

Third-Party Litigation Financing in the US

AARON KATZ, PARABELLUM CAPITAL LLC AND STEVEN SCHOENFELD, DELBELLO DONNELLAN WEINGARTEN WISE & WIEDERKEHR, LLP

Search the [Resource ID numbers in blue](#) on Westlaw for more.

Litigation financing is a mechanism by which a party not affiliated with a certain lawsuit pays for another party's (usually a plaintiff's) legal fees and costs to pursue that lawsuit, in exchange for a portion of any proceeds recovered by settlement or collection of a damages award. It is also known as alternative (or external) dispute funding.

Third-party litigation financing (also referred to as alternative or external dispute financing) is a mechanism by which a party not affiliated with a certain lawsuit pays for another party's (usually a plaintiff's) legal fees and costs to pursue that lawsuit, in exchange for a portion of any proceeds recovered by settlement or collection of a damages award.

Part of a growing industry in the UK and the US, the market for litigation financing is estimated to exceed \$1 billion (N.Y.C. Bar Ass'n Comm. on Prof'l and Judicial Ethics, Formal Op. 2011-2 (2011); see also Second-hand suits, *The Economist* (April 6, 2013)). In the US, banks, special litigation financing investment funds, hedge funds, and electronic marketplaces that match plaintiffs with funders have collectively invested substantial capital into this new asset class. The capital invested in litigation is categorized as uncorrelated investments because the returns are not correlated to the price movements of the stock, bond, commodity, or similar traditional capital markets.

In the current market, third-party litigation financing is primarily being used to pursue plaintiff-side or affirmative claims. This is because the metrics for success in affirmative claims are clear: if a claimant recovers cash from its adversary, then there is cash to pay the funder. However, there is interest in the industry in developing ways to help companies finance their defense-side dockets as well. The model is more difficult for defense-side financing situations because there is no clear metric for success when a company settles a claim or loses but pays less than its potential liability.

Some financing companies have considered reverse contingency arrangements, but the market for these types of products is still in the early stages of development.

This Practice Note provides an overview of third-party litigation financing for commercial litigation, including:

- How to evaluate whether litigation financing could be beneficial to a company's overall claims management (see Preliminary Considerations).
- How market forces have created a demand for litigation financing in the US (see Increasing Demand for Third-Party Litigation Financing).
- Scenarios where litigation financing may be appropriate for a corporate plaintiff (see Appropriate Situations for Third-Party Litigation Financing).
- The ethical issues raised by litigation financing (see Ethical Issues).
- How a litigation financing company assesses a claim (see Funder Considerations in Evaluating a Claim).
- The steps involved when applying for litigation financing (see Application Process for Third-Party Litigation Financing).
- The various types of financing products and pricing structures (see Litigation Financing Products, Deal Structure and Pricing).
- The role of the funder after the investment is made (see Post-Investment Role of the Funder).

The financing of personal injury and consumer claims and class actions are beyond the scope of this Practice Note.

PRELIMINARY CONSIDERATIONS

Litigation financing companies offer a range of financing options. To determine whether third-party litigation financing could be beneficial to a company's overall claims management, corporate counsel should:

- Evaluate the company's potential commercial claims in the US and abroad.
- Obtain estimates of the related legal fees and costs of litigation.
- Consider what financing options may be appropriate, such as whether the company should:

- fund the case from corporate cash flow;
- enter into an alternative fee arrangement (AFA) with litigation counsel; or
- combine these options in some way.

Third-party litigation financing arrangements are complex financial transactions that must be negotiated and structured to address the unique needs of the specific investment. Because investors may be asked to put significant amounts of capital into a situation with extraordinary risk, they seek pricing appropriate to that risk. Therefore, corporate counsel and executives should approach these arrangements with the same diligence and care that they apply to any important, high-value transaction.

INCREASING DEMAND FOR THIRD-PARTY LITIGATION FINANCING

Traditionally, corporate claimants have paid for legal fees and other litigation costs from corporate cash or, occasionally, through contingency fee arrangements with outside counsel (see Standard Document, Engagement (Retainer) Letter: Contingency Fee Arrangement ([0-521-9300](#))). The business model and use of capital of most US corporate law firms are set up for hourly billing fee arrangements and are not usually suited to take on contingency fee commercial litigation. Because corporate counsel are under considerable pressure to reduce their legal expenses, they have demanded AFAs from their outside counsel to such an extent that offering at least some type of discount has become the norm for many law firms (see Article, Alternative Fee Arrangements ([0-502-5910](#))). Courts also have become more receptive to the need for litigation funding. One court, for example, granted plaintiff a continuance so that it could secure external funding to prosecute the litigation (*Telesocial v. Orange, S.A.*, 2015 WL 1927697 (N.D. Cal. April 28, 2015)).

PRESSURE TO REDUCE LEGAL FEES AND COSTS

Despite AFAs becoming more accepted, companies continue to insist that their legal departments innovate to reduce their overall legal expenses, especially in connection with litigation. One way to do that is to arrange for outside financing of the legal fees and costs to pursue affirmative claims.

