Professional Perspective

Litigation Finance for Lawyers Advising Corporate Boards

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Corporate board members assume important fiduciary duties to the company whose management and activities they oversee, including ensuring that any material assets and expenditures are properly managed. Litigation involving the company—either as plaintiff or defendant—can often implicate these duties, since material assets and expenditures may be involved.

Litigation funding can afford some relief by helping to defray material expenses and protect material assets. Many board members, however, are not familiar with litigation funding, and may not appreciate the potential benefits it has to offer. Lawyers advising boards can add value and help ensure board members satisfy their fiduciary duties to the fullest extent by educating board members about the ways in which litigation funding can be used to the company’s benefit.

Claims against third parties arising from breach of contract, unfair competition, or infringement of intellectual property, for example, may represent potentially valuable assets of a company, but a company may be reluctant to pursue litigation due to the material costs involved. For example, the intended defendants in such causes of action may be much larger than the plaintiff, or have a reputation for seeking to use their size to intimidate potential claimants. This may result not only in a failure to capitalize upon a valuable opportunity, but also in material harm to a company’s business and its assets.

Board members should be aware not only of the potential value of possible litigation and the importance of protecting the company’s assets by taking litigation action when necessary, but also understand the financing options available which can level the playing field. Lawyers advising boards can play an important role by educating board members about litigation funding, how it works, under what circumstances it may be an attractive option, and whom to contact in the event questions arise.

Modern Commercial Litigation Funding

Today, a company considering whether to file a lawsuit may be able to finance its litigation expenses based on the anticipated future proceeds from that same litigation. This can help alleviate some of the financial pressures associated with lengthy and expensive litigation and enable the company to focus its resources on its business, rather than litigation. Likewise, companies that are parties to litigation that is ongoing and already have substantial sunk costs may be able to recover a portion of their past expenditures, as well as share the litigation risk going forward.

Litigation funding can be used to pay for case-related disbursements, like expert witnesses and e-discovery costs, when litigation counsel is hired on a contingent-fee basis. And when litigation counsel’s fee arrangement is not purely contingent, litigation funding may be used for counsel’s fees as well. Reducing costs, including legal spend, is a hot-button issue for many companies, particularly in periods of economic uncertainty.

However, many law firms are reluctant to carry the entire risk of contingent-fee models, and companies need to be able to hire their counsel of choice for high-stakes litigation. Litigation funding can help ensure that companies can retain their preferred law firms while reducing the impact of such firms’ hourly fees on the companies’ core operations.

Litigation funding may also help satisfy the working capital needs of the company. Importantly, most litigation financing is structured as a non-recourse obligation, such that if the ultimate outcome of the litigation be unfavorable, the company does not owe anything to the funder. Because of this, litigation financing is not a loan, and the company’s obligation to repay the funder solely if the litigation is successful does not create a liability on the company’s balance sheet. None of the assets of the company are affected, nor are its reportable financial ratios for loan covenant purposes, etc.

In the U.S., litigation funders are not permitted to exercise any control over the cases they fund, since this would violate ethics rules regarding the attorney-client relationship. While an experienced funder may have useful suggestions about a company’s choice of counsel and its case strategy, ultimately it is left up to the company and its legal counsel to decide. Thus, board members need not worry that a litigation funder will usurp their decision-making authority, nor interfere in any way with their duty of diligence and oversight.
To the contrary, litigation financing can make a board member’s job much easier by enabling companies to pursue meritorious litigation while simultaneously removing significant financial risk from the costs of that litigation. Moreover, a litigation funder’s investment in a dispute is non-recourse, meaning the funder loses its investment if there is no recovery in the litigation. This allows board members to take comfort that an objective third party has vetted the companies’ claims and is willing to back them with its own capital. The comfort component can be particularly true when the funder is experienced and has an established track record of success.

Why Board Members Should Care

Companies must defend themselves when sued, and defense-side costs can often eat up most of a law department’s budget. With affirmative litigation, on the other hand, a company usually has a choice to make as to whether or not to launch a claim. The financial impact of this decision must be carefully considered, as it is often material and may be felt over several years. Litigation claims are too frequently overlooked or dismissed by management due to their potential financial impact.

While litigation is pending, the costs incurred flow through the income statement and directly impact a company’s bottom line. Accounting standards require litigation expenses to be recorded on a cash rather than an accrual basis, and no asset related to recovery may be booked prior to final resolution of the claims. This is true regardless of how strong a claim is or the likelihood of success. The short-term accounting impact of bringing litigation and paying legal fees, plus the potential long-term impact on profits and share prices as multi-year disputes drag on, can make it difficult for companies to rationalize pursuing litigation, even when their legal claims are strong. As a result of the negative impact on their cash position and financial performance, many organizations ignore or abandon valuable litigation claims, or leave judgments unenforced.

