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MASTERING LITIGATION FINANCE: A GUIDE FOR LAWYERS

LAKE WHILLANS

ABOVE THE LAW

MASTERING LITIGATION FINANCE: A GUIDE FOR LAWYERS

There's little doubt that litigation funding is gaining ever-increasing traction, with studies repeatedly showing increases in the scale and momentum of the field's development and acceptance.

Indeed, a rapidly growing number of lawyers are gaining firsthand experience with third-party funding, and a strong majority say they will use it again.

The following is a collection of advice from the litigation finance experts at Lake Whillans, addressing high-level topics to deepen your understanding of this burgeoning area of the law.

Our hope is that this information will serve as a starting point in helping you to determine whether to consider litigation finance for a particular matter — and how to best go about utilizing it if you decide to proceed.

Litigation finance continues to evolve and be used in unique and complex ways. Lake Whillans is well-positioned to discuss the individual circumstances of a company or law firm, drawing on its years of experience structuring similar deals. To learn more about how litigation finance could help your company or firm, contact Lake Whillans.

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THE 'FLAVORS' OF LITIGATION FINANCE

The growth of litigation finance (also known as litigation funding or third-party funding) has been a hot topic in recent years, but even if you've heard of the general concept, you may be less familiar with the range of litigation finance options. Much like other forms of finance, there are different structures that can meet the needs of a particular claimholder, matter, and/or firm. This article will review the basic features of a litigation finance investment and describe some of the different structures or "flavors" of litigation finance. Lake Whillans has and will transact in any of the "flavors" described below.

THE CONE — NON-RECOURSE CAPITAL

All forms of litigation finance share a common feature, which is the non-recourse provision of capital in connection with a legal claim (or set of claims). That means that the funder receives a return on its investment only if the underlying case or set of claims is successful, but if the case fails, the funder is owed nothing. In the successful scenario, the litigation financier recovers its invested capital, plus a portion of the litigation proceeds. The allocation of proceeds between the claimholder and the funder (and counsel where counsel has a contingent stake) will depend on terms negotiated at the outset and memorialized in the funding agreement, which is generally structured as a purchase of the claim proceeds. Lake Whillans aims to structure deals such that the majority of the proceeds remains with the claimholder.

PLAIN VANILLA — SINGLE-CASE FINANCE

In the simplest structure, the funder enters an agreement with the claimholder to pay the legal fees and expenses associated with litigating a single case (e.g., lawyer and experts). This enables the claimholder to remove from its balance sheet the risk of pursuing the claim: because the claimholder does not spend its own capital on legal expenses, there is no hit to the balance sheet on an unpredictable and ongoing basis. Although the claimholder must keep the funder apprised of developments as the case progresses, the claimholder maintains independent control over case strategy. For example, the claimholder decides whether to accept any settlement offer. Lake Whillans funds single cases pending in U.S or Canadian courts, or in an arbitration proceeding worldwide. For a single case investment, we generally invest between $1-$15 million and a flexible rule of thumb is that the anticipated damages should exceed the invested amount by a factor of ten.

One variable in a single-case litigation finance deal is how much risk the claimholder's counsel takes on. At one end of the spectrum, the funder is paying 100% of the legal fees at the counsel's standard hourly rate as amounts come due as well as the other expenses associated with the litigation or arbitration. At the other extreme, counsel may agree to take the case on a full contingency for the legal fees, and the funder is only paying for other expenses associated with the litigation (e.g., experts and other out-of-pocket expenses). Often a deal will fall somewhere in the middle: the lawyers will be guaranteed a certain payment from the funder (either a percentage of its earned fees or all its fees up to a cap), but will still have some "skin in the game," generally either as a contingent percentage of proceeds or an additional percentage on the unpaid fees. The flexibility to negotiate such arrangements with counsel and a funder makes it possible for a claimholder to select from a wider range of counsel than if it were to choose only among lawyers willing to work on full contingency, and allows firms to offer alternative structures that balance the need for certain and ongoing income with sharing in potential upside. Unlike some funders, Lake Whillans does not require that the firm take risk in order for us to fund a matter, but we are open to sharing risk with a firm.

RUM RAISIN — DEFENSE-SIDE FUNDING

Most often, in a single-case financing, litigation funders are financing the claimholder who is seeking monetary damages, from which the funder can take its share if successfully obtained. However, in some instances, we are able to finance a defendant. Funding is available to a defendant when a "win" for that defendant allows it to continue to hold some right or asset, which is tied to an income stream that can be shared with the funder. A common fact pattern we encounter is when a defendant is sued for breach of contract and the plaintiff seeks a declaratory judgment that the contract is terminated, and a "win" for the defendant means it continues to hold the right to continue to perform the contract and reap its benefits. For example, that could be the continued exclusive right to sell or distribute a product in a certain geography pursuant to a distribution agreement, or continued rights to valuable IP under a license agreement. Lake Whillans' return in those examples would come from the revenue earned from the product sales that were able to continue after successfully defending the claims. (Or from a settlement that included a buy-out of the contractual rights). Other examples where defense-side funding might work include disputes over ownership of real estate or companies or other monetizable assets.

NEAPOLITAN — PORTFOLIO FINANCE

Although single-case funding dominated litigation finance in its early years, portfolio funding has become increasingly central to the industry as it has matured. In a portfolio funding deal, the litigation financier invests in a set of claims either held by the same claimholder or litigated by the same law firm. By aggregating claims, a claimholder can generally obtain funding at a lower cost of capital: the funder is willing to accept a lower return because investing in a portfolio is less risky than investing in a single claim with a binary outcome.

For companies, portfolios may include a few larger claims or a number of smaller claims that may not otherwise have been pursued. The financing may be used not only to support the costs of the portfolio of affirmative claims, but may also include additional amounts given directly to the company that can be used to pay legal costs for matters in which the company is a defendant.

For a law firm, a portfolio funding deal can enable it to take cases on contingency or grow a book of contingency cases at reduced risk to the firm. The funder will provide capital to the firm based on the expected contingent fees it may receive from the portfolio. The firm can use this capital to pay the recurring expenses of the firm, smooth cash flow, and/or grow the firm while the cases are ongoing. This type of funding can be particularly useful for firms involved in a number of cases that have many years ahead before likely monetization or for a firm that is actively growing in order to service existing cases and attract new ones. For firms just beginning to build a contingency portfolio, either internally driven or because of client-pressures to do so, funding can ease the cash flow challenges and mitigate the risk of contingency arrangements. The structure and pricing of these transactions can vary depending on the size of the portfolio, the risk associated with it, the quantum and timing of cash flows, whether the case portfolio is fixed or growing, as well as other factors.

COOKIE DOUGH — MONETIZATION OF CLAIMS

Whether a litigation funding agreement covers a single case or a portfolio of cases, it may include monetization of underlying claims. This means that the funder will pay a portion of the anticipated recovery directly to the claimholder based on the claim's expected value and time to monetization. The capital provided to the claimholder need not be used for the litigation costs, but by the claimholder for an array of purposes, including operating expenses, servicing debt, R&D, or a host of other purposes. Monetization could be part or all of a single case or portfolio finance deal. For example, this structure may be attractive to a claimholder after it has secured a judgment or arbitration award, but is facing a lengthy appeal or collection battle and would benefit from obtaining capital today rather than waiting months or years. Lake Whillans is also able to make outright purchases of claims that are susceptible to valuation, but still carry litigation and timing risk, for example, claims for class members in large antitrust matters (e.g., we are able to purchase or finance claims in the pending Visa Mastercard antitrust litigation).

For a claimholder with limited resources, upfront monetization can provide non-recourse capital to fund operating expenses of the business while it endures the potentially lengthy litigation of its claim. For a large corporate, this structure can be useful to self-fund the legal department with respect to other legal expenses, and thus mitigating the legal department's status as a pure cost center.

