THIRD PARTY FUNDING: AN ATTORNEY'S PERSPECTIVE ON HOW TO CHOOSE A FUNDER

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A company[2] or a law firm which is looking for a litigation funder (hereafter "funder") to finance a lawsuit may be compared to a company which seeks to raise capital from a private equity investor[3]. Like private equity investors, funders are all (very) different, and the proposal to finance a lawsuit which stands good chances to be accepted by a specific funder might as surely be rejected by another one.

Approaching the wrong litigation funder will have many negative implications for the company or the law firm who seek funding. The most notable ones are a significant waste of their financial, human and time resources, all of which are irrecoverable costs[4].

It is all too frequent in practice that a company or a law firm spends months with a funder to examine a case only to realize that all interested parties could or should have known right from the outset that no funding agreement would eventually be signed. Moreover, since a funding relationship usually lasts several years, understanding as early as possible whether a funder would be the right partner for that company or law firm is critical.

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2 While law firms remain the primary interlocutor with funders, a number of funders indicate that an increasing number of companies directly approach them to seek funding.

3 For some litigation funders, third party finance is "venture capital" in the legal field.

4 It is not uncommon that 4 to 9 months may pass by between the time a company or a law firm prepares a funding request which it addresses to several funders and the time they actually enter into a funding agreement.

For the funder, the implications of a case which he eventually decides not to fund may be less detrimental than for a company or a law firm as his losses are mitigated by the management fees he normally receives to operate. There is also an asymmetry of knowledge about the litigation funding's market which benefits the funder since he's a repeat player. Companies and law firms who seek funding for the first time may therefore benefit from being assisted by professionals (whether they are brokers, lawyers or consultants[5]) with experience in selecting, negotiating and reaching a fair agreement with funders on their behalf.

While there is abundant documentation (most often produced by funders themselves) explaining what they expect from companies and law firms which seek funding, there is almost no literature produced by companies or law firms about what they should seek from a funder when they approach them. Furthermore, since the capital available to finance litigation funding and the number of funders has exploded over the past few years[6], companies and law firms should know that they have much more choice and leverage when seeking funding than a few years ago. They can and should act accordingly.

This article sets out some key information companies and law firms may want to ask funders when they approach them and some key considerations they may want to keep in mind when choosing a funder to partner with. While these recommendations may be considered subjective and non-exhaustive, they are based on the experience of the author when dealing with more than a dozen (well-known and less well-known) funders and brokers over the past few years.

Approaching the right number of funders: When seeking funding, the company or the law firm should decide first on the number of funders or brokers they will approach. The right balance must be found between approaching a single funder – which will reduce the company or law firm's chances to obtain either a funding offer at all or a competitive one – and approaching too many funders – which may multiply unnecessarily the company or the law firm's time and costs to obtain funding. There is no "one-size-fits-all-solution" in this regard. In complex cases, approaching a broker – who will select for the company or the law firm funders who they believe would be the right fit for the case, including occasional funders which do not market their litigation

5 In such instances, their costs become part of the budget for which funding is sought.

6 According to the lawfirm Brown Rudnik LLP, the litigation funding market would be worth USD 39 billion.

funding services – and four or five funders with a reputation for dealing with the type of cases might be a good strategy to obtain eventually a competitive offer from two or three of them. In any event, a non-disclosure agreement (NDA) should be signed with all the funders approached before any information is shared with them.

Understanding who the funder is: There are many types of funders. Some may be either listed (and as such subject to specific regulatory requirements) or unlisted corporations (which are unregulated in most jurisdictions) but which primary or sole activity is litigation funding. Some others are asset manager firms, hedge funds, family offices, crowdfunding platforms, institutional investors or private investors who may either occasionally invest in disputes[7] or, on the contrary, have set up a dedicated litigation funding desk. Some companies or individuals also act as brokers between funders and plaintiffs or law firms: they do not have capital to invest directly in a dispute, as their role is to find (for a fee) potential funders for the lawsuit envisaged by the company or the law firm. Understanding to which category the funder belongs is critical in many respects. First and foremost, this has consequences on the funder's authority to decide (or not) on its own to invest capital in a case. Discussing for months with a funder that is ultimately unable to close the funding transaction will be extremely frustrating for a company or a law firm. The category and structure of a funder also has consequences on the speed of the funding decision-making process, the level of risk he may take, the return on invested capital (ROIC) he may expect or must make, the types of cases he will invest in, his investment time horizon etc. Companies and law firms may therefore want to check all publicly available information about the funder to understand his specificities. If given the chance, companies and law firms may also be well advised to speak with the funder's current or previous clients to understand better how he functions.

Making a conflict-of-interest check: Funders normally make a conflict-check right after initial contact is made with them to ensure that the funded case would not negatively affect one of their investors or clients. However, as it appears that it is not always the case in practice, companies and law firms may, when signing the NDA, explicitly ask for a confirmation from the funder that he has no, and does not expect to have, a conflict of interest.