It’s also important to note that when a company pursues litigation to protect its assets and vindicate its rights, it does more than take a stand against a single bad actor—it also sends a message to the market that a company is serious about protecting itself. This is important, because taking a weak stance when disputes arise may embolden others to breach contracts or infringe on intellectual property rights.

To the extent that claims may not be pursued due to the costs, including the related accounting impact, litigation financing can offer a valuable solution. Lawyers advising boards can help board members fulfill their fiduciary duties and increase enterprise value by introducing litigation funding as a way to avoid these lost opportunities while minimizing the impact of litigation costs, both near-term and long-term. When a funding agreement is reached, the financial picture around litigation dramatically changes for the company.

Consider the following benefits:

- Capital earmarked by a company for litigation can be reallocated to other company priorities
- Litigation expenses are assumed, in part or in whole, by the funder, and do not affect a company’s income statement
- More predictable litigation costs lead to more accurate financial forecasting, an increased ability to manage cash, and less earnings volatility
- The investment dollars provided by a funder may be counted as revenue (although there may be a concomitant expense entry if those dollars are earmarked for an anticipated expense), possibly helping to boost profitability, and with no dilution of shareholders’ equity
- Depending upon the size and certainty of a company’s legal claims, funding may even be available to support a company’s working capital needs, in addition to direct legal costs

A company can use funding proceeds to hire the best possible counsel and experts to handle its case, maximizing the likelihood of success and the potential payout from any recovery. Having a relationship with a reputable funder may extend well beyond financing considerations, since litigation funders are in the business of evaluating claims, and can therefore provide valuable insight. Further, working with a funder and building a strong litigation strategy can make it clear that a company is willing to aggressively vindicate its rights when necessary, and hold competitors and others accountable for any legal wrongdoing.
Advice for Board Members with Significant Company Litigation

Boards overseeing companies with significant litigation or litigation portfolios should be aware of their company’s financing options, and knowledgeable about the pros and cons of litigation funding. Lawyers advising boards can help ensure board members take steps to become properly informed by stressing the importance of proper management of litigation, including taking into account litigation financing considerations.

Consider the aspects of the funding decision that are discussed below.

Evaluating the Strength of Claims

Unlike companies that are in the business of providing services to their clients or products to their customers, litigation funders have ample experience evaluating the strength of claims and estimating their value, as well as familiarity and relationships with lawyers, law firms, financial advisers, and accountants with significant litigation experience.

When to Seek Funding

While many companies seek funding before bringing a lawsuit or soon after filing, others may not consider it until much later in the case—for example, on the eve of trial. Seeking financing at a later stage in the case is tacit recognition of the inherent unpredictability of judge and jury outcomes. Bringing in a financial partner enables a company to recover a portion of its sunk costs, and to share the risk in the event of a potential adverse outcome.

Even after a favorable judgment is entered, appeals can still take many months or even years to resolve, and collection efforts may be costly, uncertain, and lengthy. There is no one right answer as to when a company should seek funding. One important thing to remember, however, is that the funder will likely require at least 30 days to complete its due diligence, obtain necessary approvals, and finalize transaction documents; complex or undeveloped claims may take even longer to assess.

Protection of Confidential Communications

A company must be careful in dealing with a funder not to disclose confidential attorney-client information, or risk waiving a key client privilege. The establishment of a robust NDA is critical, and will serve to protect attorney work product, but pure attorney-client information may be treated differently under applicable state law. According to one recent study from Westfleit Advisors, courts have largely determined that litigation funding documents were protected from discovery based on the work-product doctrine.

The case of Miller UK Ltd. v. Caterpillar, Inc. continues to be a guiding light on this topic. There, the court made a number of detailed findings, including that:

- The litigation funding agreement itself is not relevant to any claim or defense in nearly all cases
- It is therefore not discoverable
- Work product material is protected under a written or an oral non-disclosure agreement

Nevertheless, this is still an area for caution, and because of key differences between the scope of protections for the attorney-client privilege versus the attorney work-product privilege. A prudent approach would be to make sure that companies considering funding do not share pure attorney-client privileged information with a funder.

Potential Disclosure and Economic Implications

Board members need to think through the potential effects of accepting funding, including any tax impact and reporting requirements. Important questions to consider include:

- How will funds be treated for tax purposes?
- Is the receipt of funding a reportable event?
- If yes, will any required reporting necessitate disclosure of the funding arrangement, and how does that impact the decision to use funding?
The answers to these questions may be different for different companies, and thus the company should consult its own accountants for advice on these topics.