Depending on the lawsuit's outcome and its particular financing arrangement, a company that uses outside financing to pursue a claim can limit its legal department expenses and may even recover enough cash on the claim to finance in whole or in part the legal department budget for other matters. This arrangement, which also allows a company to spread the risk of pursuing a claim, encourages legal departments to think like a plaintiff by looking at potential claims as an asset that can be turned into cash.

ABILITY TO MONETIZE LEGAL CLAIMS

Litigation financing companies in the US promote their services as a way for companies to access investment capital to fund their valuable claims. Some of a company's most valuable (although illiquid) assets are commercial claims, including claims for breach of contract, infringement of intellectual property rights, antitrust violations, and similar legal claims. Usually, a company cannot access the monetary value embedded in those claims unless it incurs the expense of what

is often costly litigation. However, under certain circumstances, third-party litigation financing can function as a tool for corporate plaintiffs to obtain the monetary value embedded in specific claims that are otherwise too expensive to pursue due to budgetary constraints.

OPPORTUNITY FOR RISK-SHARING

Third-party litigation financing is a market-based solution for corporate legal departments and the law firms they retain in a range of situations (see Appropriate Situations for Third-Party Litigation Financing). At the most general level, third-party financing facilitates fee arrangements between clients and outside counsel that might not be possible otherwise. For example, when a client needs a discount or contingent AFA that would require its trial counsel of choice to share risk that is beyond the law firm's tolerance level or capabilities, third-party financing can help bridge that gap by allowing the company to retain the firm on an alternative-fee basis. At the same time, third-party litigation financing can enable a law firm to:

- Offer its clients fee arrangements that are not strictly based on hourly billing.
- Take on additional preferable fee arrangements that are partially outcome dependent.
- Share risk cautiously while protecting itself from a total loss in the event of an adverse outcome.

APPROPRIATE SITUATIONS FOR THIRD-PARTY LITIGATION FINANCING

Litigation investments are complex transactions tailored to address a company's unique situation and specific needs and objectives, such as to:

- **Pay unaffordable legal costs.** A company that cannot afford to pursue an action, or that has run out of funds during a pending litigation, may benefit from a third-party funder to defray all or part of its attorneys' fees or out-of-pocket litigation expenses (or both). These situations may include a small company with an expensive litigation investment or one in a distressed situation.
- **Use available capital for other business needs.** A company that can afford its legal fees and expenses may prefer to use its available capital for other purposes. For example, a large company may have equity or debt capital available to pursue meritorious claims, but would prefer to use that available capital for attractive business opportunities (such as overseas expansion or research and development). Or, a company may want to apply its limited legal department budget to more urgent (and less controllable) expenses on its defense-side docket.
- **Free up embedded capital.** A company may have a case that is already under way and adequately funded, and know that the claim represents an important contingent asset that could be underwritten and monetized to free up some embedded capital for other business or legal department uses. In this situation, a funder may invest capital on a risk basis now, against an agreed portion of the expected returns. This approach would be similar to a company's securitization of its accounts receivable.

Traditionally, companies have been unable to access efficiently the value embedded in their affirmative litigation-related claims. Legal departments have generally been unable to monetize claim assets

through the capital markets. Often, accounting rules have prevented companies from assigning any value to claim-related assets short of pursuing them to conclusion and cash recovery in litigation. Because companies have been unable to realize (or in many cases value) their legal claims as assets on their books, or to unlock the value of their claims in the marketplace, they have been prevented from accessing potentially large amounts of capital for productive business purposes. In some instances, third-party litigation financing has helped companies unlock the value of their claim assets and transform their legal departments from cost centers into profit centers (see, for example, *Vanessa O'Connell*, Company Lawyers Sniff Out Revenue, *The Wall Street Journal* (May 13, 2011)). Additionally, in-house legal departments have felt cost pressure and are considering alternative financing as a tool for managing their budgets in certain areas (see *Jess Davis*, In-House Counsel Eye Litigation Funds for Trademark Battles, *Law360* (May 7, 2013)).

ETHICAL ISSUES

Third-party litigation financing raises ethical issues that affect the funder's pre-investment evaluation of a claim and post-investment control of the litigation. These ethical issues relate to:

- Champerty and maintenance.
- The duty of confidentiality and the related attorney-client privilege.
- Litigation counsel's duties of loyalty and independence.

CHAMPERTY AND MAINTENANCE

Historically, the common law doctrine of champerty, as codified in most states, barred third parties from financially assisting a claimant in a civil suit. In practice, this has meant that third parties could not help a claimant commence or prosecute a civil suit in exchange for a portion of the monetary recovery.

