emerging in the United States, there is no industry association or index, and no benchmark or norms for returns. Burford, the largest publicly held litigation finance company, produces regular reports that are cited even by its competitors as the best source of industry trends.

A survey released in 2016 by Burford of large law firms and in-house counsel at major companies found that firms are intrigued by the prospect of litigation finance and inclined to give it a try – an indicator of significant growth. The Burford survey asked about the three main types of litigation investment and found that 9% have tapped outside assets to fund portfolios of work, and 47% would consider doing so; 26% have used expense funding and 44% would consider it; and 21% have used outside funds to fund a single case, while 42% would consider it.

"No matter what's happening in the market," says Bentham's Chock, "These assets have a life of their own." CIO

Returns for Litigation Assets Key to the Legal Process

Litigation investments offer a classic risk-reward scenario: risk and rewards are highest early in the legal process when a case is in discovery. Settlements and verdicts offer lower risk because the cases essentially are in collection. The first filter is the investment structure: publicly held asset management firm or private capital; portfolios of cases or individual cases. Asset managers say they usually choose to invest in plaintiff's cases that are likely to be decided within 18 to 48 months.



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