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Exploring An Alternative Model Of Litigation Finance

By **Bob Koneck, Chris Le Neve Foster and Richard Butters** (May 16, 2024, 5:10 PM EDT)

There is a new model for financing litigation.

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Its nomenclature is unsettled. But the most apt description is insurance-backed litigation funding.

It differs from traditional litigation funding in two main ways — the pricing and the parties.[1]

In terms of pricing, traditional litigation funders typically require repayment of deployed capital plus (1) multiples of deployed capital, (2) a percentage of damages, or (3) both. In contrast, insurance-backed litigation funders usually charge interest, and otherwise have no right to the damages or fees from the litigation.

Regarding parties, traditional litigation funding generally involves two parties: a capital provider, and either a law firm or its client. In contrast, insurance-backed litigation funding involves three parties: an insurer; a capital provider, and either a law firm or its client.

These differences may become increasingly important. According to Westfleet Advisor's 2023 Litigation Finance Market Report, **published in March**, the litigation finance "industry [is] in a state of flux," and some litigation funders are starting to "ration[] their capital."[2]

Lawyers and clients seeking financial support for their cases may therefore decide to explore novel financing structures. Insurance-backed litigation funding is one such novel structure. This article defines and explains the process for obtaining it.

What is insurance-backed litigation funding?

Traditional commercial litigation funding is now common knowledge.

Traditional funders provide nonrecourse capital to support litigation. Their single source of recovery is usually damages from financed litigation. If the financed litigation is unsuccessful, traditional funders may suffer a total loss. If the financed litigation is successful, traditional funders recover their deployed capital plus (1) multiples of their capital, (2) a percentage of the damages, or (3) a combination of both.

Insurance-backed litigation funders also provide nonrecourse capital to support litigation. But the structure usually differs from traditional funding.

It works like this: A law firm or their client secures an insurance policy insuring a minimum level of recovery in the litigation. The law firm or client then raises nonrecourse financing to support the litigation.

The financing is secured by, and repaid from, two sources instead of one: (1) damages from the financed litigation, as in traditional litigation funding; and (2) the proceeds of the insurance policy

that will pay out if the financed litigation yields a monetary recovery insufficient to repay the funder.

In other words, if the firm or client prevails, insurance-backed funders receive their deployed capital and interest from the recovered damages. But if the firm or client loses, the loss triggers a payout under the insurance policy that repays the funders their deployed capital and, depending on the structure of the financing, some or all of the funders' accrued but unpaid interest.[3]

This dynamic allows insurance-backed funders to price their capital using an interest rate, without any right to the remaining upside in the litigation. Insurance-backed litigation funding is thus usually cheaper. Price is its main advantage.

Its main disadvantage is enhanced execution risk. There are at least three parties making decisions needed to close the funding deal. This can slow or complicate the process.

What is the process of securing insurance-backed litigation funding?

Insurance-backed litigation funding usually involves three steps: (1) requesting terms for insurance, (2) requesting terms for financing, and (3) simultaneously closing both the insurance and funding deals.

Step One: The Insurance

The process begins with a law firm or its client seeking terms for a contingent risk insurance policy.

Contingent risk insurance is the foundation of insurance-backed litigation funding.[4] In relevant part, a contingent risk insurance policy insures a prenegotiated portion of the estimated expenditures — a policy limit — involved in litigating a single prejudgment dispute or a portfolio of prejudgment disputes.

If the insured recovers an amount equal to or greater than the policy limit, the insurer pays nothing. If the insured recovers less than the policy limit, the insurer pays the difference between any recovery and the policy limit.

Factors Insurers Consider

Insurers offering contingent risk insurance increasingly employ lawyers to review legal risks and negotiate policies, some of whom are former litigators and litigation funders. These lawyers rigorously evaluate and weigh many factors when deciding to issue terms for a contingent risk insurance policy.

These include, among other things, the merits of the litigation, the litigation budget, the projected damages, the arrangement with trial counsel, the potential for settlement, the anticipated duration, the identity and motives of the various stakeholders, and trial counsels' level of skill and experience.[5]

Insurers vary in their preferences as to claim types. But most will consider a broad spectrum of commercial disputes, such as those involving claims for breach of contract, antitrust violations or patent infringement, among many other claims.

In addition, insurers often prefer to issue policies covering a portfolio of unrelated cases over those covering a single case, though insurers will consider both. For this reason, among others, traditional litigation funding will likely remain the standard method of financing single cases for the foreseeable future.

Portfolios present multiple avenues to recovery. In theory, this diversification increases the probability that the insured will recover an amount equal to the policy limit and, as a result, that the insurer will pay no claim. Portfolios of cases are therefore less risky for insurers and easier to insure than a single case.

On the whole, insurers will support only exceedingly strong cases and lawyers.[6]

Insurance Terms

Following analysis of the above factors, alongside others, an insurer may decide to issue a nonbinding indication letter, or NBIL, outlining the proposed terms of the insurance.

NBILs are highly bespoke. Insurers carefully structure NBILs to reflect the unique and complex risk profile of the insured legal matters.