In the US, the law of champerty varies by jurisdiction and, depending on the applicable state laws, could be an issue that corporate counsel must consider when structuring litigation financing transactions. For example, Maine requires litigation financing companies that provide funding to consumers to register with state authorities and include a representation in their dispute financing agreements that they will not control the course of the litigation (among other mandates) (Me. Rev. Stat. Ann. tit. 9-A, §§ 12-104, 12-106). Ohio has a similar law requiring a provision on non-control (Ohio Rev. Code Ann. § 1349.55).

Several states expressly prohibit champerty either by statute or common law. Examples include Delaware, Georgia, Minnesota, and Mississippi (see *Hall v. State*, 655 A.2d 827, 829-30 (Del. Super. Ct. 1994); *Johnson v. Wright*, 682 N.W.2d 671, 678 (Minn. Ct. App. 2004); Ga. Code Ann. § 13-8-2(a)(5); Miss. Code Ann. § 97-9-11 (1999)). A Pennsylvania court recently held an unusual attorney fee agreement with a litigation financing component invalid based on champerty (*WFIC, LLC v. Labarre*, 2016 WL 4769436).

Recently, the courts have relaxed champerty prohibitions on third-party litigation financing. For example, in the context of a financing arrangement with a law firm client, the Court of Appeals in New York has held that "to acquire indemnification rights to the costs of past litigation" is not champerty (*Merrill Lynch v. Love Funding Corp.*, 13 N.Y.3d 190, 202-03 (2009)). (For more information on the decision, see Article, In Dispute: Love Funding.) Similarly, New York

courts have accepted litigation finance for a law firm. (See *Hamilton Capital VII, LLC, v. Khorrami, LLP*, 2015 WL 4920281 (Sup. Ct. N.Y. Co. Aug. 17, 2015) (noting that alternative litigation finance furthers the policy of favoring that cases be decided on their merits instead of based on the greater financial resources of one party and holding that financing of law firm did not run afoul of a prohibition on lawyer splitting fee with non-lawyer or restrictions on usury); *Lawsuit Funding LLC v. Lessoff*, 2013 WL 6409971 (Sup. Ct. N.Y. Co. Dec. 4, 2013).)

However, in the extreme scenario where a party without any relationship to the underlying claim or a valid assignment of the claim takes over litigation of the claim as the purported "plaintiff" for a share of the proceeds and remits the majority of the proceeds to the real party in interest, New York's champerty prohibition applies (*Justinian Capital v. WestLB AG*, 2016 WL 6270071 (N.Y. Oct. 27, 2016) (finding champertous an assignment arrangement where purported assignee of securities claims paid no consideration for assignment but nonetheless sued as plaintiff, with the understanding that the majority of the proceeds from such claim would be remitted to the actual injured party; the court found that New York's safe harbor rule that assignment of claims for \$500,000 or more is not champertous did not apply because the contract did not properly bind the assignee to pay the stated consideration)).

Additional examples of recently relaxed champerty restrictions on third-party litigation financing have occurred in the following states:

- Delaware (*Charge Injection Techs., Inc. v. E.I. DuPont De Nemours & Co.*, 2016 WL 937400 (Del. Super. Ct. Mar. 9, 2016)).
- Florida (*Kraft v. Mason*, 668 So.2d 679, 683 (Fla. Dist. Ct. App. 1996)).
- Texas (*Anglo-Dutch Petroleum Int'l v. Haskell*, 193 S.W.3d 87, 104-05 (Tex. App. 2006)).
- Massachusetts (*Saladini v. Righellis*, 687 N.E.2d 1224, 1226 (Mass. 1997)).
- South Carolina (*Osprey, Inc. v. Cabana Ltd. P'ship*, 532 S.E.2d 269, 277-78 (S.C. 2000)).
- Illinois (*Miller UK Ltd. v. Caterpillar, Inc.*, 17 F. Supp. 3d 711 (N.D. Ill. Jan. 6, 2014)).

In most states today, because champerty has been either abolished or narrowly defined, it can usually be avoided by properly structuring the investment or limiting the funder's influence on the litigation (see American Bar Association Commission on Ethics 20/20 White Paper on Alternative Litigation Finance).

CLIENT CONFIDENTIALITY AND THE ATTORNEY-CLIENT PRIVILEGE

When evaluating a prospective investment in a claim, a funder must conduct due diligence on the various parties and their claims and defenses. After making an investment, the funder will want to monitor it, including the progress of the litigation and any conclusion that results in the collection of proceeds to which the funder may be partially entitled. A funder may look at public information on potential claims (such as pleadings) if the litigation has already commenced. However, it may want additional information from the claimant and its litigation counsel, especially before committing to an investment in a lawsuit.

Risk of Waiver

Attorneys have an ethical duty to preserve a client's confidential information. Therefore, litigation counsel should not disclose information to a third-party funder without explaining the risks of doing so to the client and obtaining the client's informed consent (American Bar Association Model Rules of Professional Conduct (MRPC) Rule 1.6(a)). The principal risk is that sharing information with a third-party litigation funder might waive the attorney-client privilege and, although less likely, the work-product protection. These waivers could:

- Subject privileged information to discovery by the adverse party.
- Damage the claimant's case (and consequently, damage the funder's investment).