Ultimately, every litigation finance deal is unique, and the structure and terms will depend on a broad range of variables. These include the value at stake relative to the projected litigation cost, the strength of the claims, the finances of the claimholder and defendant, the stage of the litigation, and anticipated obstacles to enforcing a favorable judgment. An experienced provider of litigation finance will tailor a funding agreement to meet the needs of the claimholder, counsel, and funder.

WHY DO CORPORATE LEGAL DEPARTMENTS TURN TO LITIGATION FUNDING?

In the previous article, we explained what litigation financing is and the various structures or “flavors” that are typical in the market. But why are companies using it? Is it only cash-strapped companies that look to litigation funding? While filling the budget gap is certainly one benefit, there are multiple reasons why litigation finance is gaining in popularity with corporate general counsels’ offices.

RISK MITIGATION

First, using outside financing allows companies to mitigate the risk from litigation. It’s a fact of life for large companies that they will eventually have to sue somebody. But even when the claim has merit and it’s important to protect the business, it’s not news that the C-suite will not cheer the budget drain, even if it’s a healthy company. Further, litigation is inherently unpredictable; there may be unpleasant surprises during discovery, and in the end, the case is in the hands of a judge or jury. Corporate officers don’t like that risk, or the unpredictable costs that come along with litigation, which make budgeting difficult.

Litigation finance solves those problems. In the typical litigation finance deal, the plaintiff in a complex commercial lawsuit (or portfolio of claims) with a high value — Lake Whillans looks for cases or portfolios with damages in excess of $20 million — receives capital in exchange for allowing the financier to share in the proceeds of the litigation. The capital can be used to pay the legal fees and expenses of the litigation, and in some instances, used by the company for other corporate purposes. Lake Whillans typically supplies $1 million to $15 million for single case financing. The financing is non-recourse, meaning that the company has no obligation to the funder if the claim isn’t successful or doesn’t yield a sufficient amount.

THE BENEFITS OF OFF-BALANCE SHEET FINANCING

Litigation financing has clear advantages for the plaintiff company, starting with the fact that it enables the company to take the litigation cost off its balance sheet. At a publicly traded company, litigation costs are reported on the company’s statement of profits and losses as an expense against profits. Any eventual financial recovery from the litigation would be reported, too — but it would be reported as an “extraordinary event” rather than profit, and that could be years down the road. Thus, litigation drags down the company’s profitability without a corresponding benefit at the end. By financing the litigation, however, a corporate law department can cover its legal costs using the litigation funder’s capital and take the litigation expense off its balance sheet entirely. That means the statement of profits and losses more accurately reflects the company’s true profitability. For companies focused on valuation, for example if the company is anticipating a capital raise, acquisition, IPO, or other strategic transaction where its valuation is important, keeping costs off-balance sheet has huge benefits. Especially when valuation is calculated by applying an earnings multiple, every dollar not subtracted as legal costs means multiple dollars of value in a valuation.

OPTIMAL PURSUIT OF THE CLAIMS

Litigation finance can enable companies to make optimal decisions with respect to litigation. To start, a company can choose the best lawyers suited for its case, rather than ones that fit within a constrained budget or are willing to work on a contingency. Further, with the department’s legal costs covered, it no longer has to weigh its legal strategy against the costs created by a hostile opponent, such as extended discovery or aggressive pretrial motions. Every decision can be made according to the best interests of the litigation, even if that means spending that might have otherwise pushed the legal budget into the red. A company can avoid being forced to accept an under-value settlement offer because the legal spend is ballooning at an inopportune time for the company and/or the litigation is dragging on longer than expected. And if the case unexpectedly ends with a loss, the department loses no money, because the legal fees were already paid through litigation financing.

RAISING CAPITAL

Furthermore, because litigation finance raises capital, it can allow the company to pursue priorities that it might otherwise not be able to afford. That starts with the litigation itself. Sometimes, a lawsuit may be meritorious but too expensive to pursue, particularly for a smaller company without a lot of excess capital. Or, for some larger companies, where legal spend is apportioned or siloed among different business entities, one business line's budget may be insufficient to fund the litigation. Litigation finance can fill that gap, freeing companies to vindicate their rights without stretching themselves thin financially.

Even without that issue, extra capital (either as saved litigation expense or infused capital) can fund an expansion of a business, cover operating expenses or finance any other company priorities that might otherwise be out of reach. By monetizing its litigation asset, companies can unlock the value of that asset at a time that fits their needs.

AN EXPERIENCED ALLY

Finally, litigation finance can provide more expertise to bear on litigation decisions, validating a corporate legal department's decision to pursue claims. Because litigation finance firms have every incentive to value a claim properly and accurately predict its success, you can be assured that we will thoroughly and critically analyze your claim's chances as well as collection and enforcement risks. Lake Whillans employs a team of lawyers experienced with the kinds of claims we finance, so that opinion will be highly informed, providing an objective opinion before the company makes a decision to pursue litigation, which may have economic, reputational, and opportunity cost risks. The funder's imprimatur on a case may help a GC or other advocate of the litigation overcome internal skepticism and disputes within the organization about the worthwhileness of pursuing the claims. An experienced funder can also add value in selecting counsel, setting and negotiating realistic budgets with law firms, and can help prepare the attorneys litigating the case by asking the hard questions during the diligence process, and can be a knowledgeable sounding board for strategic and settlement decisions. (Lake Whillans does not control settlement or strategy of the cases it funds, but will offer its input when asked). By partnering with a litigation finance company like Lake Whillans, the corporate legal department is recruiting an experienced ally that shares the same incentive to maximize the value of the claims, which is ultimately the goal of any litigation.

IT'S NEVER TOO EARLY OR TOO LATE TO SEEK LITIGATION FINANCE

In light of the rapidly shifting economy, many law firms and their clients are facing greater challenges in financing meritorious litigation. Litigants are taking stock of their cases and the path forward, mindful of increased pressure to reduce and conserve budgets. Law firms are assessing potentially heightened collection risks. In this uncertain environment, litigation funders like Lake Whillans stand ready to serve as a resource to both claimholders and law firms.

If you lead a corporation that holds monetizable litigation claims, the potential advantages of litigation finance as a risk-reduction mechanism merit careful attention. Similarly, if you lead a law firm that is bringing claims on a contingent fee basis, you may wish to explore the benefits of receiving upfront, non-recourse funding collateralized by a portfolio of the firm's contingent fee cases.

As claimholders review their portfolios of pending and potential litigation, they should be aware that litigation funding is an option not just at the outset of a case, but at any stage prior to collecting on a judgment or arbitral award. This article will consider the pros and cons of three potential entry points for litigation funding: at the outset of the case, midstream, and post-judgment. Lake Whillans has experience funding cases at every stage.

AT THE OUTSET

Engaging a funder at the outset of litigation — before the case is filed — has several advantages. Most obviously, the earlier the funder is engaged, the sooner the company or law firm can receive funding and reduce or stop entirely its own spend. Claimholders may be reluctant to initiate litigation or arbitration without a well-developed plan for funding fees and costs, so funding at this stage may be necessary to enable cases to go forward. Litigation finance enables a claimant to conserve more of its capital for use in core business operations, a benefit that is particularly valuable in times of economic uncertainty. Potential claimholders should note that some litigation funding agreements provide working capital to the claimant corporation in addition to covering litigation expenses.

Another benefit to seeking funding at the outset is the opportunity to test the merits and likely damages using the funder's expertise. The diligence process that experienced funders like Lake Whillans conduct before making an investment decision can be an invaluable opportunity to receive feedback from a sophisticated, impartial outsider on the strengths and weaknesses of the claimholder's case. Counsel can adjust the framing of the claims in response to that feedback, strengthening the case before it is presented to the court or arbitral tribunal. This stress test and external validation can also help overcome internal reluctance some company management may have to bringing claims in this uncertain environment.

