

## BROADRIVER INSIGHTS

# Commercial Litigation Funding — Reflections on Best Practices



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## Overview

The litigation funding market is attracting large amounts of capital as investors seek attractive risk-adjusted returns that are self-liquidating and uncorrelated to market volatility. According to the Westfleet Advisors Litigation Finance Buyer's Guide, approximately USD 9.5B of AUM is currently dedicated to U.S. commercial litigation funding.

Canada, where Nomos Capital has been active since 2016, is a growing market for commercial litigation funding. One global litigation funder has estimated that CAD 3.2B is spent on litigation in Canada annually, and that the total addressable market is approximately CAD 1.7B. This estimate may be underinclusive as a greater number of plaintiffs leave litigation and arbitration assets "on the table". Instead of expending capital to pursue viable claims, a party may forego seeking dispute-resolution due to cost or time-and-attention considerations.

## Emergence of the asset class

Litigation funding is, in its simplest form, the supply of capital by a third-party to a legal dispute toward legal expenses incurred by a party to the dispute, in exchange for a return on the capital. The modern incarnation of third-party commercial litigation funding emerged about twenty years ago in Australia although lawyers in a number of other jurisdictions – officers of the court who have privileged access to originating investment opportunities – have been funding litigation by means of contingency fees and other forms of success-based, outcome-oriented compensation for a number of years depending on the local rules and regulations.

## Corporate finance for law firms

Litigation funding is essentially a form of corporate finance for law firms. Restrictions on non-lawyer ownership of law firms mean firms have few sources of investment capital. Debt is an option, but equity comes in the form of additional individual lawyers who join the partnership.

Many law firms are particularly sensitive to cashflow. Management must accommodate the obligations of a cash-based compensation system. Most law firms are partnerships, and cash salaries must be paid before the partners may draw their profits.

A law firm increases revenue by utilizing litigation funding. The funding, which is non-recourse and non-dilutive to the partners, may take the form of single-case funding where the funder pays costs and fees associated with a particular matter, or it may be a "portfolio" arrangement where the funder provides funding to the firm secured against a portfolio of fee (usually contingent fee) receivables. Either way, the law firm converts a client that is unwilling, unable, or reluctant to pay fees into a source of revenue.

The terms vary, but most funders require that a law firm itself share in some of the risk by discounting its fees or participating in the deal waterfall, or both.

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## Corporate finance for businesses

A litigation or arbitration claim is an asset. However, the asset may have a negative present value depending on the claimholder's resources to pursue the claim. Litigation funding permits the claimant to monetize that asset. Due to accounting rules, the use of funding boosts profitability, all things being equal, by eliminating above-the-line legal expenses and shifting some of the risk to the funder. A "portfolio" arrangement is also possible where the business has exposure to a number of litigation assets.

## Typical deal terms

A funder may provide capital at various stages of a dispute-resolution process: before a claim commences, after a final judgment, award or settlement, or anytime in between. The perceived risks drive the terms on which funding is provided, but the risk of a loss in a funded matter means the capital is expensive. Usually a funder seeks a multiple of its invested capital (say, two times to five times), or a percentage of the recovery (say, twenty to forty percent), or a formula that incorporates a combination. The return may also depend on duration to recovery, and a priority return of the invested capital is increasingly standard.

Most commercial litigation funders do not have a standard set of terms although there are several paradigms. Litigation funding is attractive both to law firms and to clients because of the bespoke nature of the economic terms, which ought to reflect the specifics of the claim, the underlying theory of damages, and the specific needs of the client and the law firm. For example, a more entrepreneurial law firm may be open to, and capable of, having 50% of its fees funded while another firm may require at least 80% of its fees funded. Similarly, different clients have different appetites for sharing risk alongside a funder.

According to Canadian courts, a litigation claim is akin to a "pot of gold". A prudent, disciplined funder knows that alignment amongst the parties (law firm, client, funder) is essential to ensuring a mutually acceptable outcome. If too little of the gold is allocated to the client, the client may lack incentive or motivation to settle within a zone of reasonableness. Similarly, a skilled funder understands that it is crucial to mitigate moral hazard. To the extent possible, a client must be materially invested in its claim. The "risk-free litigation experience" – except where absolutely necessary (an insolvent claimant for example) – is antithetical to the underlying transactional logic of litigation funding.

## Underwriting standards

Litigation funders look at dozens of quantitative and qualitative characteristics when conducting due diligence. These include the amount of funding requested relative to the possible outcome of the claim, the subject matter of the dispute, the attitude and objective of the parties, the ability of the defendant to pay a judgment or settlement, the experience and expertise of all lawyers involved, the underlying factual and legal framework, the theories and range of damages, the legal merits and anticipated defenses, the duration to recovery under various scenarios, the venue or tribunal, and many others. Litigation funders conduct extensive diligence, including reviewing key evidence and legal memoranda, interviewing key parties, and preparing sophisticated financial models before assessing the impact of a potential investment on its existing portfolio. Success in litigation funding requires much more than merely assessing the internal legal merits of a claim.