Among other important items, the NBIL will contain a policy limit. The NBIL will also provide a premium for the proposed policy. This is often a single upfront payment constituting a percentage of the policy limit.[7] Funders generally finance this for law firms or law firms' clients.

And some NBILs may provide a backstop date at which the insured can make a claim, even if the insured litigation is ongoing. To illustrate, the NBIL may allow the insured to make a claim up to the policy limit at (1) the final, nonappealable result of the insured litigation or (2) five years from policy inception — whichever is earlier.

The above feature is helpful to funders. It provides certainty about the timing of repayment, which allows funders to better manage risk and price their capital.

Step Two: The Funding

After receiving one or more NBILs, the law firm or its client is ready to engage funders.

Types of Funders

Some dedicated litigation funders — i.e., those who focus exclusively on legal finance — can provide insurance-backed litigation funding. But many dedicated funders are unable to offer the credit-like pricing that accompanies an insurance-backed funding deal.

The pool of funders for insurance-backed deals thus includes many others for whom legal finance is one of multiple unrelated investment strategies, such as large hedge funds, credit funds and family offices.

Factors Funders Consider

Funders analyze the same issues as insurers noted above. But funders will also heavily focus on the terms of the proposed insurance, because proceeds from this insurance will, as discussed, repay the funder's deployed capital — and possibly interest — if the financed litigation is unsuccessful.

Additionally, funders will evaluate the credit risk of the defendant or defendants. The reason: Contingent risk insurance policies usually insure legal risk, not credit risk. So these policies will generally not pay if the litigation is successful, but the defendants are unable to satisfy the judgment. Funders must therefore be confident that the defendant or defendants can and will pay a final judgment.

Funding Terms

For the reasons noted above, insurance-backed funders face less risk than traditional funders. As a result, they do not typically take a percentage of damages or charge multiples of their capital. Instead, they charge interest only.

This interest accrues during the funding arrangement and is payable only upon (1) a successful outcome in the funded cases, or (2) a payout under the insurance policy.

The loan-to-value — that is, the capital committed relative to the policy limit — determines if proceeds paid under the insurance policy will cover only capital committed or, instead, also accrued but unpaid interest.

If the loan-to-value is 100%, the funder is providing committed capital equal to the policy limit. A payout under this policy will therefore cover the committed capital at most. If the loan-to-value is, for

example, 90%, a payout under the policy could cover committed capital with 10% of the policy limit remaining to cover accrued but unpaid interest.

Apart from the above, insurance-backed funding terms mostly mirror the terms in a traditional litigation funding arrangement.

Step Three: Closing

After reviewing the range of insurance and funding options, a law firm or their client — whoever is seeking the insurance and funding — will sign an NBIL and a funding term sheet.

This begins a period of exclusivity during which the insurer and funder will finalize their due diligence and negotiate the funding agreement and the insurance policy.

The law firm or client will then simultaneously sign both the funding agreement and the insurance policy, the funder will finance the premium for the insurance policy, and the funder will begin financing the litigation.

Conclusion

The legal finance market is evolving. Insurance-backed litigation funding is an example of this evolution.

Insurance-backed litigation funding usually offers cheaper pricing to law firms and clients seeking financial support for expensive and meritorious cases, but it can involve higher execution risk.

Law firms and clients should therefore carefully consider if this alternative to traditional funding is a good option.

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[1] "Litigation finance" may refer to either commercial litigation finance or consumer litigation finance. These two markets involve distinct laws, parties, pricing, structures, funding procedures, and claim types. This article focuses on commercial litigation finance.

[2] https://www.westfleetadvisors.com/publications/2023-litigation-finance-market-report/.

[3] Insurance-backed litigation funding as described here is comparatively novel. But dedicated litigation funders— that is, those who focus exclusively on legal finance—have already used a similar structure in two scenarios. In one scenario, the dedicated litigation funder obtains an insurance policy covering a portion of the capital it raises. This "principal protection" in theory allows the funder to subsequently provide less expensive funding to lawyers and their clients. In another and likely more common scenario, a dedicated litigation funder enters multiple separate traditional litigation funding agreements with separate law firms or clients. These are priced in the traditional litigation funding way. The funder then obtains insurance that protects its committed capital across this portfolio of funded matters. The funder has therefore de-risked by insuring a minimum level of recovery across a portfolio of separate funded disputes. Insurance-backed funding as described in this article does the same, but it allows the law firm or their client to benefit directly from the insurance, rather than the dedicated litigation funder.

[4] An increasing number of insurers offer "contingent risk insurance" or "litigation risk insurance," which are umbrella categories that encompass a variety of policies that insure the legal risks of both plaintiffs and defendants. Examples include judgment preservation insurance, adverse judgment insurance, contingent fee insurance, and capital protection insurance. A summary of these policies is

beyond the scope of this article.

[6] Over time, this could bifurcate the legal funding market. Parties with the best cases could pursue the credit-like pricing of insurance-backed legal funding and parties with slightly riskier, albeit still meritorious, cases could pursue the equity-like pricing of traditional litigation funding.

[7] Insurers may instead ask the insured to pay a smaller upfront premium payment (again, tied to the policy limit) along with a second premium payment that is deferred and contingent on a successful outcome on the litigation.

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