Pricing for an early stage case may be more expensive than for later stage cases. This is primarily due to two factors: risk and time to return. From a risk perspective, early stage claims are generally viewed as riskier than later stage claims that have been tested in court — for example, by surviving a motion to dismiss and engaging in discovery — and where a defendant's defenses are generally known. From a time to return perspective, early stage claims are generally viewed as taking longer to return than cases that are closer to final resolution. Of course, each case is unique and specific pricing would turn on the specific circumstances attendant to each claim.

MIDSTREAM

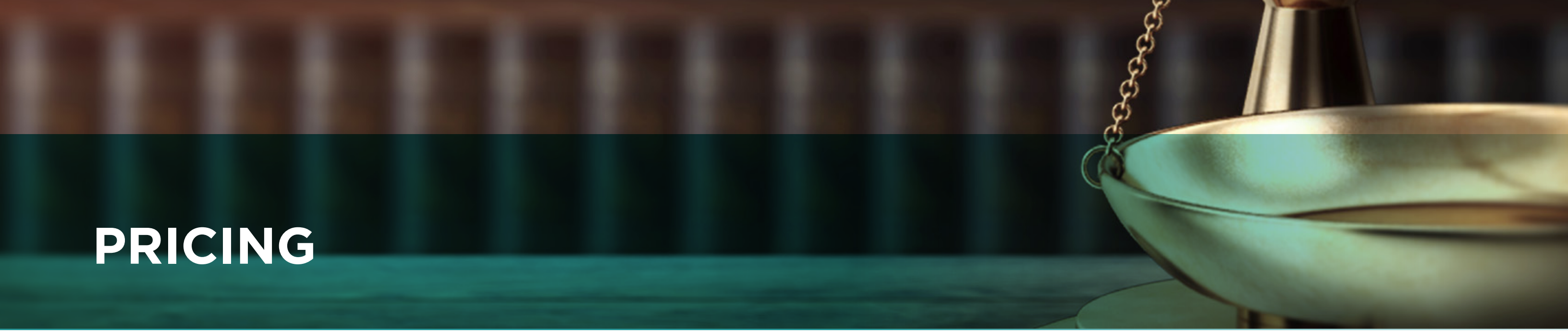
In some cases, an opportune time to seek funding is midstream, often after the case has survived initial procedural hurdles and fact discovery is well underway or complete, but before a trial begins. Litigation fees and expenses may be climbing steadily amidst discovery, depositions and the need to retain experts — an unwelcome fact to businesses already struggling to cope with the current environment. In some instances, claimants that initially planned to fund a case to completion find an unexpected mismatch between the actual litigation costs and its initial budget, which may have been underestimated or necessarily reduced in the current economic climate. Litigation fatigue may be setting in as hope for an early settlement has faded. Mitigating risk at this stage may simply be prudent for the claimant, while a litigation funder can enable such a claimant (and its counsel) to continue to optimally pursue the case. The good news: at this stage, the funder's capital may be cheaper because the claims have demonstrated greater viability than at the outset of the case, especially if discovery and court rulings have been favorable to the party seeking funding.

POST-JUDGMENT/AWARD

A claimant may also decide to seek funding after securing a favorable judgment or arbitral award but before collecting the proceeds. Such funding can be used not only to finance further proceedings, but to monetize a claim, thereby hedging the risk of loss and bringing significant dollars onto the balance sheet today. Bringing in a funder at this stage can be especially prudent if there are appellate, enforcement or collection risks. Common instances of litigation finance at this stage include (i) monetizing a case that has had a favorable trial outcome but for which a (perhaps lengthy) appeals process is yet to play out; (ii) funding for enforcement and collection efforts that may require proceedings in multiple jurisdictions of uncertain length and cost; and (iii) monetizing a company's share of a proposed settlement in a large class action, where the anticipated payout may be subject to appellate and time risk. In all of these scenarios, the corporation may prefer to monetize all or some of the judgment/award immediately, especially if its liquidity needs have changed.

Generally, funding at this stage of the case can yield the most favorable pricing for the claimholder. The main downside of waiting until this late stage to engage a funder is that the claimant likely had to invest significant capital to fund the pre-judgment phase of the case and is at risk for not recouping its capital if an unfavorable outcome ensues, and may have already suffered opportunity costs by not allocating that capital to core business activities.

Whatever the stage of the case, claimholders should bear in mind that litigation funders are available to assist at any stage of their case. An experienced provider of litigation finance will be happy to discuss the optimal timing of a potential investment, considering the nature of the claim, the expected timetable of the litigation, and the claimant's risk tolerance.



PRICING

By now you've likely heard about litigation finance and some of the advantages it can offer to claimholders (in a nutshell, the flexibility to pursue a claim without having to pay attorneys' fees or other costs from the company's balance sheet, as well as the ability to monetize all or a portion of a claim). "Sounds great," you might be thinking, "but how much is this going to cost me?"

This article will review the basic pricing structures that litigation funders typically employ and the reasons why a claimholder may prefer one approach over another. At Lake Whillans, we have transacted using each of these pricing structures, and approach each transaction flexibly with the mindset of utilizing whatever structure works best for the claimholder. Further, we provide pricing early in the process; you can generally expect to have terms from us within 5-10 days of reaching out to discuss your matter.

FACTORS DRIVING LITIGATION FINANCE PRICING

Litigation funders consider two primary factors when setting pricing for an investment: risk level and timeline of the case. For a funder, investments in a single litigation or arbitration claim involves significant risk. Funders provide capital on a non-recourse basis, meaning that if the claim fails, the funder loses its entire investment. The greater the risk that a case will fail to achieve a return, the greater the cost of funding will be. Key drivers of the risk level of a case are the strength of the claim (and any defenses), the certainty and amount of damages, and likelihood of collection. When claims are bundled in a portfolio, the risk of loss is generally mitigated to a degree (as long as the claims do not all turn on the same risk), and therefore portfolios will generally receive lower pricing than a single claim.

As for timeline, the longer the funder anticipates its capital will be tied up, the greater the return the funder needs to reflect the time value of money. Key drivers of the timeline of a case include the stage of the case at the time of investment, the type of case, and the particular decision maker (i.e., the court/judge/tribunal). Litigation funders can make an investment at any stage, ranging from before the case has been filed through to after a judgment has been secured (but before it has been collected). Early-stage cases tend to be riskier and to have a longer timeline than later-stage cases, and the pricing will reflect those differences.

Given the high degree of uncertainty inherent to a litigation investment, funders naturally must require a larger return than, for example, a bank would earn on a fully secured recourse commercial loan. At the same time, responsible funders agree that the claimholder should keep the majority of any litigation proceeds. An experienced funder like Lake Whillans will work with the claimholder to structure a funding agreement that makes sense for all parties. Responsible funders will model various outcomes in terms of timeline, range of awards, and settlement projections, and may decline to fund a case if, in the likely scenarios, too little is left for the claimholder, in particular when the funding would prevent the claimholder from accepting a reasonable settlement.

FIXED MULTIPLE VS. PERCENTAGE OF LITIGATION PROCEEDS

There are two basic models for structuring a litigation funder's return on capital: fixed multiple and percentage of proceeds, and a combination of both is often utilized. In the fixed multiple model, the funder recoups its capital along with a multiple of the amount it invested. The multiple can vary over the duration of the case: for example, the funder may be entitled to a multiple of 0.5 on capital invested if the capital is returned within a year and then to a larger multiple as time increases. As an example of this type of arrangement, suppose the funding agreement entitles the funder to (i) return of the capital it invested plus (ii) a 2x multiple on the capital invested. Let's suppose the capital invested is $1 million; when the matter concludes successfully, the funder would receive $1 million as return of capital, plus a 2x multiple or $2 million for a total of $3 million. (This might be referred to as 3x pricing since the funder receives 3x what it put in).

In a percentage of proceeds model, the funder recoups (i) return of its invested capital plus (ii) a percentage of the proceeds from the litigation, 20% for example. So using our $1 million investment hypothetical, if the claim recovers $10 million, the funder receives $1 million plus 20% of $10 million (i.e., $2.0 million) for a total of $3.0 million. In the percentage model, the funder's share of proceeds may be subject to a maximum dollar amount, or the percentage may decrease as the award size increases.

