

Litigation Financing Brings Opportunities For PE Firms

By **Scott Ford and Kurt Steinkrauss** (April 27, 2018, 12:28 PM EDT)

Litigation financing has quickly grown from a fledgling concept into a robust industry. The core concept is simple: In exchange for a share of any proceeds, a financing source agrees to pay all or a portion of the plaintiff's legal fees on a nonrecourse basis. The industry generally focuses on corporate claims, and the range of subject matter of the underlying cases is wide, from intellectual property and trade secret disputes to standard breach of contract matters. Deal structure and sizes vary, particularly with regard to the parameters around the percentage of recovery and the amount of the total fees contributed (including caps).

The industry has matured and grown by answering and putting to rest some of the fundamental questions that were (and often still are) posed reflexively by both lawyers and the business community: Does the structure satisfy the ethical rules? How is the attorney-client privilege protected and preserved? Who controls litigation strategy and settlement? While the landscape is still evolving, both industry practice and court decisions: (1) confirm that properly structured deals satisfy ethical rules and do not violate arcane prohibitions on investing in lawsuits; (2) provide that careful adherence to the rules governing attorney-client privilege will avoid waiving the protections in communications with third-party financing sources; and (3) validate the fundamental concept that the client and its counsel, not the funding source, control litigation strategy and settlement.

Potential For PE Participation

There are at least four different opportunities for private equity firms in this area. First, PE firms have invested in litigation financing companies. Indeed, some funding firms exist as established and stand-alone PE funds seeking outside investment and focus only on litigation financing. Most funding firms are populated by a combination of experienced business professionals and attorneys, often with very impressive pedigrees and track records.

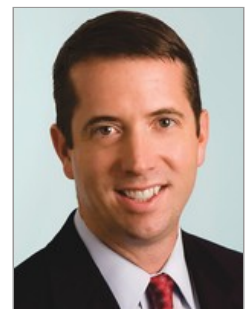
Second, PE firms can arrange for a financing firm to back a litigation for one of its existing portfolio companies, thus resulting in significant cost savings. The prospect of monetizing a potential claim (or set of claims, especially with regard to a company's patent portfolio) can be tantalizing. But, often, the weighted prospect of allocating the investment's cash given the risk of an uncertain recovery yields a highly defensible decision to forego litigation. Thus, if the expenses can be taken off the books, the decision becomes easier, even if the risk of recovery remains the same (though some assert that the backing of a funding company enhances the strength of a claim because it has been evaluated). Such an arrangement may also increase the value of the asset, positioning it for a sale.

Third, a secondary market is emerging in which the financing firms sell shares of a particular investment or case. For example, a financing firm may source and fund a litigation matter, but as the matter matures, it may be presented to a secondary market for additional investment. In this sense, the opportunity is akin to ways in which securities are divided into tranches and sold into submarkets. But, this secondary industry is still very much developing, and it should be watched carefully as a potential target for enhanced regulation.

Fourth, PE firms can use financing sources to reduce the price of a target company by carving out the liability for ongoing legal fees. For example, assume that a target company is valued at \$100 million, but it is embroiled in a trade secret case. That litigation presents a short-term drain on cash, but it also presents the prospect for recovery in the long term. A litigation funding source can serve as a partner in the deal, providing, hypothetically, \$10 million, thereby reducing the PE investment to \$90 million. On a going-



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forward basis, the risk and cash drain are mitigated, but the value of the target can be enhanced significantly, even if it is shared.

Key Considerations

Certain issues are critical in assessing a PE investment or involvement at any stage of the process. First, there must be comprehensive due diligence on the strength of the underlying claims. Simply because a funding source is willing to participate in a matter does not guarantee recovery, and there are significant internal costs and resource allocations at both the PE and portfolio levels that must be considered before embarking on any litigation.

Second, there must be confidence in the law firm handling the litigation. Both the firm's reputation and its prelitigation and in-case strategic decisions on the matter are important factors in maintaining the confidence of the client, its backers and the financing source.

Third, a full understanding of the opposing party, its counsel and the court must be obtained and considered. For example, if opposing counsel is known for not settling and taking cases to trial, the assessment of costs and risks of the matter is different than if opposing counsel comes into the matter seeking a quick settlement.

Fourth, a thorough investigation as to the ability to collect on any verdict should be performed, even before a suit is filed. A judgment may look great on paper, but it is worthless if it cannot be satisfied, and there are ways to determine collectability even before a case is brought, as well as means to secure and chase collections during and after the litigation. While a legal funding source will make these same considerations, they should also be done by a PE firm if it opts to participate in any level or cycle of the litigation funding industry.

Bottom Line

There are many developing options to mitigate the risks of litigation costs, including contingent fee agreements and alternative fee arrangements. But the litigation financing industry is quickly becoming one of the most attractive risk-reducing options. And, more so than some of the alternatives, the industry presents interesting opportunities for PE firms in terms of the ability to structure acquisitions and position portfolio companies for disposition. Every prospect must be considered carefully and uniquely, but overall, the landscape is very different than it was 10, or even five, years ago.

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