

Lawsuits!

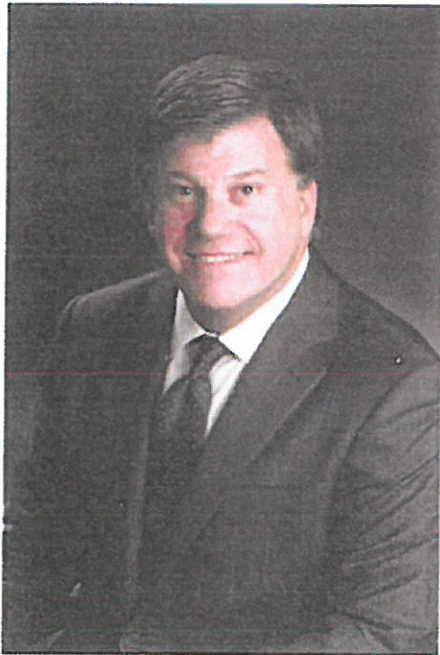
*The newest class of asset
investment*

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Lawsuits — the newest class of asset investment

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Have lawsuits become the newest class of asset investment? Will the next asset allocation include commercial litigation cases in addition to equities, bonds, cash and gold? Does "assumption of the risk" take on a whole new meaning as financing of commercial cases becomes a mainstay of in-house counsel's alternate fee arrangement repertoire? Could an attorney's next referral call come from a hedge fund rather than a client's general counsel?

From the perspective of many in the fields of finance, risk capital, and hedge funds, as well as those looking for the "next big thing," the answers are unequivocal: *yes*. Having

recently returned from Infocast's inaugural Litigation Finance and Investment Summit, held in the heart of Wall Street, right across from the New York Stock Exchange, we also have to agree the answer is *yes*. As stated in the brochure for the event, "Litigation Finance is an emerging multi-billion dollar market in the U.S. This asset class is yielding highly attractive returns for pioneering investors...." Assembled at this event were some of the true founding fathers, as well as founding funders, of the industry. It was a brain trust of Wall Street investors, large firm lawyers, and legal and business scholars.

Some of the questions posed at this great intersection of the legal and financial worlds were: Is alternative litigation finance just another form of off-balance sheet funding for corporations to fund their commercial litigation? What role should regulators play if any in dealing with the ethical issues posed by these funding models?

Here's how it works: Some person or entity advances money towards the prosecution or defense of a claim filed with the appropriate court, tribunal or arbitral body, in exchange for the right to share in the proceeds of any settlement, recovery, or judgment. While the outcome is contingent on a favorable terminal event, the right to share in the proceeds is absolute.

Although litigation finance has been around in a variety of formats for many years, it's the topic *de jour* among bar associations and investment advisors. Hence, the notion that litigation finance is the newest attractive asset class in an otherwise well-diversified portfolio.

So, why do people speak of it as an asset class at all? Isn't this just about some kind of lawsuit? What's the big deal? As an asset class, these claims are treated as tangible and subject to valuation. Unfortunately, until now, many claimants couldn't afford to maximize the value of their asset through the prosecution of the claim. As a result, *without litigation financing, the asset was devalued or lost completely.*

To produce a diversified portfolio, such funds have invested in several categories of cases, notably in intellectual property claims, including patent infringement or

patent licensing claims, antitrust, and price fixing cases.

With the costs of e-discovery rising exponentially, the costs of expert witnesses, forensic accountants or forensic discovery examinations and investigations running into the hundreds of thousands of dollars, litigation finance may be a beneficial way to help re-align the often competing interests and tensions between clients on the one hand, and their attorneys, litigation support providers (such as e-discovery management, evaluation, investigation, or examination providers), and expert witnesses, on the other. When the attorney can look to a third-party or a litigation financier, then the client can be pleased, if not appeased, that someone else is covering those additional funds - albeit in return for a portion of the proceeds of his or her case.