These two basic models can also be combined. The funder may be entitled to a certain multiple, plus an additional percentage return. In this hybrid structure, both the multiple and the percentage return are smaller than in a pure fixed multiple or percentage structure, but the combination of the two provides a risk-balanced approach to account for the possibility of achieving either the low end or high end of possible award size outcomes, which we will demonstrate below.

REASONS TO PREFER A GIVEN MODEL

A claimholder's preference for a given pricing model will depend largely on its risk tolerance and its assessment of the expected recovery relative to the funder's investment. In our above example, assuming a $1 million investment and a $10 million return, the 3x pricing and the 20% of proceeds model yield the same result for funder and claimholder ($3 million to funder/ $7 million to claimholder). But the ratio changes depending on the size of the award.

In our example, if the award comes in at the high end of the expected range at $20 million, the 3x multiple pricing yields the funder the same $3 million, and the claimholder receives $17 million (or 85%). But if it was priced using the return of capital plus 20%, the funder recovers $5 million, and the claimholder receives $15 million (or 75%). Thus, if the claimholder expects a large recovery (as compared to the capital provided by the funder), it might prefer a fixed multiple model because the claimholder retains more of the upside in a high-recovery scenario.

The converse is also true: in a low-recovery scenario, the fixed multiple is relatively more favorable to the funder. Using the same example, if the award is $5 million, the 3x multiple pricing again yields $3 million for the funder, and the claimholder receives $2 million (or 40%). This result would likely be undesirable to the claimholder, so it may prefer the return of capital plus percentage model. Applying the return of capital plus 20% pricing would yield $2 million to the funder and the claimholder would receive $3 million (or 60%). Thus, if the claimholder wants to protect against the downside risk of a lower recovery, it may prefer a percentage of proceeds model, in which it has to share more of the upside in the high-recovery scenario but is relatively more protected in the low-recovery scenario.

Of course, the funder's view of the case and its risk tolerance will also inform the pricing it prefers, and a hybrid model provides a compromise option that often appeals to both funder and claimholder. For example, hybrid pricing may include (i) return of capital, plus (ii) a 1x multiple plus (iii) 10% of proceeds. If the award yields $10 million, the split is the same ($3 million to funder, $7 million to claimholder) as it was in our two pricing examples above, but allots the risk/reward more equitably between funder and claimholder in the low recovery scenario ($2.5 million to funder, $2.5 million to claimholder) or the high recovery scenario ($4 million to funder and $16 million to claimholder).

THE RESERVED FACILITY VS. DISBURSED FUNDS

To further understand pricing, especially in the context of a fixed multiple return structure, it is important to be aware of the distinction between the reserved facility and amount disbursed. Funders typically do not pay out their full investment in one lump sum; instead the funder makes a series of payments over the course of the case. The reserved facility is the amount that the funder sets aside to cover its full (projected) investment. Disbursed funds are what the funder has paid out at any given point. For a case litigated through trial, the reserved facility may equal the amount disbursed. Conversely, if a settlement offer is accepted at an early stage, only a small proportion of the reserved facility is likely to have been disbursed.

From a claimholder's perspective, it may seem most appropriate to pay the multiple on the amount disbursed: why should the claimholder have to pay for funds it never actually receives? From the funder's perspective, however, the reserved facility is capital that cannot be used for other investments and is at risk from the moment it is reserved or committed, so if the case settles before a large portion of the earmarked funds have been disbursed, payment of the multiple only on the disbursed funds will result in a low return to the funder that may not adequately compensate it for the risk that it took. These conflicting aims are frequently addressed by pricing that is based on a multiple of amounts actually disbursed, coupled with a minimum return for the funder.

THE WATERFALL

The last key term of a pricing agreement is the waterfall. The waterfall is the order of priority in which shares of any recovery are paid to entitled parties, including the funder, the claimholder and, in some cases, counsel (if counsel has a contingent stake in the litigation).
A standard waterfall provides for the funder to recoup its invested capital before any other party is paid. The order of allocation of the remaining proceeds will be a product of negotiation, but it typically involves pro rata payments to the funder and counsel, based on their relative entitlements. The claimholder typically takes the remainder, after the funder and counsel have been paid.

For an experienced provider of litigation finance, each funding agreement is the product of careful assessment and discussion with the relevant stakeholders. There is no one-size-fits-all pricing structure. The best way to determine which structure best fits the needs of your situation is to discuss it with your provider.

LITIGATION FINANCE SOUNDS GOOD — BUT WHAT ROLE WILL THE FUNDER PLAY?

Much of the discussion of litigation finance naturally focuses on the underwriting phase of the funding process. In other sections, we discuss the variety of flavors of litigation finance deals and the fact that it's never too early or too late to seek funding. We've also discussed the pricing that a claimholder should expect in negotiating a litigation funding agreement.

But what about when all the terms have been agreed and both claimholder and funder have signed the funding agreement? What role does the funder play? Who controls settlement? And what type of interaction should a claimholder expect to have with the funder on an ongoing basis? And how do the mechanics of funding work? How does the money flow both for covering litigation expenses and for dividing the proceeds from a successful claim? Lake Whillans has seen many litigation funding investments through to their conclusion, and although each case has unique elements, there are some standard practices.

CONTROL OVER SETTLEMENT AND STRATEGY

Unless the funder has acquired the claim in its entirety, generally the funder has no right to control the litigation, and an experienced and reputable funder will not normally attempt to direct case strategy. For example, the funder should generally not have the contractual right to dictate things like what motions to file or not file, arguments to make or not make, experts to retain or witnesses to call. A good funder is in the business of making investments and not litigating cases, and will let the lawyers do the litigating. A typical Lake Whillans funding agreement will disclaim all rights to direct or control the conduct of the litigation. (Whether the funder's non-binding input is requested is a matter of preference and is discussed below).

Most importantly, in a Lake Whillans transaction, the claimholder generally retains full freedom to decide whether to accept any settlement offer. (While most funders operate this way, some may nonetheless include punitive economic terms or "hammer terms" if settlements that are beneficial to the funder are rejected by the claimholder).

Because settlement control will lie with the claimholder, it's important to make sure funder and claimholder incentives are aligned throughout the litigation and especially with respect to settlement offers. Funders seek to avoid the situation where the claimholder is incentivized to reject a fair settlement offer because the funder is the only one who will be paid from the settlement. For example, Lake Whillans would be unlikely to fund a case if a reasonable settlement is only $5 million, and the claimholder is seeking

COMMUNICATION

Claimholders and counsel often wonder (worry over) the role the funder will play once a case is funded. While ongoing communication is to be expected, funders like Lake Whillans will not play an intrusive role. At a minimum, the funding agreement will specify that the funder has a right to information about the progress of the case and to be informed of any major developments. (Such communication is generally protected from disclosure to adversaries: communications with the funder are understood to be protected at a minimum by the work product privilege.)

Beyond the contractually required updates, the frequency of communication between funder and claimholder is driven largely by the preferences of the claimholder and counsel, the size and experience of the claimholder's in-house legal team, the stage/activity level of the litigation or arbitration, and other idiosyncratic factors. Claimholder and counsel often come to view the funder as a valuable sounding board, between its deep familiarity with the case, its focus on the big picture as opposed to the day-to-day battles of litigation, and experience with similar situations in prior investments. Lake Whillans has engaged in a range of communication styles across its investments — from formal and less periodic updates, to ad-hoc communications as needed, to scheduled phone calls (generally monthly). It's been our experience that the process of getting to a transaction often forms a mutually respectful relationship that naturally lends itself to continuing constructive and desired communication.