7 These funders are sometimes referred to as "quiet money" since it is not public that they fund disputes.

Checking the financial capacity of the funder: It is for the funder to be forthcoming with the company or the law firm about the origin of the capital he raised to fund cases, whether his capital is committed or reserved, and to establish his ability to sustain the costs of the envisaged dispute for its entire duration. Understanding where the sources of the capital managed by the funder come from and whether the funder has direct access to this capital is key to ensure that the funder has the authority and ability to provide the funding needed throughout the dispute.

Asking about the investment decision-making process: Companies and law firms should not hesitate to ask the funder about his investment decision-making process as it directly impacts the timing and costs of raising capital. For instance, a fund in which the investment decision is made by those who directly handle the funding request will be able to act faster than a fund in which the funder's case underwriter will need to obtain an additional approval from a new business committee, an internal investment committee and/or an external committee made of the investors in the fund. Some funders are simply structured in a much more bureaucratic way than others. While some funders choose to provide a term sheet within a few weeks and leave it to the due diligence phase to review thoroughly all the aspects of a claim, others prefer to make an extensive review before they offer a term sheet and enter into the due diligence phase. Since it is normally only during the due diligence period that parties are under an exclusivity duty and that funders have budgets to remunerate external counsels or experts to review the merits of a case, understanding how the funder works in this respect is key for the companies and law firms.

Furthermore, while some funders prefer to rely mostly on their internal legal teams to review the merits of a case – even in cases where they are not familiar with the legal field, the market or the jurisdiction involved – some others rely mostly on external counsels to confirm (or infirm) the merits of a case presented to them. This last solution which is more costly for the funder (and ultimately for the company and the law firm as those costs will be included in the funded budget) may also prove faster and less cumbersome for the company or the law firm which role would be to provide only answers to specific questions rather than assist the funder in re-examining entirely the case.

Finally, companies and law firms may want to check whether the funder's team is composed of professionals from both law and finance backgrounds,

to ensure that the funding agreement is tailored as much as possible to the envisaged lawsuit in every regard.

Agreeing on the timeline: As funders are often inclined to under-estimate the time they need to i) give a first answer about their appetite for a case and/or ii) provide the company or the law firm with a term sheet and/or iii) run the due diligence that will lead into entering into a funding agreement, companies or law firms may want to obtain a formal commitment from them in terms of a timeline after their first conversations about the case. Whereas this is not a common practice, such commitment could include a clause whereby the funder would have to pay the company or law firm a penalty for not complying with the timeline he committed to.

Enquiring about the experience, expertise and appetite of the funder for a case: Funders all have specific experience, expertise and appetite for a certain type of cases. This experience, expertise and appetite may depend, *inter alia*, on:

- *The type of funding sought:* An increasing number of funders offer, in addition to single case funding, portfolio[8] and law firm funding[9] which normally prove less costly for companies and law firms. Furthermore, if the disputed case implies (as is often the case) that an After-the-Event (ATE) insurance may be needed to cover the adverse costs, companies and law firms may want to ask to the funder whether he offers such services or coordinates with some insurance companies to resolve this issue;
- *The nature of the dispute which needs funding*: Funders may have specific experience and expertise in all kinds of legal fields such as commercial, IP, data protection, product liability competition, arbitration laws, etc. and have a good knowledge of certain markets and industries. Understanding what claims the funder has financed in a specific legal field or market, the outcome of these claims, the prior experience the funder may have had as a litigator in this field – as this may help his understanding of the foreseeable issues that will be encountered in the case – will

8 Portfolio funding is an agreement whereby a litigation funder provides capital to a company to support several lawsuits, rather than fund a single lawsuit.

9 Law firm funding is an agreement whereby a litigation funder provides capital to a law firm in exchange for a portion of the financial recovery from a portfolio of lawsuits.

allow the company or law firm to have a clear picture of his appetite for the case and of his expertise in the field which may prove useful to the company or the law firm in their strategy to conduct the claim;

- *The stage of the dispute:* While some funders are willing to cover the costs of a case as early as the book building phase (i.e. which consists in gathering a sufficient number of claimants to make the claim viable), some others expect the case to be already book built and cover exclusively the litigation costs; in some instances, some funders may accept to fund the book build phase, while being reimbursed by some others who will finance the litigation costs if/when the book built targets have been achieved;
- *The jurisdiction and laws involved:* Some funders may have a lot – and others no – experience with the judicial system or the applicable laws governing the dispute. This affects directly their capacity to assess the viability of a case and normally impacts negatively the terms of the funding offer. For instance, it is not uncommon that some funders with a common law background find it difficult to invest in disputes governed by civil law systems, and vice versa;
- *The potential duration of the dispute*: It seems that most often funders prefer cases which will be resolved in less than 5 years, while some specialize in cases that either last less or, conversely, more. It is therefore critical to assess the potential duration of an action, as well as the chances of a settlement right from the outset;
- *The partial or total monetization of the claim*: Only a limited number of funders have shown so far an appetite for buying upfront (partially or totally) a claim, while most others don't.

