Craig Arnott, managing director of Burford Capital, in the London financial district

MONEY MEN

The growth in litigation funding, based on a new breed of analysts who are expert in predicting success, is changing the face of international dispute resolution

Story / **CHRIS MERRITT**
Photography / **STEPHEN LOCK**

When the world's largest litigation funder burst onto the Australian market this year, it did so in a way that was intended to make a splash. Burford Capital, which has investments worth $US3.3 billion, agreed to finance a massive class action against AMP.

But what really turned heads was the price. It is not unusual for litigation funders to back claims for a fee worth 25 to 30 per cent of whatever is recovered.

Burford's fee? If AMP throws in the towel before the end of next year, the funder will take a mere 10 per cent. But that 10 per cent fee needs to be kept in perspective.

This claim, like others that soon followed, is all about forcing AMP to compensate the company's shareholders for losses in the value of their shares after AMP admitted misleading the corporate regulator.

Documents filed in the NSW Supreme Court assert that AMP's failure to tell the market about its misconduct wiped out $2 billion in shareholder value. So if AMP surrenders and writes a cheque for the full $2 billion, Burford's 10 per cent could come to a nice round $200 million. Welcome to Australia.

But there is a bigger surprise. Class actions are not even Burford's target market. Instead of financing shareholder claims against the corporate sector, this funder would be much happier working for big business—providing capital for in-house legal departments and the national law firms that fend off class actions for corporate Australia.

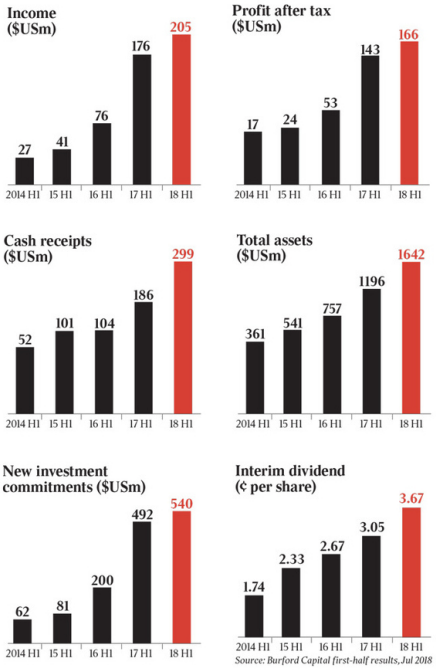
Burford managing director Craig Arnott says his company will only dip its toe in the class action space "if an AMP comes along—something that is absolutely bang to rights and, we think, straightforward".

"Our main target focus group is actually big corporates and the law firms who represent them. That is where we see very significant growth. Australia is very interesting because that really hasn't started there yet," says the London-based Arnott.

Burford has already done deals with British companies, and one of those deals left the legal press agog two years ago when the company provided $US45 million in portfolio finance to FTSE 20 company British Telecom.

Arnott believes the Australian litigation funding industry will eventually divide into rival camps, just as law firms have divided into plaintiff firms and the corporate firms.

Burford Capital first-half results, July 2018



Source: Burford Capital first-half results, Jul 2018

17%
income up

61%
cash generation up

37%
total assets up

"There will be funders who develop relationships with those law firms that here in London would be the Magic Circle or the Silver Circle, and then you have funders who are dealing with where funding started—shall we say the firms that are at the lower end of the spectrum."

Arnott's prediction should not be lightly dismissed. Before joining Burford he had been at the Bar in Sydney and is a former partner in London with Fried, Frank, Harris, Shriver & Jacobson and had previously practised at Gilbert + Tobin and with Cravath, Swaine & Moore in New York. That, of course, was after the Rhodes scholarship.

In Britain, he says Burford's relationship with corporate clients generally takes the form of what he described as "portfolio" funding for a range of matters instead of one-off cases.

"The biggest portfolio we have with a corporate at the moment is a competition-related matter that's with a very substantial listed company here that has a dominant position in the UK but is expanding elsewhere," he says. "So we are picking up all their work outside the UK where they have competition claims against incumbents in overseas markets."

In this country, the role of litigation finance has been closely associated with the growth of shareholder class actions. But Arnott says the overall funding market has been inverted and is no longer dominated by what he describes as "David v Goliath matters".

