LITIGATION FINANCE JOURNAL

Spotlight Interview – Howard Shams

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In another Spotlight Interview, Michael McDonald, PHD sits down to discuss litigation finance with Parabellum Capital's Managing Principal, Howard Shams.

McDonald: What is the most important consideration for an investor when approaching the asset class.

Shams: Any investor new to the asset class should realize that "litigation finance" is a broad term encompassing a variety of investment strategies. While it's colloquially used to describe an investment that will be affected by a litigation outcome, there are many different strategies that will yield different results, create different risk profiles, suffer different tax consequences and even raise different ethics issues. Managers may promote the idea that they are a "one stop shop" for solutions, but investors may find that strategy dilutive and undisciplined.

McDonald: Can you elaborate?

Shams: Sure. There are investors who invest in capital structure instruments (i.e., stocks or bonds) whose price will likely move depending upon a litigation result. But buying capital structure instruments creates correlation to the financial markets and investors may be seeking non-correlation. There are other investors who loan money to law firms against portfolios of contingency cases. But "lending", even when non-recourse, means fixed income rather than equity returns. And that type of lending often includes lending against mass tort cases, which has more reputational and other non-economic risks than a typical commercial matter. And there are investors that will happily hedge or monetize the risk of an adverse appellate outcome. But that comes with more binary risk and volatility. None of these strategies are bad. But investors should understand the specific investment thesis of their managers in order to establish coherence and discipline in portfolio construction.

McDonald: Is there anything else of significant importance?

Shams: Well, investors should understand that the structure of the manager itself impacts investment. Collectively, there are probably several billion dollars invested, or committed to be invested, in litigation risk investments. But a large asset manager may need to deploy significant capital and therefore may be forced to chase after larger opportunities. A publicly traded firm, interested in creating enterprise value to enhance their stock price, may want to do things that achieve that objective. A hedge fund, seeking more immediate performance, may have very different risk parameters. Investment style is often derivative to manager structure.

McDonald: Where do you see yourself fitting in?

Shams: Parabellum focuses mainly on early-stage, single-case investments that can provide equity-like returns. We stress alignment of interests between ourselves, law firms and their clients. Indeed, we obsess about it. Naturally we also underwrite extensively, do thorough due diligence and model possible outcomes and return scenarios. And our underwriting is formidable. But we place a great deal of emphasis on alignment because it's so critical to risk management, in particular minimizing the risk of adverse selection.

McDonald: Does hedge fund involvement and the entrance of individuals concern you?

Shams: Candidly, yes. In particular, the capital may not fully research and understand important boundaries of privilege and the complex ethics landscape especially the risk of impermissible lawyer-fee sharing. Inexperience means new investors may also be less sensitive to reputational risk issues in the subject matter of the litigation, or fail to fully delve into background issues of the plaintiff. There is also the real possibility that inexperience leads to adverse publicity or calls for unwarranted regulation.

McDonald: Is increased competition leading to a mispricing of risk?

Shams: As a team, we spend a great deal of time thinking about this. We see a lot of flow and are surprised sometimes at the aggressive pricing that other firms are showing.

McDonald: Why is that?

Shams: I think different analysts can have different views of the risks inherent in litigation. But all sophisticated thinkers understand that litigation presents "knowable unknowables" – risks that cannot be anticipated or therefore appraised even if you feel you have a good read on the law. It's easy to see sense the danger of a "race to the bottom".

For example, in the mass tort lending space, interest rates have dropped substantially in the past 18-24 months as new entrants have come into the market. Funds have capital and they need to deploy it. We understand that. But, generally speaking, we're not so sure current pricing properly compensates for the risks involved. In the mass tort space, for example, people used to lend in the high 20's, even 30%. Today, we're seeing lending at 12 – 14 %. Has the risk really been cut in half? Were things so dramatically over-priced before? We're not so sure that's the case. Time will tell.

McDonald: Why have we seen relatively little interest from traditional institutional investors like CalPERs in litigation finance compared to other niche alternatives like venture capital, reinsurance of cat bonds, or real assets?

Shams: We've actually seen substantial interest from institutional investors. The asset class has a number of things going for it, including an outstanding return profile and the fact that it is uncorrelated to markets. There are a range of institutional investors including endowments and pension funds that have invested with us. And then there are the single or multi-family offices, many of which are so substantial that they look and act a lot like institutions.

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But as with any new asset class, I would think you should expect that it's going to take time for large institutions, with layers of approval including their consultants and boards, to make commitments. In particular, there is a lot of scrutiny just because of the word "litigation". As with anything new, it takes time for people to acclimate. And they are. But as usual, first movers will get rewarded for their ability to approach the unfamiliar.

Michael McDonald is an assistant professor of finance at Fairfield University in Connecticut. He holds a PhD in finance. Michael consults extensively with organizations ranging from Fortune 500 companies to start-up businesses on financial matters through Morning Investments Consulting. Michael has served as an expert witness in legal disputes, and is an arbitrator with the Financial Industry National Regulatory Authority (FINRA). Michael can be reached at M.McDonald@MorningInvestmentsCT.com.

Howard Shams co-founded Parabellum and serves as a Managing Principal. Mr. Shams is a former Managing Director of Credit Suisse, the global investment bank. During his 15 year tenure at the bank, Mr. Shams was a senior manager within the bank's Leveraged Finance Business Unit and a member of the Global Credit Products Operating Committee. He also served as Head of Special Situations, responsible for developing niche strategies and new accretive businesses for the group, especially to the extent focused on unusual or developing asset classes. In 2006, he began the Legal Risk Strategies & Finance business at Credit Suisse, which was the first institutional commercial litigation finance business of its kind, and which ultimately spun off the bank's platform as Parabellum Capital.