Understanding the financial criteria and expectations of the funder: Understanding what the financial criteria and expectations of a funder are critical to avoid discussing for months a potential funding offer which terms would have been refused right from the outset by the company or the law firm. This includes enquiring about the following issues:

- *The budget required for the case:* Some funders specialize in cases for which the budget to cover the costs of the lawsuit is inferior to 1 million euros or between 3 to 5 million euros, while some others may only want to invest in cases where the budget is superior to 10 or 15 million euros. As most founders do not, or cannot, fund cases exceeding thresholds agreed

upon with their investors, it is critical to understand from the outset the level of capital which the funder is in a position to invest in each case;

- *The expected returns on invested capital:* While some funders will be satisfied with obtaining a pre-determined multiple of 2.5 to 4 of their investment or a 15 to 25% share of the damages, or a combination of both, some others may have a fiduciary duty to their investors to seek the highest possible return on capital invested. Law firms and companies should also ask funders what ratio they expect between the investment size and the minimum amount of minimum damages that must recovered. While some funders accept a ratio of 1:10 or less between the capital raised and the expected damages, some others will seek a much higher ratio;
- *The waterfall:* Funders are often first in the waterfall and as such are entitled to a priority return of their initial capital investment before there is any sharing of the proceeds with the company and/or the law firm. Understanding the type of priority return that the funder is normally expecting is essential for the company and the law firm in so far as it impacts directly their share in the proceeds, especially in cases where the damages obtained are not as high as expected. For instance, given the commitments they made to their investors, some funders must have a multiple 2 or 3.5 of the invested capital as a priority return before any proceeds are shared with the company or the law firm;
- *The legal, tax and corporate structures and the lawfulness of the funding arrangements*: Funders are based in many jurisdictions across the globe. It is for them to ensure – even before they start reviewing the merits of a case – whether the legal, tax and corporate structures they have put in place or are planning to put in place and the funding arrangements they normally enter into will comply with the specifics of the jurisdiction in which a case is funded; for instance, a funder finding out after 3 months of negotiation with a law firm that he will have to pay what he considers excessive taxes for funding a case in a specific jurisdiction wastes significant resources of the company or the law firm (in addition to wasting his own resources);
- *The due diligence fees:* During the due diligence phase (after a term sheet has been offered and accepted), funders support the costs of reviewing the merits of the case; companies and law firms may want to agree from the outset whether the fees they incur before or after the due diligence phase will be fully or at least partially recovered once a funding

agreement is signed. In this regard, most funders still consider that the time and resources used by companies and law firms to assist them in concluding the funding agreement should be supported by them as they should "have skin in the game" (whereas funders on their end receive in most cases a management fee covering their expenses); it is for companies and law firms to negotiate with funders that their fees be covered;

- *The management fees:* Some funders charge management fees throughout the duration of the funding agreement which are included in the budget for which funding is granted. These management fees are normally proportionate to the funding raised. Companies and law firms may therefore want to ask funders from the outset if they charge such fees, rather than learning about those fees at an advanced stage of discussions when they receive a funding offer.

Other considerations when choosing a funder: Other important considerations must come into play when choosing a funder. They include understanding:

- *The funder's control on the claim and its costs:* It is critical for a company or a law firm to understand the level of scrutiny and reporting that they will have to provide to the funder, whether this concerns the merits of the case or the costs incurred. While it is entirely legitimate for a funder to monitor closely the developments of a case and its costs, companies and law firms may quickly regret their decision to have chosen a specific funder who will systematically discuss the merits of the expenses incurred by them despite the fact they fall under the budget agreed upon;
- *The added value other than capital:* It is undisputed that the primary role of the funder is to bring capital. However, some funders are in a position to bring much more to the table. This includes for instance sharing their networks and contacts to assist in book building a case, or helping select and retain legal, economic or IT experts with whom companies and law firms will work. These potential benefits can be discussed with the funder from the outset;
- *The right team:* Companies and law firms should not underestimate the need for them to assess from the first conversations they have with a funder whether he is business-oriented, ethical, responsive and that his interests are fully aligned with theirs. Mutual trust and respect will also

allow all interested parties to maintain good relationships throughout the funding agreement.

In a nutshell, as the litigation funding market matures and the competition between funders will keep on increasing, it will be easier for companies and law firms to compare and identify which funders are the best fit for them. In the interim, companies or law firms might want to be pro-active in gathering the information mentioned above and questioning the funder on all the above-mentioned issues when seeking funding.