International disputes between companies are the new growth area—but those fights are not taking place in court.

"It's boom time for international arbitration," Arnott says. "There is a massive shift towards using arbitration instead of the courts—a truly massive shift. And it's not because it is less costly. It is

actually more costly, which is the inverse of what it was supposed to be. But people like it because it is private, final, and because they can appoint one of the arbitrators.

"An international commercial arbitration will cost at least $20 million up to $50 million a pop."

Burford, which was founded in 2009, is listed on the London Stock Exchange and has offices in New York, Chicago, London and Singapore, where strong growth is expected due to the city state's role in international commercial arbitration.

"Singapore is taking this over because they brought in specific legislation to permit external finance in arbitrations," Arnott says. "There had been rules that prohibited it, but they did that because Hong Kong was about to do it and Singapore wanted to steal a march on them. Singapore is going to be a massive centre."

His confidence is shared by Patrick Moloney, whose listed funder, LCM, is about to open an office in Singapore, and by another listed funder, IMF Bentham, which is already there.

LCM is already doing business in Singapore and its new office, which will be operating by the end of the year, will also service its clients in Hong Kong. Both cities are perfectly placed to take advantage of the growth in commercial arbitration, which has already made this one of LCM's fastest-growing lines of business.

"If you have two international trading partners, neither one wants to accede to the jurisdiction of the other, so what you want is neutral ground and you want it to be pretty predictable and dependable, in terms of the legal system, and you probably want that place to be a bit of a mixture of cultures—a meeting of east and west, which makes Singapore and Hong Kong perfect," he says.

Maloney says LCM will eventually open an office in Hong Kong, but he believes litigation funding in both cities will follow the same pattern of steady growth that has occurred in Australia. "I don't think we can expect these markets to explode," he says.

But he says one area of business that is growing faster offshore than in Australia is demand by corporate general counsel for outside capital to fund litigation.

"If your skill-set is not in picking litigation it is probably wise to give some consideration to outsourcing that risk and taking that drag off the balance sheet. This is starting to filter in to the Australian market," Moloney says.

He expects this part of the business to grow, but does not want any category to dominate LCM's portfolio of investments. And at the moment, he says the uncertainty over the rules governing competing class actions has reduced the attraction of this business. "There is terrible uncertainty over who is going to prevail in terms of competing open classes," he says. "LCM has taken a step back from those opportunities.

"We certainly fund class actions. It has been part of our business for some time but we have certainly stepped back from that front-end, competitive part of it at the moment because one of our criteria is certainty of law and we don't get past the first criteria at the moment."

This problem came to a head recently when AMP faced five separate class actions filed in two different courts over the same allegations of wrongdoing.

Moloney is confident the courts will restore certainty to this area and he hopes the resolution does not make it possible for plaintiff law firms to gain a strategic advantage by racing to be first to file proceedings. There is considerable merit in being cautious and considered over whether to bring a class action, he says.

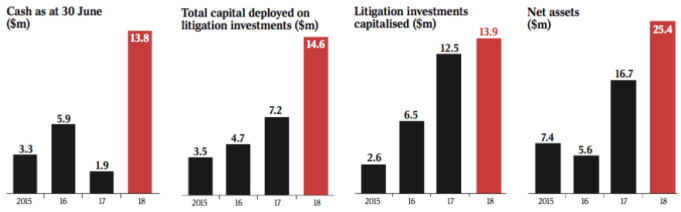
Maloney, like Arnott, has more faith in the potential for the corporate sector to become a major market for litigation funding.

"Funding your own litigation is very inefficient," Moloney says. "There is a horrible mismatch between the allocation of your resources and the return."

LCM full year results, August, 2018

	FY2018	FY2017	Change
Gross revenue	$29.2m	$3.4m	▲ 754%
Net income from litigation projects	$16m	$2.2m	▲ 633%
Net profit before tax	$12m	($2.9m)	▲ 518%
Operating expenses/income ratio	21%	124%	▼ -84%
Total equity	$25.4m	$16.7m	▲ 53%
Return on equity	41%	–	–
Working capital ratio	6.3:1	6.7:1	▼ -6%
NTA (cents per share)	18.6	-0.003	▲ 7103%
Cash	$13.8m	$1.9m	▲ 640%
Litigation investments capitalised (intangible assets)	$13.9m	$12.5m	▲ 12%

Source: LCM full year results, August, 2018



increase in revenue

754%

Andrew Saker of IMF Bentham points to another factor that favours this segment. There is a risk that if companies choose not to use outside capital for litigation they might simply abandon promising causes of action to avoid diverting their own capital from their business.