DISBURSING FUNDS

Once the funding agreement is in place, the funder is of course under an obligation to disburse funds according to the parties' investment agreement. Lake Whillans will at the outset establish a reserved facility, representing an amount set aside to cover the full amount of the funder's commitment. (Some funders do not reserve the full amount of capital for the investment and, instead, rely on financial management to meet their investment commitments. It is always worthwhile for claimholders to ask prospective funders how they ensure that the investment commitment will be available.) Funders typically make a series of payments over the course of the case, drawing down on the reserved facility, which payments are triggered by different events depending on the nature of the investment.

If the transaction involves an upfront payment (which can be all or part of a transaction), that payment will be made promptly after the transaction closes, usually within 10 business days. (Upfront payments can include full or partial monetization of a claim paid to the claimholder or be used to pay counsel's outstanding accrued legal costs).

In a single-case investment that involves payments to the claimholder's counsel at hourly rates and/or for expenses, the law firm will send its standard periodic invoices to the claimholder, which are either forwarded or copied to the funder. The funder will pay those bills directly to the firm as they come due after being approved by the claimholder. If the funder has transacted with a law firm related to a portfolio of cases, payments will typically be made according to a specified schedule (including in some cases, all upfront), when the firm requests draws, or when certain milestones are reached.

DISTRIBUTION OF FUNDS UPON SUCCESSFUL RECOVERY

If the case succeeds and proceeds from the successful claim are collected, the recovery is usually placed in escrow and distributed to the funder, counsel, and claimholder as specified in the funding agreement. The agreement will contain a negotiated "waterfall" laying out the order of priority the recovery is to be paid to entitled parties. Typically, the funder recoups any capital it disbursed before any other party is paid and its profit either gets priority over the remaining stakeholders or, in some cases, shared pro rata with counsel (assuming that counsel has a contingent stake in the litigation) and/or the claimholder. The claimholder takes any remainder.

Ensuring a smooth interaction between funder, claimholder, and counsel begins with pre-investment due diligence. A claimholder seeking funding should assess whether a potential funder has a track record of working effectively with claimholders and counsel.

HOW TO CHOOSE A LITIGATION FUNDER

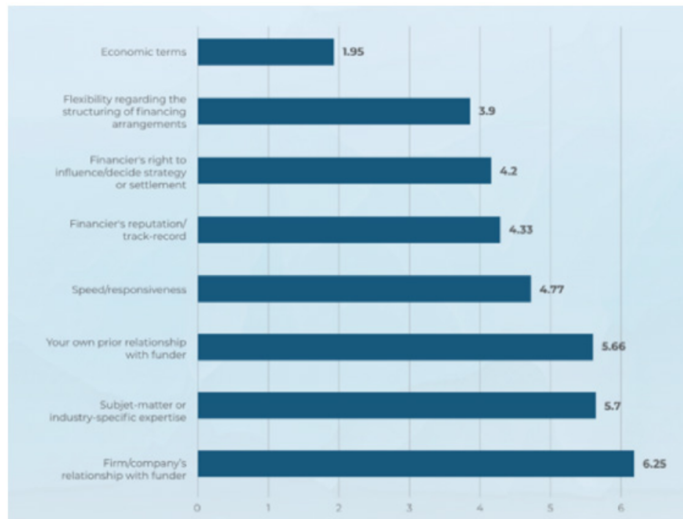
Litigation finance is growing in prominence in the legal industry, embraced not just by lawyers but also increasingly by courts and state bars. As lawyers and claimholders have come to understand the utility and flexibility of litigation finance, the demand for funding has increased, and so too has the number of funders in the market. Some funders (like Lake Whillans) focus exclusively on litigation financing, whereas others are incorporating litigation finance investments as part of a larger investment portfolio. Some funders are interested only in the highest-value disputes, whereas others target smaller investments. Some will fund a strong case in any area of commercial litigation, whereas others specialize in a more focused range of cases.

How are claimholders choosing among the increasing diversity of funding options? How should they be choosing? In this article we first present some empirical evidence on considerations in funder selection and then offer our advice, gleaned from our long experience in the litigation finance market.

HOW ARE CLAIMHOLDERS CHOOSING A FUNDER?

You might expect a claimholder who is new to litigation finance to begin with rankings such as those produced by Chambers & Partners. (Lake Whillans as a firm, and Lake Whillans co-founder Boaz Weinstein individually, each have been ranked among the top bands in every year that the Chambers rankings have been produced.) But although rankings may be the starting point, the primary factor in the ultimate decision is not which funder has the strongest reputation. Rather, lawyers report that the most important consideration is which funder offers the most favorable economic terms.

Lake Whillans and Above the Law conduct an annual survey of lawyers — both at law firms and in-house — to understand their perspective on litigation finance. In our 2021 edition, we asked respondents to rank eight factors in choosing a litigation funder, with “1” as most important and “8” as least important. Here are the results:



Partners and in-house counsel both identified economic terms as the most important consideration, but partners ascribed this factor greater relative importance, scoring it 1.77 as compared to 2.08 for in-house counsel. Both groups ordered their priorities nearly identically.

It isn’t surprising that the cost of capital is an important factor. After all, the headline cost figure is one of the simplest ways to compare across funders. But savvy claimholders and counsel understand that alignment on other dimensions besides cost is also critically important. In the next section we propose a more comprehensive set of factors to consider when deciding which funder(s) to approach.

WHAT FACTORS SHOULD CLAIMHOLDERS AND COUNSEL CONSIDER IN EVALUATING FUNDERS?

Preferred Investment Type. Funders vary in the types of cases they invest in, both with respect to claim type and forum, and may exclude certain types of claims. Lake Whillans invests in most commercial cases, including breaches of contract, breaches of fiduciary duty, business torts, trade secret misappropriation, antitrust, and investor-state disputes. We do not fund patent claims. We invest in single cases as well as portfolios (including law firm portfolios). We will fund litigation or arbitration pending in the U.S. or Canada, as well as international arbitration.

Preferred Investment Size. Funders often have a minimum and maximum investment size. Our typical investment ranges from $1.5-$10 million for single cases, and larger amounts for portfolios. (We are willing to consider investments of smaller or larger amounts under the right circumstances.) The size of the investment we are willing to make depends on the quantum of damages, likely settlement scenarios, the current posture of the matter, and other factors. Understanding your capital needs before you approach a funder can help you find the right one.

Required Risk Allocation Between Funder, Claimholder, and Counsel. Some funders prefer not to bear all the risk of the litigation and require the claimholder and counsel to "take risk." For the claimholder, that means using its own capital to pay at least some portion of the fees and expenses. For counsel, it means taking a contingent stake (i.e., upon success, the firm earns a percentage of the proceeds, fixed fee, or multiple on unrealized fees) in lieu of some portion of its ongoing fees. Distributing the risk this way may not be feasible or desirable for every claimholder or its counsel, so it's important to understand if risk-sharing is among a funder's requirements. (While we are open to transactions that involve risk-sharing, Lake Whillans does not require it.)

Reserved Capital. Litigation can take several years so you will want to be sure that the financier is able to make good on its commitments in the future. Ask whether the funder currently has sufficient committed capital to fully fund the investment? What percentage of the budget will the funder hold in reserve? (Lake Whillans reserves 100% of its committed investment amounts.)