For example, in *Leader Technologies, Inc. v. Facebook, Inc.*, the court compelled disclosure in discovery of documents shared with financing companies during discussions about potential financing, rejecting the argument that the documents were protected by the common interest exception to the waiver of the attorney-client privilege (719 F. Supp. 2d 373, 376-77 (D. Del. 2010); see also *Litigation Funders Face Discovery Woes*, Nat'l L.J., Feb. 21, 2011). However, a court has held that disclosure to prospective investors of documents reflecting the plaintiff's litigation strategy did not waive the work-product protection (*Mondis Tech. Ltd. v. LG Elecs., Inc.*, 2011 WL 1714304 (E.D. Tex. May 4, 2011); *Viamedia, Inc. v. Comcast Corp., et al.*, 218 F. Supp. 3d 674 (N.D. Ill. November 4, 2016) (finding that due diligence documents shared between claimant and litigation funder did not waive the work-product doctrine because it did not make it more likely that the information would fall into the hands of the defendants)). A bankruptcy court also held that the work product doctrine protected from discovery certain parts of the dispute funding agreement and opinion-related communications between the client, the client's attorney, and the funder (*In re International Oil Trading Company, LLC*, 548 B.R. 825 (Bankr. S.D. Fla. 2016)). Additionally, courts have found that information shared with an investor under "controlled conditions" and as part of a confidentiality, common interest and non-disclosure agreement is protected by both the attorney-client privilege and the work product doctrine (*Devon IT, Inc. v. IBM Corp.*, 2012 WL 4748160 (E.D. Pa. Sept. 27, 2012); *Doe v. Society of Missionaries of Sacred Heart et al.*, 2014 WL 1715376 (N.D. Ill. May 1, 2014)).

On April 3, 2018, Wisconsin enacted a new statute requiring the disclosure of third-party dispute funding agreements in civil actions filed in state court (2017 Wisconsin Act 235 (Apr. 2018)). Under Wisconsin Act 235, "a party shall, without awaiting a discovery request, provide to the other parties any agreement under which any person, other than an attorney permitted to charge a contingent fee representing a party, has a right to receive compensation that is contingent on and sourced from any proceeds of the civil action, by settlement, judgment, or otherwise." However, Wisconsin Act 235 does not address the potentially privileged nature of certain terms within funding agreements (for example, economic terms) that may reveal risk assessment in the nature of mental impressions and opinions of litigation that several courts have found are protected by the work product doctrine and can be redacted (for example, *In re: International Oil Trading Co.*, 548 B.R. 825 (citing *Carlyle Investment Management LLC v. Moonmouth Co.*, 2015 WL 778846 (Del. Ch. 2015); *Charge Injection Techs., Inc. v. E.I. DuPont De Nemours & Co.*, 2015 WL 1540520 (Del. Super. Ct. 2015)) (permitting the redaction of terms, including payment terms in a funding agreement, to prevent disclosure of attorney mental impressions and opinions)).

Nonetheless, even if a litigation funding agreement is produced in discovery, a court may exclude the evidence at trial for lack of relevance or risk of prejudice (or both) under FRE 403 (*AVM Technologies, LLC v. Intel Corporation*, 15-33-RGA (D. Del.) April 28, 2017)).

Claim Evaluation with Limited, Non-Privileged Information

Because the consequences of waiving privilege are detrimental to both the claimant and the funder, they have a mutual interest in avoiding a privilege waiver. Therefore, they must tread carefully when exchanging information about the claimant's case.

Although concerns about waiver limit a funder's ability to conduct due diligence and increase the risk of the funder's investment, usually these concerns do not prevent the funder from obtaining sufficient information to evaluate a prospective investment in a claim. This situation is similar to attorneys who work on a contingency fee basis and routinely determine whether a litigation is worthy of investment despite incomplete or uncertain information.

In any event, the claimant may disclose the underlying documents and other information that:

- Are not privileged.
- It reasonably expects will be disclosed to the adverse party during discovery in the litigation.

Using that information and other data it may collect, the funder can assess the claim.

After the funder makes an investment, the claimant's litigation counsel may report on developments in the case that are either publicly available or already disclosed to the adverse party, subject to any protective order or other confidentiality limits. Usually this type of information is enough to allow the funder to monitor the litigation, typically as a passive investor, without compromising the claimant's attorney-client privilege.

COUNSEL'S DUTY OF LOYALTY AND INDEPENDENCE

Litigation counsel owes a duty of loyalty to a client. This duty requires litigation counsel to act in the client's best interests and give the client independent legal advice without interference from third parties, even if a third party pays the attorney (MRPC Rule 1.7). An attorney cannot serve parties with conflicting interests (MRPC Rules 1.7, 1.8(f), and 5.4(c)). However, an attorney may have an interest in the outcome of a civil case because an attorney may contract with a client for a reasonable contingency fee (MRPC Rule 1.8(i)(2)).