Funders are notably stringent: most report funding between 3% and 5% of the investment opportunities they review. With the arrival of COVID-19, it is worth emphasizing that the following underwriting criteria warrant attention.

### Collectability

Any sensible funder delves deeply into whether the defendant (or its insurer) can satisfy a judgment or settlement. Does the pot of gold even exist? Many "successful" litigants have experienced the unpleasantness of a pyrrhic victory – winning on paper but unable to collect or enforce. Funders should be focusing now more than ever on the medium-term solvency of even a very large defendant. It has always been prudent to select for claims for damages that account for a modest proportion of the defendant's balance sheet. What used to be considered a deep-pocketed defendant even three months ago may no longer be as attractive an adversary in a dispute. Smart litigation funders think like equity investors and look for a defendant (or as appropriate the defendant's insurer) that has significant cash on hand and very little debt.

### Law firm solvency

Litigation funding agreements include conditions under which the client may change lawyers or law firms after funding has commenced. A funder should always assess whether the funded law firm is financially sound. In the current economic climate, it is particularly important to closely examine the financial strength of the law firm acting for the funded party. A funder ought to select for well-managed law firms, with a number of actively profitable practice areas.

### Claimant's attitude

Related to the above, a claimant may have to discount its objective under conditions where the defendant's financial health is deteriorating. A funder should diligently and carefully examine whether the claimant's goals are realistic (beware the client that will not settle for less than 100 cents on the dollar), but in a COVID-19 world a plaintiff would be smart to remain open to taking a haircut in exchange for a sure payout. It is as important as ever for a funder to drill down on whether the claimant will be commercially reasonable.

### Duration

Litigation funding assets have durations anywhere between one year or less or up to ten years. Three to five years from first funding advance to final collection is a typical range for commercial funding investments in Canada. Due to COVID-19, however, courts may be intermittently unavailable when required (for example to adjudicate a pleadings motion, a discovery-related dispute, or a hearing on the merits of the claim). Out-of-court discovery processes, in the current environment, may also be constrained by public health measures. Consequently, a funder ought to accommodate possible delays in modeling the projected gross IRR of a deal.

### Novel legal issues

Disputes pertaining to COVID-19 itself are on the rise. Most sensible funders understand that novel legal issues introduce volatility into a portfolio of litigation assets and therefore shy away from untested legal theories. A disciplined funder ought to see through the increased demand for funding for riskier cases, and instead remain systematic by doubling-down on objective risk-mitigation techniques especially through asset-selection.

### Monitoring

It has become increasingly standard that a funder may cease funding under certain conditions, including a material change in circumstances of the client, the case, the law firm, or the defendant. Sophisticated funders receive regular updates from the funded lawyers and from the client regarding developments in the course of a funded matter. Although a funder cannot dictate the terms of settlement, the funder is entitled to participate in strategic discussions and provide advisory opinions. Given the rate at which conditions may shift, a funder must be particularly diligent in managing its investments to ensure prompt action to any developments in the underlying case. In the event of a catastrophic development, a funder will be entitled to exercise its right to terminate funding in which case, depending on the terms, the funder may retain an interest in the outcome of the litigation or may be entitled to repayment of advances plus interest.

## Conclusion

The outcome of litigation is uncorrelated with capital markets and commodities markets. The Canadian commercial litigation funding opportunity set has been estimated at CAD 1.7B. A well-constructed portfolio of litigation investments offers an institutional investor exposure to a set of high-yielding assets diversified across various economic and substantive features.

Litigation or arbitration is a business problem for the claimant, and it is essential for a funder to undertake a thorough analysis of the range of likely outcomes – whether at a contested hearing or through a consensual settlement. It is especially important to conduct a deep assessment of the parties' objectives and motivations. Nomos Capital, in partnership with BroadRiver Asset Management, understands the vital importance of risk mitigation and management to achieve targeted outcomes. With over seventy years' combined experience managing and participating in commercial litigation, and with deep roots in the Canadian legal and business communities, the team is well-positioned to prudently deliver attractive risk-adjusted returns in Canadian commercial litigation opportunities.



BY EZRA SILLER

Ezra is a founding principal of Nomos Capital, an affiliate of BroadRiver Asset Management, and is responsible for originating, underwriting, and structuring investment opportunities in the Canadian litigation and arbitration market. He provides prospective funded parties and their counsel with strategic advice and analysis at all stages of the litigation life-cycle.

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