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Litigation Funding Series: Transactional Q&A

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Jonathan Friedland and Jeremy Waitzman provide this article as part of a series from their guide for plaintiffs and commercial litigators seeking funding in the United States: Litigation Funding Series: Introduction and History, Litigation Funding Series: CLF vs. Secured Lending and CLF vs. Consumer Litigation Finance, and Litigation Funding Series: Types of Commercial Litigation Funding and Role of Insurance in CLF.

What Is the First Document a Prospective Fundee Should Insist a Prospective Funder Sign?

A non-disclosure (a/k/a confidentiality) agreement. An NDA in the context of a prospective CLF relationship should be a two-way agreement, meaning that it protects each party against improper disclosure of its confidential information by the other party. Sometimes the NDA is included in another document, such as a consulting agreement that could provide additional protections for the parties.

Regardless of the form of the NDA, it is imperative that it be in place before any confidential information is shared with a prospective funder and that it clearly states that the confidential information will be exchanged for the primary purpose of the litigation or anticipated litigation.

What Is the Second Document a Prospective Fundee Should Insist a Prospective Funder Sign?

A term sheet or letter of intent, like many commercial transactions, is far more efficient (i.e., cheaper) for the parties to negotiate a term sheet or LOI rather than jumping right to definitive documents, since a well-drafted term sheet or LOI will likely bring to the surface business issues that are “deal breakers” to either party. A mutually executed term sheet or LOI in the CLF context, like in some other commercial transactions, usually provides the funder with a period of exclusivity during which it will conduct its due diligence and try to negotiate and execute a definitive CLF agreement with the fundee. The term sheet, once agreed, will serve as the business framework for the transaction.

What Key Elements Are Usually Included in a Term Sheet or LOI?

Funding: The funding amount and timing of CLF advances, including whether funding will be in a single lump sum, or if funding will be made as needed or in tranches, based on the fundee or underlying case meeting certain milestones.

Use: While sometimes funding may be used at the sole discretion of the fundee, more typically, CLF advances are for specific purposes only. These uses are most commonly tied to expenses of pursuing litigation – namely to cover attorneys' fees and other expenses incident to the prosecution of the case, such as expert fees or third-party discovery costs. Alternatively, they may be used for a specific purpose (e.g., pursuing IP licensing strategies) or more generally as working capital.

Security: While the CLF advances may be non-recourse as to the fundee, the funder will nevertheless require a security interest related to a fundee's breach of the agreement. The scope of the security almost always includes proceeds of any sort from the applicable funded litigation and accounts created to accept proceeds therefrom. Depending on the credit risk of the fundee or the nature of how the funds will be used (e.g., general working capital), the funder may require more comprehensive security.

The funder will commonly require the fundee to authorize it to file an "all asset" UCC-1 financing statement even when, as is often the case, the fundee has not granted the funder a lien on all assets. First time fundees are commonly surprised by this. The reasons funders do this is that it makes drafting the UCC-1 simpler and because it serves to obscure the fact that a CLF transaction has occurred.

Funder's share of litigation proceeds: The term sheet will provide what portion of the proceeds the funder will be entitled. Given the risk and non-recourse nature of these advances, the "rates" are often higher than you would see in a typical bank loan. While the rate may sometimes be expressed as a stated percentage interest rate (e.g., 35% internal rate of return), most often the return is expressed as a multiple of invested capital (e.g., 2x invested capital), which multiple may increase depending on how long it takes for funder to be paid (e.g. 2x if paid within 2 years, 3x if paid after 2 years). In addition, it is not uncommon for a return to have a residual component that may kick in for "home run" type returns. The terms around a funder's share are some of the most important and pivotal terms of the entire transaction.

Distribution of litigation proceeds: The distribution (or waterfall) of proceeds is also a highly negotiated provision. While the first stage is almost always at least a 100% return of the funder's CLF advances (which may be pari passu with counsel if counsel is paid on a contingent basis), proceeds in excess of that amount may be split in a number of different ways. These may range from the funder being paid its full share prior to the fundee's receipt of any proceeds to the fundee being able to take a certain dollar value or large percentage of funds at some higher level of the waterfall. More typically, however, once the funder has received a dollar amount equal to its initial advances, the parties will share some percentage of the next tranche of proceeds. Depending on who the fundee is (i.e., plaintiff vs. law firm), payments to the law firm are also typically addressed within the waterfall structure.

Termination events: Once an agreement is signed, a funder typically must fund the CLF advances on the criteria stated in the agreement (e.g., reaching certain case or timing milestones and proving proper backup invoices and documentation) unless there is an event of default or unless an event occurs that, while not an event of default, permits the funder to cease funding. Most CLF agreements, for example, allow a funder to cease funding in connection with a material adverse change (MAC). Negotiation over what constates a MAC is common, and examples may include a very negative development in the litigation (e.g., a legal ruling in the case that limits the possibility of success or damage recovery), the withdrawal of counsel, or other circumstance that greatly diminishes the likelihood of success.

Most of the time, if the funders elect to cease funding, it does not mean that the funder is entitled to an immediate return of its CLF advances, but rather, shall remain entitled to some portion of the proceeds if they are received. However, if funding halts because of an event of default, the occurrence of that event of default may trigger an obligation under a bad boy guarantee. A fundee is well advised to understand, up front, what triggers the funder will expect.