Ethical duties of loyalty and independence play a critical role in third-party litigation financing. For example, a third party with an interest in the outcome of the claimant's litigation may be financing litigation counsel's legal fees and costs directly or indirectly through the claimant. Insurers play a similar role in providing litigation financing for defendants. Insurance companies usually contract for the right to be involved in the defense and settlement of a case subject to acting in good faith and respecting the interests of the insured.

In theory, funders of affirmative claims have room to engage in a similar role in exchange for their funding, but responsible investors will use extreme caution to avoid that level of involvement. A third-party funder who controls the litigation may run afoul of litigation counsel's ethical duties of loyalty and independence in addition to

champerty laws (see Champerty and Maintenance). Therefore, third-party funders usually do not:

- Hire or terminate litigation counsel.
- Direct litigation strategy.
- Make settlement decisions.

A Florida state appeals court concluded that a funder who controlled the litigation in these ways rose to the level of a party to the lawsuit and therefore was liable for the defendant's attorneys' fees and costs (*Abu-Chazaleh v. Chaul*, 36 So.3d 691, 693-94 (Fla. 3d DCA 2009)). However, funders of commercial claims usually do not try to exercise this amount of control over the litigation.

FUNDER CONSIDERATIONS IN EVALUATING A CLAIM

A litigation financing company evaluating a claim for potential investment analyzes issues relating to:

- Adverse risk selection and moral hazard.
- The merits of the claim and potential damages available.
- Possible obstacles to recovering damages.
- Reasons to decline a funding opportunity unrelated to the merits of the claim or collection risks.

ADVERSE RISK SELECTION AND MORAL HAZARD

A funder faces two significant structural challenges when evaluating a claim for potential funding:

- Adverse risk selection.
- Moral hazard.

The funder must avoid investing in a lawsuit for a company that seeks third-party funding only for matters with the highest risk profile and the lowest chance of success while self-funding all of the company's less risky litigation investments. Frequently, the funder is at an informational disadvantage because the claimant is unable to share important case information due to privilege or other restrictions, such as court-ordered confidentiality. This makes it especially difficult for the funder to evaluate fully the risks that accompany specific cases. As a result, a funder is always at risk of having a portfolio of funded lawsuits that are adversely selected toward litigations with a higher risk of unsuccessful outcomes.

The funder also faces the possibility of moral hazard, by which the litigation counsel or the claimant (or both) can behave in a way that is detrimental to the funder after the financing transaction has closed and the funding arrangement is in place. This is because the funder is precluded from controlling litigation or settlement decisions in most jurisdictions due to champerty and related restrictions.

Therefore, while the funder's investment itself reduces the client's risk and investment of resources (and possibly disincentivizes the client to make the best litigation or settlement decisions), the funder is unable to protect itself by controlling those decisions. In effect, the funder faces the challenge of deploying significant capital into a lawsuit that could have a very high risk profile. The possibility of moral hazard on the part of the claimant and its litigation counsel is usually accounted for in the funder's pricing of its investment by, for example, increasing the funder's prospective share of any settlement or damages award.

Although the funder is usually a passive investor, in some situations concerns may arise regarding the client's control over settlement

decisions. In general, between a client and its attorney, the client has the sole authority to decide whether to settle a civil lawsuit (MRPC Rule 1.2(a)). This is inherent in the fiduciary nature of the attorney-client relationship. While it has been suggested that a client could, in an arms-length transaction, give up some of its authority over settlements to a funder (see American Bar Association Commission on Ethics 20/20 White Paper on Alternative Litigation Finance), a responsible funder will be extremely careful in this area and, as a practical matter, will seek only to protect itself against fraud or bad faith.

Aligning Incentives

To overcome the challenges of adverse risk selection and moral hazard, the interests of the claimant, its litigation counsel and the funder must be aligned. The funder compensates for its lack of information and control by structuring the transaction to ensure that all of the parties have the same incentives. Accomplishing this requires true risk sharing; that is, the claimant and its litigation counsel must be at risk of meaningful loss alongside the funder. However, in many situations the funder is more insistent that litigation counsel share the risk than that the claimant do so. This is because litigation counsel is often a better judge of the risk than the claimant itself, and litigation counsel's role is usually critical in determining the dispute's outcome.

Litigation counsel's time and budget has a substantial embedded profit margin. This makes the funder's and litigation counsel's respective investments unequal so that designing a risk-aligning transaction with litigation counsel is often imperfect. Therefore, the funder seeks to structure a transaction in which the funder and litigation counsel are investing and sharing risk in a parallel fashion, with the funder investing alongside litigation counsel as each incremental dollar is spent on fees or disbursements in the case. This way the funder knows that litigation counsel is putting at least some of the law firm's resources (principally, the investment of billable attorney time) at risk as the case proceeds.

