

Professional Perspective

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Doing Due Diligence on Litigation Funders

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Developing an appropriate strategy for securing litigation funding is important—not only to reach an agreement that makes sense, but to do so in a timely manner. A strategic approach is especially important where capital needs are urgent due to financial constraints or impending case deadlines. However, for the uninitiated, distinguishing among funders can be difficult, and critical considerations often do not become apparent until late in the process. This article provides a non-exhaustive overview of issues in evaluating potential funding partners that attorneys and clients should consider exploring at the outset of an inquiry.

The Challenge

Commercial litigators routinely receive cold calls and emails from funders big and small, with capital and without. Yet little guidance exists for attorneys and litigants seeking to actually understand relevant characteristics of market players.

While “best practices” guides exist, they tend to limit their focus on ethical, procedural, and structural issues. And even though various rankings are available, they raise the question of intended audience: are they for investors, clients, or attorneys? Each group has its own priorities and may prefer different funders for different reasons.

Finding funding can be time-consuming, so those seeking funding should be aware of various practical considerations as they consider their options.

Capital

The source and stability of a funder's capital can be relevant to its ability to close and finance an investment to conclusion. Pure-play funders are typically publicly traded, structured as private equity funds, backed by a single capital source or majority owner, debt-financed, and may be crowd-sourced. Multi-strategy hedge funds are also active in the space. Other entities function as fundless sponsors that raise capital on an ad hoc basis. Structure is not always apparent from a funder's website or marketing materials. Each model has benefits and drawbacks that should be understood early in the process.

On the front end of a transaction, it is important to understand how much capital a funder has relative to a given investment, and how proprietary that capital is. As discussed below, the more autonomy and discretion a funder has over its capital, and the less concentration risk relative to its overall book, the fewer obstacles to funding. If a funder needs to solicit outside investment, that process—as well as the funder's track record in obtaining outside investment—should be discussed.

Beyond the initial commitment of capital, liquidity and flexibility can be critical in post-closing situations. The market has seen various entrants and exits over the past several years. Liquidity is also important where commitments need to be upsized to account for unforeseen expenditures.

Discretion and Autonomy

A funder's autonomy is relevant to assessing the likelihood of closing and ability to react to litigation and economic developments. Autonomy is often closely correlated with capital structure.

While a funder may express enthusiasm, others may have a deciding vote that impedes an investment, even at its final stages. Some funders have complete discretion over their investment decisions. Others may need consent from affiliates or investors, or are subject to veto rights. Certain entities lack proprietary capital and need to solicit outside investment to procure funding. Furthermore, for larger investments, funders with less capital or approaching concentration limits may need to seek co-investment from larger capital sources. Co-investors will run their own underwriting processes and independently decide whether to participate.

Autonomy is also important after an investment is made. Many facets of litigation are difficult to predict, sometimes requiring changes to the initial funding terms.

Although a lack of autonomy may not ultimately be an impediment, it should be understood at the outset. Knowing what approvals are needed, and at what stages in the process, aligns expectations with respect to the odds of closing and capacity to deal with developments.

Process and Authority

Funders are often asked how long it typically takes to close. Unfortunately, this question rarely yields a useful answer. That is because funders deal with cases at varying stages of development, with varying quality of information and economic expectations. Indeed, the most time-consuming aspect of the process is often the contract negotiation, which is unique to each case.

Instead of inquiries regarding timing, understanding process should be prioritized. Process can be closely tied to autonomy. After intake, it should be understood what remains in due diligence, what information is required to propose economics, at what stages the committee is involved, how approval is obtained, the structure of documents and when drafts are exchanged, how often economics are re-traded based on the results of due diligence, and how often fully-diligenced opportunities obtain investment committee approval.

On a related note, the level of authority and confidence possessed by a contact at a funder is relevant to understanding the probability of getting to a commitment. Positive feedback is encouraging and the execution of a term sheet may seem promising, particularly where exclusivity is granted.

Nonetheless, many funders are quick to propose economic terms to acquire exclusivity without first developing a strong perspective on merits. In addition, to close, buy-in from actual deal sponsors and voting members of an investment committee is typically required. It can be difficult to discern the odds of closing without indications from senior members of a funder's team, particularly where investment committees are large and dispersed geographically.