**The Economic Analysis for Funding**

A board member should ask questions about the company’s economic analysis prior to entering into a funding agreement. For example:

- Has the company obtained a detailed budget from the law firm it intends to use?
- What alternative billing arrangements are available?

It is important to document the answers to these questions and treat this process like a company would before it enters into any other material transaction, such as an amendment to its credit agreement or a lending transaction.

**Information the Funder Will Need**

When evaluating a specific litigation for investment purposes, a funder will delve deeply into the nature of the claims being asserted, the potential defenses that may arise, the amount of recoverable damages, and the wherewithal of the defendant to pay. A funder will not only want to hear the facts supporting the company’s claims, but will need to verify the evidence available to support the claims. A company that has gathered and organized all the data and documents relating to its claims, including any defenses likely to be asserted, will enjoy a much faster and smoother due diligence process than one that awaits the funder’s questions to begin. Not incidentally, all this information will likely need to be gathered and organized for the litigation anyway.

**Experience and Reputation of a Funder**

Commercial litigation finance is a rapidly expanding industry. There are now many funders to choose from, and the quality and character of the financial counterparty is very meaningful. Litigation can take many years to reach a resolution, so it is critical that your funding partner have the experience and resources to see the transaction through to the end.

**A Case Study**

**The Scenario**

Consider a scenario in which a company’s growth has been undermined by a larger competitor, and its litigation counsel has advised that the company has a strong claim for misappropriation of trade secrets against a competitor that is worth $100 million. However, the case will likely take three years and cost $8 million in attorneys’ fees, plus $500,000 in costs to pursue. The company’s management and its board are unfamiliar with litigation funding.

The company requires $1 million in working capital to fund its business each year, or $3 million in total for the three years. Its current financial condition is such that there are no additional assets against which banks are willing to lend further. The law firm that the company wants to hire to handle the case will not take it on full contingency, but is willing to take it on partial contingency of 20% and be paid only 50% of its fees plus all out-of-pocket costs throughout the case. The company faces serious financial difficulties if it fails to pursue the claim, but it cannot see a path toward self-financing the cost of litigation, despite its importance for the survival of the company.

**The Funding Proposal**

Lawyers advising the board introduce the concept of litigation funding. The company approaches a funder to explore financing options that will allow it to hire the law firm. While returns vary by deal, assume that the funder offers funding in the amount of $7.5 million—$4 million for the attorneys’ fees, $500,000 of costs, plus $3 million in working capital—in exchange for 25% of any recovery. The funder’s return—for the entire investment, including the working capital—and a 20% return to the law firm, are both contingent upon a successful result in the case.

**The Upside of Using Funding**

The company assumes no financial risk in this scenario, yet a successful result could earn it $58 million in net revenue after paying returns to the funder and the law firm. This amount considers the $100 million in recovery, less 25% to the funder and 20% to the law firm, plus the $3 million in working capital advanced by the funder. Additionally, the working capital
provided by the funder gives the company additional liquidity, and the ability to focus on its business throughout the course of the litigation. The non-recourse nature of the financing arrangement means that even if the company is unsuccessful in litigation it may still be better off pursuing the claim.

**Comparison**

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<thead>
<tr>
<th>Action Plan</th>
<th>Proceeding without Funding</th>
<th>Proceeding with Funding</th>
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<tbody>
<tr>
<td>Action Plan</td>
<td>Forgo the claim</td>
<td>Funding of anticipated legal fees and costs for the matter plus $1 million in working capital per year for three years, on a non-recourse basis, with an agreed return to the funder of 25% of total recoveries, upon successful conclusion of the matter</td>
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<tr>
<td>Company Investment</td>
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<td>$0</td>
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<tr>
<td>Funder Investment</td>
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<td>Company Gross Revenue Potential</td>
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<td>Company Net Revenue Potential</td>
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<td>Company Opportunity Cost</td>
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<td>Company Capital at Risk</td>
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<td>$0</td>
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<tr>
<td>Additional Costs/Benefits</td>
<td>Threat of corporate insolvency and inability to curtail harm by competitor</td>
<td>Preservation of company liquidity, resources for continued growth and leverage against a competitor</td>
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**Conclusion**

Lawyers advising corporate boards should educate themselves about new and different financing alternatives available to help protect the company’s assets and improve the outcomes for its litigation assets. Because litigation funding can help board members in fulfilling their mission to oversee management of risk and maximization of value, lawyers advising board members can add value by alerting boards to the availability of litigation funding.

Litigation funding can materially change the equation for a company that possesses a meritorious claim but lacks the resources or risk tolerance needed to pursue it. In order to help board members fulfill their fiduciary duties, lawyers should advise board members to be aware of their company’s litigation portfolio, including potential claims, and to understand the availability, operation, and potential benefit of litigation funding.