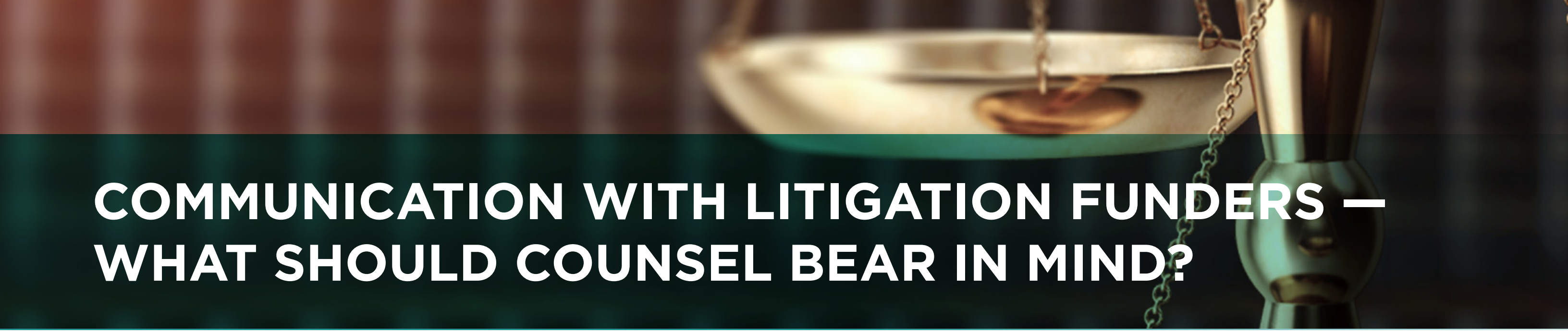
Right to Exit Funding. Speaking of getting to the finish line with resources in place, you should understand whether and under what conditions the funder can stop funding the litigation. For example, some funders may contract for a right to exit if there is a material negative change in the litigation (negative discovery, adverse ruling, etc.). These terms can leave the claimholder and counsel in a difficult place. In general, we underwrite our investments with those risks in mind and commit to funding cases to final resolution as defined for the particular investment.

Control Over Litigation or Settlement. Some funders may contract for direct or indirect control over the litigation or settlement. For example, while a funder may not have the authority to accept or deny a settlement offer, there may be terms that increase the cost of the funding if offers deemed reasonable by the funder are rejected. (Lake Whillans does not include provisions of this sort in its funding contracts.)

Other Points of Comparison. There are other differentiators that may be relevant in choosing among funders. Some examples include whether the funder requires exclusivity while it's conducting diligence (Lake Whillans does not), the speed at which a funder can arrive at a decision (we generally conduct our diligence within 30-45 days after reaching agreement on the economic terms), the funder's experience with the transaction type and with the subject matter, and the funder's flexibility in structuring the deal to meet the needs of the claimholder and its counsel.

Personal Compatibility. Finally, it's important to find the "right fit" when partnering with a funder. Size up potential funders during the first few discussions to decide whether you trust the people on the other end to be constructive partners through the ups and downs of litigation. One thing to consider in this regard is whether the funding team has experience with cases like yours. Funders who have been involved with similar cases can be a helpful sounding board over the course of the litigation. At the same time, you'll want to avoid funders who seem too eager to insert themselves in litigation strategy. Try to feel out a funder's typical approach to communication with counsel over the course of a case to ensure that expectations are aligned.

Applying a relatively short list of criteria, it's possible to choose efficiently the right funder(s) to approach for your matter.



COMMUNICATION WITH LITIGATION FUNDERS — WHAT SHOULD COUNSEL BEAR IN MIND?

Counsel who have not been through the process of raising litigation funding often have questions about the risks of disclosing confidential information about their client's case. The process of obtaining litigation funding necessarily involves sharing information about the facts, legal theories, damages and defenses of a claim, often coupled with discussions about the claimholder or counsel's views on the strengths and weaknesses of each. Cases are more likely to get funded when a robust dialogue is established on these topics. Nonetheless, counsel should be aware of where the boundaries lie, and how to protect their clients from inadvertent waivers and fulfill their professional responsibility obligations.

Our goal in this article is to provide insight into how information sharing with funders has been viewed by the courts and works in practice. Experienced funders like Lake Whillans are highly attuned to the case law pertaining to privilege waivers. As described below, we help counsel establish appropriate safeguards that enable us to conduct due diligence on potential investments without unduly jeopardizing privilege.

GUIDEPOSTS

Before proceeding further, counsel should consider what case law or rules will govern their conduct, and act accordingly. For example, in the context of arbitration, certain institutions have included rules that provide that communications with funders will not cause waiver. Several state jurisdictions, including for example Delaware and Illinois, have addressed privilege issues thoroughly in case law.

Absent specific guidelines, we recommend certain best practices based on existing rules and case law. First, the claimholder's counsel should discuss the matter with the client and obtain informed consent to the sharing of information. Second, counsel should consider whether any protective order or confidentiality agreement bears upon the claimholder's ability to share information, taking care to avoid violating any confidentiality obligation. Funders are regularly asked to acknowledge the terms of an applicable protective order. In some cases, the protective order may not permit sharing certain levels of information with the funder, and it's important to communicate with the funder about those limitations.

Third, counsel should ensure that a nondisclosure agreement is in place between the claimholder and potential funder before any confidential information is shared. Nondisclosure agreements are a routine precursor to due diligence in litigation finance, and any reputable funder will have a standard form for this purpose. The agreement will generally prohibit the funder from disclosing to third parties confidential information received from the claimholder or its counsel and may also include terms expressly acknowledging the common interest shared by the claimholder and funder.

AVOIDING WAIVER OF PRIVILEGES

Generally, sharing factual information (e.g., contracts, other documents, communications) with the funder will not pose any waiver issues. This is the material most likely to be disclosed during discovery, and important to a funder's evaluation.

When determining which potentially privileged materials to share with a potential funder, counsel must be mindful of both attorney-client privilege and attorney work product privilege. The general rule is that material covered solely by the attorney-client privilege should not be shared, but material also covered by the attorney work product can be shared without waiving that protection.

One example illustrating this distinction is that in a contract dispute, a claimholder should not provide a funder with the advice the client received from its counsel during the contract's negotiation that is privileged but isn't protected as work product. In contrast, memos that are prepared by counsel in anticipation of litigation analyzing the adversary's breaches and the strengths and weaknesses of the claims arising from the breach would be covered both by the attorney-client privilege and work product protection.

Although there is a strong argument that the common legal interest exception to waiver of attorney-client privilege should apply when information is provided to a prospective funder, the law governing this area is unsettled, and several cases have held that the exception does not apply. To avoid the risk of waiver, Lake Whillans makes clear to claimholders that they should not share with us any documents protected only by attorney-client privilege. A funder can generally conduct all necessary due diligence without receiving this material. In our example, the advice the client received about the contract during the negotiation process is unlikely to affect the outcome of claims about a subsequent breach of that agreement because the contract would be interpreted on its own terms and attorney-client advice that was not shared with third parties would normally not be disclosed in the litigation.

By contrast, the attorney work product privilege is generally not waived when information is shared with a funder. Where such information has been shared pursuant to a non-disclosure agreement, courts have found no waiver of the attorney work product privilege. The rationale is that the claimholder and funder have a common incentive to protect attorney work product from disclosure to the adversary and thus disclosure to the funder (particularly when an NDA is in place) is unlikely to substantially increase the risk that an adversary will receive the information, (the basic test which must be satisfied for work product waiver to occur). Thus, counsel can share with a prospective funder its mental impressions, conclusions, opinions, or legal research or theories, i.e., the quintessential work product that is a key factor in a funders’ analysis, without waiving the protection that applies to this material.

LITIGATION FINANCE AND STATE LAW — WHAT SHOULD COUNSEL KNOW?

At Lake Whillans, we frequently field questions about the legal issues surrounding litigation finance. One question that frequently comes up is whether legal doctrines such as champerty and maintenance impede litigation finance arrangements. For the most part, the doctrines of champerty and maintenance do not impede litigation finance arrangements. But the answer will depend significantly on the jurisdiction that you are in, and one step during the process of raising litigation finance includes diligence into the applicable law on these issues.

At the outset, it is worth noting that there is a clear trend among courts across the United States — especially in those forums with a concentration of commercial cases — towards removing obstacles to commercial litigation finance and clarifying that properly structured funding arrangements do not violate state law. In this article, we discuss the law in four prominent jurisdictions: New York, California, Illinois, and Delaware.