Dispute resolution and governing law provisions: Term sheets often call for disputes to be resolved by arbitration. In addition, while there can be some variation, most commonly, term sheets are governed by Delaware law (as that is the jurisdiction most commonly used by funders to create their financing vehicles) or New York law (as that is where an outsized portion of funders are headquartered). That said, the location of arbitration will likely occur in the principal business location of the funder.

What Level of Control Does a Funder Typically Seek Over Decisions About the Case(s) Being Funded?

Funders who know what they are doing insist on having no such control. This is critical because numerous provisions of the American Bar Association's Model Rules of Professional Conduct, which are ethical rules governing attorney behavior, prohibit attorneys from sharing legal fees with non-attorneys or allowing non-attorneys to direct or control the attorney’s professional judgment in representing a client. These rules are designed to ensure that attorneys maintain their independence, professional judgment, and loyalty to their clients. Model Rule 5.4 applies to funders because funders are not practicing law (and even if they were, they do not have an attorney-client relationship with its fundee). Moreover, while a funder’s interests are usually consistent with the interests of its fundee, this is not always the case. For example, if a defendant makes settlement offers, the fundee and funder may not always agree on whether or not to accept it, but as stated elsewhere, this is ultimately fundee’s call (in consultation with its counsel).

Notwithstanding the lack of control that funders abide by, it is advisable for the funder, the fundee, and the fundee’s litigation counsel to have a common understanding before the CLF transaction closes as to the expectations of each regarding strategy and settlement. “Alignment of interest is the cornerstone of a successful funding relationship,” says Schmerler. “If there is a disconnect among the parties, reaching an outcome that works for everyone becomes more difficult.”

How Does Litigation Funding Change the Relationship Between a Fundee and Its Counsel?

Other than payment obligations, which are often covered by funders pursuant to the CLF agreement, the relationship is unchanged. That is, all strategic and other consultations continue to occur between the law firm and its clients, and all privileges continue to exist (unless significant mistakes are made). But wait, (in the words of the great American inventor, Ron Popeil) there’s more…

As noted earlier in this article, a fundee’s litigation counsel will sometimes be uncomfortable advising the fundee on the CLF transaction itself because of conflict concerns. While not all situations require this, the concern can arise for a couple of reasons. First, funders commonly require fundees to execute an irrevocable letter of instruction with their counsel. The letter is commonly limited to serving the purpose of ensuring that litigation proceeds are paid pursuant to the waterfall provided for in the CLF agreement. Second, the fundee’s litigation counsel obviously has an interest in the outcome of the negotiation, as it has a direct impact on the ability of a plaintiff to fund a litigation.

How Long Does the Process Take?

Like most commercial transactions, the answer depends on the level of complexity and the preparedness of the respective parties. That said, the typical timeframe we have observed in our practice, from NDA and first discussions to final document execution, is 2-3 months. Pretium's Schmerler observes that the process is made immeasurably easier for the would-be funder if the would-be fundee and its counsel prepare a funding memo setting forth the legal and factual bases of the case, containing an honest assessment of its strengths and weaknesses. Funders generally focus on four core issues, notes Schmerler: legal merits, likely duration of the case from funding to conclusion, reasonably available damages, and collectability. The sooner the funder can assess those with the assistance of the fundee, the quicker the process will move forward.

What Costs Are Involved in Securing Financing? How Are They Paid?

Unless a party represents itself (you've likely heard the saying "a party that represents itself has a fool for a client"), at a minimum, a fundee will need an attorney to represent it in its negotiations with the funder. Sometimes, but not always, this may be the same law firm that is handling the underlying litigation. In addition, if a broker (i.e., intermediary) is involved, there will be fees for those services.

CLF agreements commonly provide for these expenses as a draw against the overall commitment amount (but that may come at the expense of funds that otherwise would be used to support the litigation). In addition, funders almost universally expect that their fees related to the investigation (e.g., due diligence) and documenting the transaction will constitute payments or deployments against the commitment amount, as will other miscellaneous expenses that the funder may incur.

Sometimes, but not always, funders will agree to cap these fees, but any cap should be included in the term sheet. When expenses are deployed against the commitment amount, the funder will be entitled to repayment upon receipt of proceeds, though it is a negotiated point as to whether the return is on a dollar-for-dollar basis or whether the advanced fees will be entitled to the same return as any other funds deployed in the transaction.

What Happens if the Fundee Loses the Litigation?

Unfortunately, no proceeds will be available to the funder or the fundee. If the funding is structured as a "portfolio" type investment, the funder may be able to recover CLF advances from the first matter in a subsequent matter. Otherwise, the funder will, subject to the caveats immediately below, simply have made an unsuccessful investment, with no recourse against the fundee. CLF agreements include covenants, representations, and warranties. The breach by a fundee of a covenant typically gives the fundee the right to stop making advances. The breach of a representation or warranty may also give the fundee the right to stop making advances and may also result in recourse liability depending on the nature of the breach (as can fraud or intentional misrepresentations on the part of a fundee).

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