Usually, specific arrangements are individually negotiated and dependent on other terms, such as fee caps where the attorney's total paid fee apart from a contingent component is limited to a certain amount. As an example, the funder or the claimant may negotiate a reduced billing rate with litigation counsel (such as 60% of counsel's standard rate). When the claimant is either awarded damages or settles the case for a favorable amount, the percentage of fees that was withheld during the litigation (in this example, 40%) is paid to litigation counsel upon recovery after the funder has been paid. Moreover, the claimant's agreement with its litigation counsel would likely include a provision to pay counsel a contingent bonus or kicker tied to a metric for success with respect to the proceeds recovered. Although this may not guarantee a perfect alignment of interests (or guarantee a successful outcome), if properly done and carefully underwritten, this type of deal structure can help ensure that interests are sufficiently aligned to protect the funder against true adverse risk selection.

MERITS OF THE CLAIM AND POTENTIAL DAMAGES

To conduct adequate due diligence and underwrite a litigation financing transaction, the funder tries to understand a potential claim's risks as much as possible, despite the funder's likely inability to obtain full case information. Understanding risk includes analyzing

the merits of the legal claims and the potential damages available. The funder also tries to understand:

- How long the matter is likely to last.
- The nature of the parties and their litigation counsel.
- Any ethical or regulatory concerns that may arise.

An important consideration in this analysis is whether the outcome of the case can turn one way or another based on a single factual finding or legal conclusion by the jury or court, or additional risks that the financing transaction's structure cannot address (for example, unusual collection risks such as recoveries that depend on pursuing foreign assets). The funder tries to avoid these risks and, if it accepts them, prices the investment appropriately by increasing its prospective share of any settlement or damages award.

POSSIBLE OBSTACLES TO RECOVERING DAMAGES

An important consideration in a funder's analysis is the risk that the client will not be able to collect its award even if it succeeds on the merits of its claims. If available assets are not readily identifiable, independent investigation or discovery in the litigation may be required.

Collection efforts occasionally involve the challenge of pursuing assets both in the US and abroad, possibly in multiple foreign jurisdictions. This can involve substantial expense and added legal risk, as a successful recovery may require expertise in the laws and procedures of multiple foreign jurisdictions. In some instances, the corporate structure of the defendant may require reliance on a veil-piercing or other theory that permits direct access to the assets of a related entity that is better able to satisfy the judgment. The credit-worthiness of the defendant also can be an issue when the defendant (possibly because of the judgment itself) is at risk of insolvency. Finally, there may be situations where political considerations within a given country can be an obstacle to a US entity's ability to collect from a local concern.

REASONS A FUNDER MAY REJECT A CLAIM

There are several reasons a funder may decline a funding opportunity that have nothing to do with the merits of the case or the risks of collection. For example, the dispute may implicate domestic or international political issues that entail risks or uncertainties that the funder does not want to bear. Alternatively, the case may be against a party that the funder does not want to be seen as investing against. In other circumstances, the case may relate to sensitive or controversial subject matter with which the investor simply does not want to be associated. Additionally, a funder who also invests in public securities may turn down an opportunity that would restrict its ability to trade public securities because as a litigation investor it would be privy to confidential information about the applicable claims and litigants.

APPLICATION PROCESS FOR THIRD-PARTY LITIGATION FINANCING

Although most litigation financing arrangements are heavily negotiated and customized transactions, the funding process usually involves some or all of the following basic steps:

- Preparing for the funder's assessment of the claim.
- Conducting due diligence for the funder's initial evaluation of the claim.
- Executing the financing agreement.

PREPARING FOR ASSESSMENT

As part of the traditional, early-case assessment process, a claimant should consider whether the claim should be pursued. This analysis may include:

- Identifying and reviewing key documents and witnesses.
- Analyzing legal theories.
- Assessing potential monetary recoveries.

For additional issues that plaintiff's counsel should consider before commencing a lawsuit in federal district court, see Practice Note, *Commencing a Federal Lawsuit: Initial Considerations* ([3-504-0061](#)).

If the claimant decides to pursue third-party litigation financing, it should prepare relevant case materials for the funder, but only after consulting with litigation counsel to avoid sharing any materials that may implicate a waiver of privilege or breach of confidentiality (see Client Confidentiality and the Attorney-Client Privilege). Examples of potentially relevant case materials include:

- Primary documents relied on in the case (for example, the operative contract).
- Likely evidence (such as correspondence and witness statements).
- Key court documents filed in an already pending case.
- Non-privileged documents analyzing and supporting the legal claims and the damages sought.

Additionally, the claimant should provide the funder with an estimated budget for legal fees and expenses, preferably broken down into the various expected stages of the litigation. For a monthly litigation budget template for estimating or calculating projected or actual legal fees and expenses, see Standard Document, *Litigation Budget Template* ([7-525-8883](#)). For a flowchart that can help calculate the costs of litigating throughout a case's various stages see Case Assessment Decision Tree and Costs Worksheet ([3-525-9318](#)).