NEW YORK

New York has taken a statutory approach to defining the contours of investments in claims. What is left of the champerty doctrine is codified in Section 489 of New York's Judiciary Law, which bars "buy[ing] or tak[ing] an assignment of . . . a bond, promissory notes, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon." N.Y. Jud. Law § 489(1). Importantly, the statute contains a safe harbor provision that exempts transactions "having an aggregate purchase price of at least five hundred thousand dollars." Id. § 489(2). Litigation funders such as Lake Whillans generally make investments in excess of that amount, so the safe harbor would apply to most claim assignments that attract litigation funding. In any event, most litigation funding arrangements do not involve the assignment of a claim at all; rather, the more typical approach is for the claimholder to retain the claim, with the claimholder (or law firm) selling an interest in the potential future proceeds of the claim (or contingency fee earned). Such a transaction would thus appear to not implicate § 489 at all, and New York courts have repeatedly upheld the validity of funding agreements in the face of challenges. See, e.g., Hamilton Capital VII, LLC, I v. Khorrami, LLP, 2015 N.Y. Slip Op. 51199(U) (Sup. Ct. N.Y. County Aug. 17, 2015) (funder entitled to portion of law firm's gross revenues); Lawsuit Funding, LLC v. Lessoff, 2013 WL 6409971 (Sup. Ct. N.Y. County Dec. 4, 2013) (enforcing law firm portfolio deal).

As a general matter, courts applying New York law have found that a traditional litigation finance arrangement—where there exists uncertainty as to whether and when the funder will recover its investment—is not a loan and thereby exempt from usury laws. A recent case that might have given the New York Court of Appeals the opportunity to opine on this aspect of litigation funding is Fast Trak Investment v. Sax , which relates to New York's usury laws. Fast Trak involved a portfolio funding agreement between a funder and counsel, with the unusual twist that while both claimholder and counsel agreed to pay the funder a portion of proceeds from the funded case, the funder was also entitled to a portion of the fees counsel earned in separate cases not financed by the funder, in the event the primary case did not yield a specified minimum return. In this context, the Ninth Circuit certified to the New York Court of Appeals the question of: "Whether a litigation financing agreement may qualify as a 'loan' or a 'cover for usury' where the obligation of repayment arises not only upon and from the client's recovery of proceeds from such litigation but also upon and from the attorney's fees the client's lawyer may recover in unrelated litigation?" Before the Court of Appeals could hear the case, however, the parties withdrew certification and the appeal was dismissed. Fast Trak Inv. v. Sax, 18-17270 (9th Cir. Jul. 23, 2021).

CALIFORNIA

California practitioners need not worry about champerty—California law has never prohibited champerty or maintenance. See In re Cohen's Estate (1944) 66 Cal.App.2d 450 [152 P.2d 485]. The risk that a funding agreement could be held to violate California law is thus comparatively low.

However, counsel should take care to investigate the possibility of required disclosures in connection with a funding agreement. The federal district court for the Northern District of California has a standing order requiring "[i]n any proposed class, collective, or representative action" the disclosure of "any person or entity that is funding the prosecution of any claim or counterclaim." However, courts in that district have rejected efforts to force discovery in connection with litigation funding, and there is no obligation to produce the underlying funding agreement. MLC Intellectual Property, LLC v. Micron Technology, Inc., No. 14-cv-03657-SI, 2019 WL 118595, *1-2 (N.D. Cal. Jan. 7, 2019). And attempts to discover further information have also failed: in Impact Engine v. Google, that court denied a discovery request for materials related to a funding agreement, ruling that the materials were protected by the work product doctrine. Case No. 3:19-cv-01301, Dkt. No. 129 (S. D. Cal. Jul. 17, 2019).

While California is an outlier in its disclosure rule, recently, the District of New Jersey has adopted a local rule broader than California's that requires the disclosure of litigation finance arrangements for all cases. Discovery into the terms or other details related to funding is permitted only upon a showing of "good cause" by the opposing party that the funder is controlling the litigation, a conflict of interest exists, or class interests are not being protected or promoted. New Jersey is the only other district besides the Northern District of California to address litigation funding disclosure by rule. Other efforts to require disclosure have not gotten past the proposal stage, in part because rule makers have not been convinced of their necessity.

ILLINOIS

Illinois has also been an important source of decisions enabling the practice of litigation finance. The seminal case is Miller v. Caterpillar, which entailed breach of contract and trade secret misappropriation claims brought under the Illinois Trade Secret Act. 17 F. Supp. 3d 711 (N.D. Ill. 2014). The case was notable in part because it was one of the first instances of a party in U.S. litigation openly relying on funding. The arrangement was typical: the funder provided the smaller plaintiff company, Miller, with capital to pay for the legal fees and costs of the litigation in exchange for a share of any proceeds that Miller obtained. Defendant Caterpillar argued that the funding arrangement violated the Illinois statutory ban on maintenance, which dated back more than a century. The Miller court rejected that interpretation, noting that the maintenance statute prohibited "officious intermeddling" and holding that Miller's use of litigation funding could not be so characterized.

In addition, the court denied Caterpillar's request for discovery in relation to communications between Miller and the funders. It held that Miller had a reasonable expectation of confidentiality because the work product shared with the funders was provided subject to a non-disclosure agreement. Therefore, work product protection was not waived. The opinion has been persuasive authority in a number of other cases across various jurisdictions that also hold that work product protection applies to communications with funders.

DELAWARE

Consistent with the national trend, the Delaware Superior Court in 2016 rejected the argument that litigation funding constitutes champerty and maintenance despite the presence of common law applying those doctrines in the state. In Charge Injection Technologies v. DuPont, funded plaintiff CIT alleged that DuPont had wrongfully used and disclosed CIT's technology. DuPont contended that, while CIT had not assigned its claim, it was no longer the "real party in interest" and the agreement was champertous because the funder had "de facto control over the litigation." The court explained that the "historical justification for prohibiting any form of champerty or maintenance was to prevent disinterested third-parties from stirring up or encouraging fraudulent or frivolous lawsuits." Thus, the Court's focus was on whether CIT itself was inclined to bring the claim and whether the funder was controlling the litigation. The court found that the funding agreement—which was freely negotiated—did not give the funder any right to direct, control or settle the claims, and further that CIT did not agree with the funder to enforce claims that it was not itself disposed to prosecute. Thus, the funding arrangement did not constitute champerty or maintenance.

Delaware practitioners should also note a recent federal court decision confirming that materials shared with litigation funders are shielded from discovery by the work product doctrine. ELM 3DS Innovations LLC v. Samsung Elecs. Co., Case No. 14-1430-LPS, Dkt. No. 372 (D. Del. Nov. 19, 2020).

State law in relation to litigation funding continues to evolve, and counsel should try to keep abreast of new decisions. But the trend is clear: funding is becoming a standard part of the litigation landscape in every major U.S. forum, and a properly structured funding agreement is highly likely to withstand judicial scrutiny.

LITIGATION FUNDING IN BANKRUPTCY AND DISTRESSED SITUATIONS

Litigation finance provides a creative tool for companies to consider as they plan for what may be long-running and cost-intensive litigation.

Ed. note: Litigation finance is transforming the fields of both law and finance. To help our readers gain a better understanding of what litigation finance entails, we've partnered with Lake Whillans to present an ongoing series so you can better understand how litigation funding works, its pros and cons, and its past, present, and future.

The COVID-19 pandemic thrust law firm bankruptcy practices into the spotlight, with high-profile corporate bankruptcies reaching levels not seen since 2010. For example, over the course of 2020, S&P Global Market Intelligence counted 630 bankruptcies of public companies with either assets or liabilities valued at $2 million, or private companies with public debt and at least $10 million in assets or liabilities. (There were 578 such bankruptcies in 2019.)

At the same time, the disruption coincided with the growth of utilization of litigation finance as a tool for financing litigation. Add a bankruptcy environment where traditional sources of financing by outside lenders, creditors, and law firms may be constrained, it is unsurprising that restructuring attorneys and advisors are increasingly turning to litigation finance.