The history of alternative litigation finance in the commercial space began in Australia, where Hugh McLernon, a former prosecutor, co-founded IMF Ltd. in 1989. IMF has funded cases in the past decade that have resulted in settlements and awards totaling almost \$900 million. IMF went public in 2001 and has been listed on the Australian Securities Exchange for the past 10 years. Its stock price has risen from less than 25 cents a share in 2002 to almost \$1.90 in May 2011.

Litigation finance then immigrated to Europe, taking root in the U.K. about 15 years ago. Germany has enjoyed an active and mature funding market for more than 10 years. Finally, it emerged in the U.S. about three years ago and has recently been exported to Brazil, Canada, and Hong Kong.

In 2007, Juridica Capital Investments was the first U.K. litigation financing fund to be listed on the Alternative Investments Market of the London Stock Exchange. Juridica currently has about \$210 million invested. It typically invests between \$3 million to \$10 million with claims between \$25 million and \$100 million. In its first full year in operation, its net assets rose 30 percent; its share price rose 25 percent; and it paid a 5 percent dividend to its shareholders.

The second publicly traded fund to be listed on the AIM was Burford Capital, started by Chris Bogart, a former Cravath, Swaine & Moore trial lawyer, then executive vice president and general counsel of Time Warner Inc., along with Selwyn Seidel, a former senior partner of Latham & Watkins LLP. Burford is the largest public fund, having just increased its capital to a little over \$300 million.

In addition to the three publically traded funds, there are several large private funds. David Dresser's Juris Capital, out of Chicago, invests between \$500,000 to \$3 million on average. Credit Suisse has a division chaired by a former DLA Piper lawyer. Allianz ProzessFinanz in Germany, Calunius Litigation Risk Fund, U.K. and Harbour Litigation Funding, U.K. round out the field.

What type of return on investment are funds looking to achieve? Although the terms and conditions of the deal structures for these investments tend to be closely guarded secrets of the trade, the general pricing of these investments is based on either a multiple of capital invested (3 or 4 to 1), a portion of the recovery (20 percent to 40 percent), or a hybrid arrangement comprised of elements of both with a typical average time line to recovery of two to three years.

One challenge these early public funds are finding is how to create an investment portfolio, which produces the consistent, "non-lumpy" returns that they have sold their investors on. To smooth out the peaks and valleys of their returns, these funds have adopted a time-correlated method of investing in short-term returns, medium-term or core-case investment strategies, and certain special situations, which might be longer-term investments with significantly higher potential for recovery.

To produce a diversified portfolio, such funds have invested in several categories of cases, notably in intellectual property claims, including patent infringement or patent licensing claims, antitrust, and price fixing cases. What they don't invest in (at least the U.K. funds) are personal injury, mass tort claims, class actions and other lawsuits brought by individuals.

Like other sophisticated investors, these funds base their decisions on the present value of their expected return. In the words of Chris Bogart: "We're fundamentally a capital provider. We take a share of the ultimate recovery, having taken the risk of funding the case. Forget this being about the law or litigation - we're providing risk funding for an investment in the same ways as in any other sector of the market. If the investment pays off we make a return on the capital we're investing."

While each fund has its own selection criteria, several core investing principles emerge. The likelihood of recovery is one component of the calculus; another is the potential amount of recovery.

IMF lists the following criteria for its investments: reprehensible conduct in addition to breach of contract, inadvertence or bad forecasting; strength of the claim; potential value; ability of defendants to pay; and cases that are as straightforward as possible. IMF avoids cases involving multiple defendants, because each named defendant increases the litigation costs. Clients who insist a defendant will pay a big settlement just to avoid publicity get the cold shoulder as well.

Presently, legal claims are considered a special or exotic asset - an alternative asset. In the future, it is clear that they will become traditional assets, as common as shares of stock or bonds. The funds are general in scope, but in time, they will become more specialized. As of now, investments in litigation are more common than arbitration or ICSID claims, but even that will change as litigation financing becomes more mainstream here in the U.S. and abroad.

Austin D. Lewis is an intern at Linzer & Associates PC., who will be attending Stanford University in the fall, to whom we are grateful for all his excellent research for this article.

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