"Outside funding gives corporates the ability to pursue matters that they might not have pursued in the past," says Saker, who is MD and chief executive.

While shareholder class actions have kept litigation funders in the headlines, they are not the main game for IMF Bentham. Saker says they account for just eight of the 76 matters on the company's books.

The company, which listed on the Australian Securities Exchange in 2001, has a strategic goal of balance so no single category dominates its business. It has 14 offices in six countries, including Singapore and Hong Kong. Of the cases it funds, the success rate is 90 per cent and clients have received more than 62 per cent of the amount recovered, or $1.4 billion.

> **The most successful funders are extremely selective, backing just a tiny proportion of the potential claimants who walk through the door**

"We have achieved a lot of what we set out to do," says Saker. "But it is a platform for the next phase."

That will involve the establishment of more specialist funds targeting the US and other jurisdictions, the possible opening of offices in continental Europe, and expanding the teams in the existing offices—particularly in Asia and Canada.

The success of IMF Bentham and the other funders depends entirely on their ability to pick winners—to accurately assess the merits of civil disputes and minimise the losses.

So how do they do it? The simple answer is that the most successful funders are extremely selective, backing just a tiny proportion of the potential claimants who walk through the door.

The importance of picking winners helps explain why the funders take the vetting process so seriously. IMF Bentham's investment managers are former litigation partners or special counsel at leading law firms. In San Francisco, for example, the investment manager is Matthew Harrison, a former litigation partner with Latham & Watkins.

Saker says IMF Bentham's investment in particular cases can range from $2 million to tens of millions of dollars but it will only finance a matter if it is comfortable that the client will receive at

least 50 per cent of the sum recovered.

He says the rigours of the assessment process helps explain why so many cases settle. So far, 83 per cent of the cases funded by IMF Bentham have settled before trial and every shareholder class action filed in Australia has settled.

Saker's explanation is that defendants know the merits of these cases have already been subjected the scrutiny.

LCM's Moloney says many people believe litigation funders simply provide capital. But he says picking winning cases is the real skill. In Australia, where losing parties in civil litigation pay the costs of the victors, a strong track record in picking winners is essential if a funder is to survive and prosper.

While LCM has only been listed for two years, the company was founded in 1998, and Moloney says it has used that time to refine its methods of vetting potential cases. The process starts with an assessment by one of the company's investment managers who, like Moloney, have backgrounds in commercial litigation.

If the case passes that first stage of due diligence it moves on to a peer review process in which all investment managers have a say. If they endorse the claim's prospects it goes to Moloney, who seeks an external view—normally from a silk.

IMF Bentham's Performance

90% success rate

$2.2 billion total recoveries

Andrew Saker, managing director and chief executive officer (left), and Clive Bowman, chief executive, Australia and Asia, IMF Bentham

If a claim passes all those stages, LCM will only take it on if it believes it will result in a recovery, frequently from the other side's insurer.

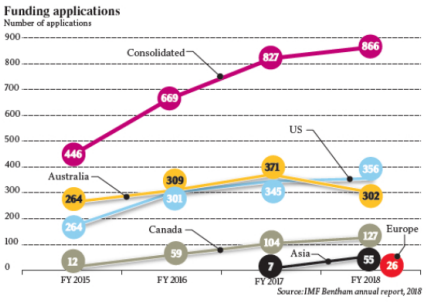
Of all the potential claims that are examined by LCM, the proportion that is eventually financed is just 4 per cent—which Moloney believes is roughly the same across the industry.

Once the assessment stage is complete, LCM will not simply finance the claim but will closely monitor its progress and help manage it through to completion.

"We have a good skill managing litigation but I'm not saying we impose our views—we don't," he says. "But we have an incredible skillset within this company to optimise the outcome of litigation."

This is where, in Moloney's view, the interests of litigation funders are actually more closely aligned with those of the client rather than the client's legal team. He explains this by likening the litigation process to that of an expensive train ride where the price of the ticket depends on the length of the journey and is paid by the client and the funder.