Attorneys and litigants therefore should not hesitate to inquire about the feedback of a funder's investment team at any given stage of the process. In addition, it is important to understand the composition of investment committees, where members sit, how often they meet, and at what points they provide tentative and final approval.

Closing Track Record

Attorneys and clients frequently ask funders about their investment track record. While historic returns may be important to investors, attorneys and clients should practically be concerned with a different type of track record—namely, the closing track record.

The litigation finance industry is closely covered by the media. However, the actual amount of investments may be surprising to industry outsiders, with many funders consummating only a handful of transactions per year, and, in many cases, those investments are concentrated in certain areas. Indeed, funders routinely reference the low percentage of cases funded relative to inquiries.

Attorneys and litigants should thus inquire into a funder's overall portfolio. More specifically, to gauge the likelihood of closing, it is important to understand how many opportunities of a certain type, such as patent versus commercial, single case versus portfolio, or case funding versus monetization, and size, such as under \$1 million, over \$5 million, or over \$10 million, in which a funder has recently invested.

Structure and Alignment

In search of the cheapest capital, counterparties often ask about a funder's multiple. Although overall return is important, it is critical to comprehend how returns are structured, and the effect of structure on the alignment of interests.

Various points impact the ultimate economics of a funding transaction. Two funders may have the same multiple, but waterfalls can differ drastically. For example, a lower, preferred multiple may preserve more proceeds in a high-recovery scenario, but increase the settlement hurdle relative to a richer, more subordinated return.

Economics should accordingly be evaluated relative to a spectrum of potential outcomes when using pricing as a means of selecting a funder.

Experience, Expertise, and Infrastructure

Funding a case involves more than paying invoices. Prior to funding, structuring requires foresight and planning regarding various circumstances that may unfold, ranging from navigating ethical and regulatory issues, to intercreditor issues, to the manner in which non-cash proceeds are monetized. In evaluating experience, it is important to distinguish between legal credentials and funding credentials.

It is also not uncommon for funding arrangements to be restructured after execution. Issues invariably arise, ranging from the withdrawal or replacement of attorneys, to the manner in which underwriting information is exchanged, to the receipt of subpoenas, to the defense of unanticipated counterclaims, to the exhaustion of the budget. The more experienced a funder, the more prepared it will be to both foresee potential issue as well as handle bumps along the road.

Moreover, the more organized the funder's infrastructure, the smoother its operations are likely to be when it comes to basic functions such as deploying capital in a timely manner.

Experience can also expedite and safeguard the underwriting process. Certain issues that should be addressed early—particularly with respect to jurisdiction, identifying ethical issues, and evolving areas of law—may be obvious to weathered funders yet flagged late in the process by newer entrants. With respect to subject matter, some funders may have deep in-house underwriting capabilities, whereas others may outsource due diligence. Other considerations, such as the manner in which information is exchanged in consideration of disclosure concerns, should be addressed thoughtfully based on prior experience.

Role

Many funders advertise added value based on the collective experience of their teams. While that value can be important, it is not universally desired. Indeed, clients and attorneys commonly seek assurances that funders will be passive investors.

Each funder monitors its investments differently. Some are entirely hands-off, whereas others may seek monthly or even weekly update calls, for which attorneys may bill against the budget. The post-closing role of a funder, and contractual rights related to information and direct or indirect control, should thus be understood to ensure they align with expectations.

Reasonableness, Responsiveness, and Relationship

Although it is not an answer that can be easily obtained, successful relationships with funders require that all parties view each other as reasonable and responsive. Litigation and economic developments can necessitate quick action by a funder, whether it relates to a shift in strategy, confirming the waterfall during a settlement negotiation, reallocating a budget, or addressing urgent working capital needs. Parties should be comfortable they can reach one another efficiently, and confident they see eye-to-eye on important issues, especially economics. There should also be a clear understanding regarding who the post-closing point of contact is at a funder.

Finally, litigation can be a long road. Relationships evolve over time as parties get to one each other more and work together to address issues that arise. Although it is impossible to know whether relationships will develop positively over time, attorneys and litigants should be confident a funder is someone they trust, like, and in whom they have confidence to achieve mutual goals.

Conclusion

It is essential to develop an appropriate strategy for securing litigation funding, and it is equally important to have a strategy for evaluating potential funding partners at the outset. The issues highlighted above are important factors to consider when doing diligence on litigation funders.