INITIAL EVALUATION

The funder's evaluation process usually begins with a confidential (but not privileged) meeting or conversation in which the claimant or its litigation counsel describes the matter generally, and the funder describes its products and potential funding solutions. If this initial discussion confirms their mutual interest, the parties execute a formal confidentiality agreement to facilitate more in-depth discussions.

The confidentiality agreement is mutual. The funder agrees to keep confidential any information or materials provided by the claimant, and the claimant agrees to keep confidential any information regarding the funder's proprietary products and process. However, all parties must bear in mind that the confidentiality agreement may not shield the communications between the funder and the claimant (and the claimant's litigation counsel) from discovery in litigation. For more information on confidentiality agreements, see Standard Document, *Confidentiality Agreement: General (Mutual)* ([1-501-7108](#)).

Term Sheet

After the initial confidential meeting, the client provides case-related information and documentation to the funder. During one or more conversations or meetings, the funder and the claimant (and frequently, the claimant's litigation counsel) discuss the claims and the parties' proposed economic terms for the transaction.

If the funder's initial evaluation of the case suggests that it makes sense to develop a transaction, and the funder and the claimant can agree on initial economic terms, the parties execute a non-binding term sheet. Although this term sheet outlines the parties' understanding of the parameters of a potential transaction, it is understood at this stage that the terms of the potential transaction may require adjustment based on the funder's evolving evaluation of the case following more extensive due diligence.

Underwriting Due Diligence and Investment Decision

After the term sheet is executed, the funder conducts a deep dive into the matter's legal and factual issues. This includes analyzing the claim's legal merits and potential recoveries, as well as several other important factors that vary from case to case, such as:

- The nature of the parties and their litigation counsel.
- The likely amount of time before resolution.
- The potential for resolution on legal issues without a jury determination.
- The collection risks.
- The nature of the court or forum.
- The unique ethical or reputational issues.

A funder's simple due diligence checklist typically includes some of the following issues:

- **Merits of the case.** What are the strengths and weaknesses of the legal arguments the claimant will make? What are the strengths and weaknesses of the supporting evidence? What arguments and evidence will the opposing party use in defense?
- **Damages.** What is the proper measure of damages for the claims asserted? How likely is it that the claimant can prove its damages at trial? What level of damages might the claimant achieve in settlement?
- **Collection.** Is the defendant financially able to pay a judgment? If not, are other payment sources available, such as from the defendant's liability insurance? Will collection require additional investigation or litigation?
- **Duration.** How long will it take for the case to reach a resolution, including any appeal?
- **Legal fees and costs.** What are the estimated legal fees and costs for the case?

For more information on estimating the cost of litigation, see Practice Note, *Commencing a Federal Lawsuit: Estimate the Cost of Litigation* ([3-504-0061](#)).

As with other financings, potential investments typically go through a vetting process after due diligence is complete. For example, an underwriting or investment committee or similar group may review the due diligence information and will either reject or approve the financing, subject to certain conditions and final documentation.

EXECUTING THE FINANCING AGREEMENT

If the funder's underwriting criteria are met, and the parties come to a final agreement on economic terms, the parties execute a definitive financing agreement. Because litigation counsel may have a stake in the agreement's terms, clients who do not have in-house counsel may wish to consider having independent outside counsel

not involved with the case negotiate and review these agreements. Where court approval of the transaction may be required, the agreement terms should account for any additional considerations imposed by the judge, such as that the terms of the financing be economically reasonable under the circumstances (see *Forsythe v. ESC Fund Mgmt. Co.*, 2013 WL 458373 (Del. Ch. Feb. 6, 2013)).

LITIGATION FINANCING PRODUCTS, DEAL STRUCTURES, AND PRICING

Most third-party litigation financing in the commercial claims segment of the market focuses on large, business-to-business litigation and arbitration across the full range of commercial disputes, such as:

- Breach of contract.
- Antitrust violations.
- Trade secret, copyright and patent infringement.
- Cross-border investment disputes and other international arbitration claims.
- Joint venture or non-class shareholder disputes.

A transaction in this market segment may require the funder to invest between \$500,000 and \$10 million or more to fund the litigation (this segment does not include personal injury or consumer class actions).

TYPES OF PRODUCTS

There is substantial creativity in the litigation financing community, and many funders may want to explore and develop transactions for cases or programs across a wide range of products and deal types. Generally, funders provide the following types of products for the commercial claims market segment:

- **Early-stage funding.** In this situation, attorneys' fees and case disbursements are borne by a combination of the litigation counsel, funder and claimant. From the claimant's perspective, this product looks like a contingency fee arrangement. However, instead of litigation counsel handling the matter on a full contingency fee basis, it pursues it on a partial contingency fee basis with the funder making up all or most of the balance.
- **Claim monetization.** In this case, funds are used for general company purposes, rather than for prosecuting the litigation. This is used where the claimant has the litigation fees and costs covered but needs immediate liquidity for other business uses. The funder provides the amount of the monetization at closing, and receives its return from any proceeds recovered on the claim.
- **Funding case disbursements or out-of-pocket expenses.** This type of funding is applicable for early or later stage cases when litigation counsel has accepted the case on a contingency fee basis but it (or the claimant) cannot, or prefers not to, fund disbursements or out-of-pocket costs. This allows litigation counsel to invest its time, rather than its cash.
- **Appeals hedging or monetization.** For judgments on appeal (or verdicts in post-trial proceedings), the funder provides liquidity or a simple guarantee of a portion of the judgment amount.
- **Law Firm Portfolio Financing.** This is a direct funding to a law firm, whereby a funder advances money to help fund a pool of contingency cases in exchange for a fixed return at a specified waterfall of recovery. The funder's investment is non-recourse and

can be recovered only out of the agreed pool of contingency cases. This arrangement allows a law firm to share risk and take on more contingency cases.

PROGRAMMATIC SOLUTIONS AND NON-CASH RECEIVABLES

Generally, funders in the commercial claims market segment are underwriting and investing in individual, large affirmative cases. However, financing is also available for programmatic recovery operations. Rather than focusing on one-off, individual situations, a funder might engage in a longer-term relationship with a client, providing financing for a range of related matters.

One prime example is an intellectual property enforcement program against numerous targets (or other recurring types of claims) that may be individually small but substantial in the aggregate. In these situations, the principal relief typically sought is cash, although there are valuation mechanisms possible where the principal relief is a business solution rather than monetary damages. The funder typically negotiates a return consisting of a cash payment when the individual cases in the program are resolved or based on the resolution of a group of cases. Transaction documents generally include a mechanism for valuing any non-cash assets (for example, cross-licenses or contractual concessions by the adverse party) recovered by the client.

Although forward-running royalties in intellectual property cases may be substantial, many funders may prefer a pre-set payout mechanism instead of a revenue stream. Nonetheless, if the business opportunity looks attractive, large, sophisticated funders may be willing to be paid out over time or carry a non-cash asset. It may also be possible to monetize the future payment stream through a financial institution, such as an investment bank.

Additionally, an investor may be able to provide solutions to assist a client with post-judgment enforcement and collection efforts, such as:

- Financing a collateral collection action.
- Monetizing a portion of the judgment.
- Hedging some of the collection risk.

PRICING

Third-party litigation financing agreements are individually negotiated deals that must be structured according to the unique facts of the case. Pricing is an important part of these negotiations because it reflects the degree of risk the funder assumes. Pricing terms, for example, depend heavily on the parties' respective assessments of the potential recovery available despite the risks presented. A funder's analysis of the risk of loss may include a variety of factors, such as:

- The strength of the claim.
- The amount to be invested.
- The duration of the investment.
- The potential collection risks.

Financing companies may weigh pricing and risk factors differently and may provide varying pricing structures for different situations. For example, different pricing factors may come into play when the funder and claimant have an existing relationship, or when the claimant's litigation counsel has a specialized skill set or reputation with respect to the claim's subject matter. Therefore, pricing and returns vary, sometimes widely, based on:

- The characteristics of the individual claim.
- The due diligence and analysis of the funder and the claimant.
- The bargaining process between the funder and the claimant.

In light of these highly individualized and case-specific factors, it is not useful to cite typical or average pricing across the dispute financing industry, or even across specific market segments or product types. Calculating an average pricing range is made more difficult by the fact that investors have many ways of pricing transactions. For example, the return may be a multiple of invested capital or a percentage of the recovery (or some combination of the two). Or, the return may be calculated as a specific internal rate of return on the invested capital. In some unusual circumstances, it may be appropriate to use a different metric entirely. For example, if the funded litigation enables the client to achieve an injunctive, transactional, or other strategic objective, the pricing might reflect some of the new business value that has been created, although not specifically based on the metrics described above.

POST-INVESTMENT ROLE OF THE FUNDER

After the financing transaction is closed, the funder monitors developments in the case as it progresses until the matter is finally resolved. Because the funder must continue to be vigilant with respect to privilege and confidentiality limitations, its monitoring is usually limited to:

- Examining publicly available case filings (which sometimes may be unavailable or redacted due to protective orders).
- Receiving reports from the claimant and its litigation counsel that comply with any applicable restrictions.
- Reviewing documents not subject to privilege or otherwise protected by a confidentiality agreement between the claimant and the defendant.

In some instances, it can take several years for a case to reach a resolution. If the case is resolved favorably, the funder is entitled to payment according to the financing agreement. Depending on the financing agreement, payment may be made or secured through cash, securities, liens, escrow accounts, or a combination of these.

ABOUT PRACTICAL LAW

Practical Law provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

If you are not currently a subscriber, we invite you to take a trial of our online services at [legalsolutions.com/practical-law](https://www.legalsolutions.com/practical-law). For more information or to schedule training, call **1-800-733-2889** or e-mail referenceattorneys@tr.com.