"The plaintiff is on the train heading towards the station where there is $100 million. The job of the defence team is to derail the train. Then you have the plaintiff team that wants the train to get to the destination but don't necessarily want to take the direct route. They would prefer to take the scenic route.



"If you are a litigation manager you want to get to the station by the most direct route, you want to optimise the outcome and you want to employ as little capital as possible. That's a colourful way

of saying we want to run litigation in the most efficient fashion and the people who have vested interests in it are not necessarily aligned with you or your funded party."

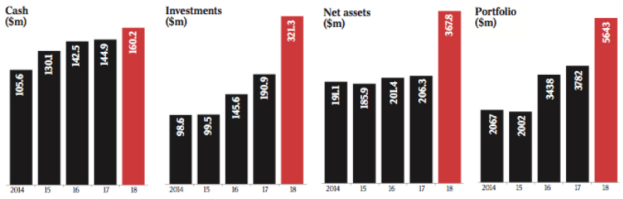
That alignment of interests is something Maloney believes has value to corporate clients who want their management team to focus on their business, not running court cases.

From time to time, the different interests at play means "butting heads" with lawyers when a corporate client seeks LCM's views on a proposed course of action. But he says that is infrequent.

IMF Bentham says its assessment process of potential cases is "agonising" and can extend for months as company officers trawl through documents looking for a claim's strength and weaknesses.

Executive director Hugh McLernon says the proportion of cases that are accepted for funding has risen from the original 4 per cent to about 10 per cent, "but that is only because people stopped bringing crap to us".

IMF Bentham annual report, 2018



The entire concept of third-party litigation funding is an Australian invention that emerged in the wake of the 1987 sharemarket crash. At the time, Hugh McLernon, now executive director of IMF Bentham, was working in Perth at Robinson Cox, which later became the West Australian arm of Clayton Utz.

He could see large numbers of civil claims that were not being run because the claimants no longer had the resources to enforce their legal rights.

Third-party litigation funding did not exist, despite the fact that jurisdictions had begun abolishing the ancient torts of champerty and maintenance that once prevented disinterested parties from financing court cases for a share in the proceeds.

When the market is going gangbusters or falling, people start trying to screw each other
- Hugh McLernon, *pictured*

McLernon says these torts had originally been developed to prevent rapacious elements in the English nobility from taking the fields of the poor as the price of supporting them in court. But he says the practical impact of these torts was reversed by the 1987 crash. Instead of protecting the weak against the strong, they were preventing the weak from enforcing their rights against the strong.

"If that wasn't an opportunity, nothing was," he says. He knew champerty and maintenance were based on public policy and he also knew that public policy could change over time. So he left Clayton Utz in 1989 and started funding litigation—a move that makes him one of the pioneers of this industry.

McLernon eventually took an interest in another funding venture that was operated by John Walker and Clive Bowman. After a long career at IMF Bentham, Walker launched a new venture, Investor Claim Partner, in 2016 while Bowman stayed with IMF Bentham and is now chief executive for Australia and Asia.

Two court rulings cleared the way for the development of the Australian litigation funding industry. The first came in 1996, when the Federal Court ruled in Movitor v Sims fund that commercial litigation funders could raise capital to provide funding to insolvency practitioners.

Ten years later the High Court cleared away another barrier with its decision in Campbells Cash and Carry v Fostif. It found that litigation funders have a legitimate role in financing class actions and are permitted to exercise broad influence over how they are conducted.

But while litigation funding might have had its genesis in

But while litigation funding might have had its genesis in Australia, IMF Bentham received more applications for funding last year from the US (356) than it did from Australia (302). In fact funding applications from Australia amounted to just 35 per cent of the global total of 866.

When the size of the market is considered, these figures should come as no surprise. IMF Bentham estimates that the Australian market for litigation expenditure is worth about $19.7 billion annually, while the equivalent market in the US is worth about $US357.6 billion.

McLernon says the outlook is bright due the strong supply of potential claims and the equally strong supply of capital: “There is just a wall of money coming to litigation funding globally at the moment.”

The reason, according to McLernon, is that demand for litigation finance is equally strong in rising and falling markets. “The only time when litigation finance quietens down is when everything is calm,” he says. “When the market is going gangbusters or falling, people start trying to screw each other.”