The Case for Litigation Funding for Commercial Lawsuits

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As with most large law firms, our transactional attorneys have counseled clients on an endless variety of commercial finance and M&A transactions, touching every point of the capital structure of the companies involved. Most of these transactions would not have been consummated absent the availability of debt and equity financing, the pricing, structure and security for which have been as varied as the transactions themselves. The most financeable deals, typically involving a modest degree of leverage and assets that were relatively liquid or whose value did not fluctuate substantially, were rewarded with non-recourse financing. In those instances, lenders assumed risks characteristically associated with equity ownership and did so without demanding outsize returns, due in large part to the quality of the assets that served as collateral. Perhaps the most common type of asset that garners non-recourse financing is non-industrial, commercial real estate with a rental stream that results in a high debt service coverage ratio.

Should a company anticipate non-recourse financing when the asset pledged as collateral is of dubious value, such as the proceeds from a commercial lawsuit? The obvious answer is “no” and, indeed, the pendency of a lawsuit or the specter of instituting one may deter traditional lenders from extending credit to a company soon to be embroiled in litigation. To induce a traditional lender to provide financing to fund a lawsuit, a borrower will likely have to provide significant collateral in addition to the potential lawsuit proceeds and, perhaps, a personal guaranty of the company’s principal. However, a start-up or single purpose entity may not have other, meaningful assets to pledge, and its owner may lack the net worth, liquidity or risk tolerance prerequisite to providing a personal guaranty needed to bridge the gap between a company’s anemic balance sheet and the lender’s underwriting requirements.

The market-driven solution to this conundrum is litigation funding sources (LFSs), which are essentially funds that invest in commercial lawsuits. A LFS performs diligence on lawsuits, weights the probability of various outcomes and the range of recoveries associated with each, factors in the delay endemic to litigation and its effect on internal rate of return, estimates the litigation budget required to support the lawsuit through to a successful conclusion, and then determines whether the risk adjusted return warrants making the investment. Fraught with uncertainty, this type of investment will be undertaken only if there is significant upside potential, as a bad bet likely means that the investment will go to zero. Not surprisingly, in our experience LFSs often seek an internal rate of return in excess of thirty percent (30%).

The vital role that a LFS may serve is illustrated by the hypothetical case of a start-up company, which cobbles together enough money from friends and family to procure a patent that promises to provide the company with a long-term competitive advantage in a growth industry. As the company negotiates a series seed round of financing with institutional investors, the company learns that its former chief technology officer, who previously defected to a large corporate competitor, has misappropriated the company’s intellectual property, which renders the company’s patent of questionable value. The start-up’s law firm sends a cease and desist letter, which the large corporation ignores, essentially daring the start-up to sue. In the wake of these developments, the institutional investors decline the opportunity to invest, and the company’s only options are to fold or obtain funding to wage war against the large corporation that stole the company’s intellectual property.

Litigation funding would be a lifeline to the start-up company in the above illustration. But we must be mindful that theory and reality have converged.[1] As lawsuits become more commonplace to combat unethical corporate behavior, the need to finance them is for some companies a core component of their working capital requirements. Just as companies require financing to purchase equipment and inventory, so companies may also require financing to support the prosecution of lawsuits to protect key assets. Since litigation is prevalent, unpredictable and expensive, it can drain a company's cash flow, unless a company can obtain financing to fund the litigation. LFSs fill this need and, thus, occupy an important niche in the marketplace of commercial finance products.

Despite the irrefutable need for litigation funding, most literature about the industry sounds a cautionary tone.[2] Before doing business in a state, LFSs must ensure that common-law prohibitions against champerty and maintenance do not render illegal an investment in a lawsuit by a LFS. Chief among the concerns in the tripartite relationship—i.e., attorney, client and LFS—that evolves will be not waiving the attorney-client privilege and whether the common interest doctrine will recognize the alignment of interest between the LFS and client. The attorney representing the client, but being paid from funds advanced by the LFS, must be vigilant to ensure that it pursues a strategy in the best interest of the client, even if the interests of the client and the LFS diverge. These complex legal issues underscore the need for skilled attorneys to provide guidance in structuring and negotiating an arrangement with a LFS and also serve as a bastion against the commoditization of legal services; these issues are not bases to rule out a LFS as a legitimate financing option in the appropriate circumstances.

Our firm's approach to transactions involving a LFS has been to utilize both a litigator and a commercial finance attorney in structuring and negotiating the operative agreements. Co-author Marie Mathews is the firm's Deputy General Counsel, whose thorough knowledge of the Rules of Professional Conduct and years of litigation experience supplement the skillset of co-author, Laurence Smith, who has practiced commercial finance throughout his career. We work together to strike the appropriate balance between keeping the LFS informed with periodic reporting without compromising the protections afforded by the attorney-client privilege and the work product doctrine. Our combined strengths help rationalize the budgeting process, impose accountability and efficiency on the law firm representing the plaintiff, and ensure a reasonable allocation of the total investment to each phase of the litigation. We also strive to ensure that the ultimate decision-making authority remains with the client, albeit subject to the LFS's right, in accordance with the definitive agreements, to limit or cease funding. The ultimate goal of the negotiating process is to achieve an equilibrium that protects the interest of all

[1] This hypothetical was posed for illustrative purpose; however, the fact pattern occurs in business all too frequently. The January 8, 2020 edition of *The Wall Street Journal* reported that Sonos instituted suit against Google for allegedly stealing Sonos' intellectual property. While Sonos is not a start-up company, it pales in size relative to Google, which can more easily weather the costs of litigation. If Sonos lacks a source of financing, it may at some point in the litigation feel like the start-up that cannot afford to continue the fight.

[2] Much of the literature demonizes LFSs. Portraying LFSs in this vein conjures in our minds the image of a house engulfed in flames, with a person trapped on a third-story window ledge facing imminent death, and being implored to jump toward an outstretched blanket held by four neighbors on the ground below. Realizing there is no other choice, the clear-thinking person jumps instantly. Under these circumstances, should a counselor's focus be on cautioning the person about the pain of broken ribs or a broken back, trying to discern the wind direction, or the risk that homeowners' insurance may not pay for hospital bills? These concerns, like the concerns raised about LFSs, seem secondary to the primary goal of survival.

constituents, while educating the client about the obligations associated with the involvement of a new and important party in interest—the LFS.

Conclusion

For most companies, commercial litigation is not an extraordinary event but rather arises in the ordinary course of business. The ability to institute and prosecute lawsuits that are critical to a company's interests therefore requires financing, which is often not available from traditional lending sources. This void in the market is being filled by LFSs. The availability of litigation funding may be viewed as a deterrent to unethical behavior, which a large corporation could otherwise perpetrate against a smaller entity that lacks the resources to bring suit. The risk inherent in the investment and its non-recourse nature militate in favor of outsize returns for LFSs. Until the market offers a more reasonable alternative, the business model of the LFS will endure and proliferate, along with the growth of commercial litigation.