Litigation finance can preserve or increase estate resources for creditors and enable additional recoveries. Financing can be useful for debtors (or potential debtors), but can also be useful for creditors in intercreditor disputes or other matters and especially useful for a litigation or liquidation trust seeking to prosecute ongoing claims. Fortunately, courts are recognizing that funding can play an appropriate role in bankruptcy proceedings, with two recent district court opinions leaving intact funding arrangements approved by the bankruptcy court.

Lake Whillans has expertise with litigation finance in a variety of distressed situations. Below we describe some of the most common scenarios.

PRE-FILING

Companies in distress that have significant litigation or litigation-related claims may look to litigation finance to free up, or even increase, cash reserves through financing the costs of prosecuting a claim or by monetizing some or all of a claim. Litigation finance can provide these companies the necessary runway to see through recovery of the business and the realization of litigation proceeds.

DEBTOR FINANCING

Many bankruptcy estates have options with respect to debtor-in-possession ("DIP") financing from traditional lenders. But there may be instances where the estate's most valuable assets are litigation claims — in that case it may make sense to discuss potential DIP financing with a commercial litigation funder. Crystallex, for example, secured this very type of financing (in its Canadian bankruptcy proceeding) from a litigation funder to prosecute a $3.4 billion claim against Venezuela for expropriation of a gold mine it had developed. The Canadian court approved the funding agreement finding that "there is a single 'pot of gold' asset which, if realized, will provide significantly more than required to repay the creditors."

A federal district court in the Middle District of Florida recently rejected an appeal challenging the approval of a funding arrangement of this sort in Valley National Bank v. Warren. The chapter 11 liquidating trustee negotiated funding from a third-party to cover the costs of pursuing claims against a bank for aiding and abetting breach of fiduciary duty and for the avoidance and recovery of $3 million in fraudulent transfers. The bankruptcy court approved the arrangement finding that "the agreement best served the Debtors, creditors, and other parties" and that it is "neither champertous nor usurious." The defendant bank objected to the arrangement arguing that the "financial interests" of the funder could impair settlement negotiations. In its April 2021 opinion, the district court held that the bank lacked Article III standing to appeal the Bankruptcy Court's decision and failed the "person aggrieved" test that must be satisfied in order to appeal under the Bankruptcy Code.

CREDITOR FINANCING

In some bankruptcies, funding to pursue litigation claims has been provided by creditors to the estate. For example, in the National Events bankruptcy, a "litigation funding DIP" funded by creditors sought to investigate potential claims on behalf of the essentially defunct debtor. A related party also provided funding under DIP provisions in the Welded Construction bankruptcy, seeking to recover funds from a construction dispute. Styled as a litigation funding agreement, the arrangement also resolved some of the claims the funder had against the debtor due to its existing business relationship.

In Dean v. Seidel, a creditor of the bankruptcy estate agreed to advance up to $200,000 to chapter 7 trustee Seidel to fund the cost of litigation against third parties. As approved by the bankruptcy court in the Northern District of Texas in April 2021, the arrangement provided for the following split of any litigation proceeds: (1) pay the trustee's statutory commission and allowed expenses; (2) reimburse the advancing creditor; (3) pay that creditor a 30% return on investment; (4) distribute the remainder to creditors. On appeal to the district court, debtor Dean challenged the funding arrangement as permitting one creditor to receive a disproportionate share of litigation proceeds relative to similarly situated creditors, in violation of the priority scheme of Bankruptcy Code Section 507. Dean further asserted that any litigation recovery must be "for the benefit of the estate." The district court noted with some concern the lack of controlling case law regarding an agreement of this type, but applying a clear error standard of review, it affirmed the bankruptcy court. The Fifth Circuit affirmed the district court's ruling on standing grounds.

In the preceding examples, related parties presumably provided funding because they had the most to gain from successful litigation. However, an unrelated litigation funder could instead have funded the claims in coordination with the debtor and creditors of the estate. Engaging a litigation funder could be appealing if related parties and creditors are unwilling or unable to provide additional funding. It is also possible that a litigation funder — specialized in assessing litigation risk — may be able to provide funds at the lowest cost of capital.

SALE OF LITIGATION ASSETS

A bankruptcy estate can sell a stake in its litigation or litigation-related claims much in the same way that it sells other assets in its bankruptcy process. Many companies hold litigation-related assets, for example, in large class actions, and these can be sold like a traditional asset in a bankruptcy. Numerous companies have sold claims in the Visa Mastercard class action (In re Payment Card Interchange) through bankruptcy asset sales. (See, for example, Shopko's motion to sell its claim for $2.2 million during its bankruptcy process last year.)

Bankruptcy estates may also have more traditional litigation claims available for monetization during a bankruptcy process (including claims stemming from the bankruptcy itself). These claims are much harder for the estate to value and their continued prosecution often requires expenses and resources of the bankrupt entity or its representatives. A bankruptcy estate may wish to sell or monetize a portion of its litigation claims to accelerate cash recoveries for the estate, reduce or offset estate expenses (including funding the litigation), and hedge its risk of loss in the litigation. The most significant example of this type of sale was the 2016 sale of a judgment resulting from a jury award in the Magcorp bankruptcy pending an appeal following an intensive bidding and auction process. A litigation funder paid $26.2 million to acquire a $50 million interest in the judgment, which allowed creditors to be paid sooner, off-load some risk of a loss on appeal and to fund the appeals process itself.

LITIGATION OR LIQUIDATION TRUSTS

Litigation trusts and liquidation trusts can also be prime candidates for litigation funding. The establishment of these trusts generally allows for the confirmation of a plan of reorganization while litigation claims that may take years to play out continue to progress. The litigation trusts typically benefit unsecured creditors who might otherwise end up with little or nothing from the bankruptcy. These trusts sometimes receive seed funding from the estate or from beneficiaries of the trust or rely on contingency arrangements with law firms, but because the assets they hold are litigation-related, and because funds expended on the fees or expenses of litigation might otherwise be returned to creditors if not used for litigation, these trusts make excellent candidates for litigation funding.

The General Motors Avoidance Action presents a prime example of how this funding can be used. The long-running dispute stemmed from the alleged improper repayment of GM's term lenders during the automaker's bankruptcy. This intercreditor dispute centered on whether the term lender's security interest had been terminated prior to repayment and, if so, how much of the funds paid to the term lenders should have gone to other creditors. The action proceeded with $1.6 million in "seed" funding from the estate, but that amount and additional amounts provided by various funding sources, including the U.S. Department of Treasury and Export Development Canada and a private funder, were exhausted after lengthy litigation. Finally Lake Whillans (through an SPV) provided a $10 million facility in anticipation of trial. Eventually, the matter settled for $231 million, an amount that would certainly not have been possible without funding for the protracted and costly litigation that took nearly 10 years to resolve, and included a two-week representative trial that narrowed the issues between the parties.

To underscore how valuable this type of funding can be for a standalone litigation trust consider the Tropicana matter. After the casino operator went bankrupt in 2008, the estate eventually formed a litigation trust to pursue claims (backed largely by investor Carl Icahn) in an adversary proceeding against its former CEO. More than a decade later, those claims survived a summary judgment motion, which wouldn't have been possible without an additional cash infusion from Icahn and other funders in 2016.

As more restructuring professionals become aware of bankruptcy and district court decisions approving litigation funding in distressed situations, we expect litigation finance will be used with increasing infrequency in the bankruptcy context. Litigation finance provides a creative tool for companies to consider as they plan for what may be long-running and cost-intensive litigation. proceeding against its former CEO. More than a decade later, those claims survived a summary judgment motion, which wouldn't have been possible without an additional cash infusion from Icahn and other funders in 2016.

Litigation finance continues to evolve and be used in unique and complex ways. As an experienced provider of litigation finance, Lake Whillans recognizes that each funding agreement is the product of careful assessment and discussion with the relevant stakeholders based on individual circumstances.

For expert advice in navigating this terrain or to determine if your company or firm could benefit from litigation finance, please contact Lake Whillans.

LAKE WHILLANS