

Litigation Funding Explained: A Guide for Investors



Blue Lakes

Introduction

Litigation Funding is one of the fastest growing asset classes today, captivating investors with its potential for high returns and non-correlation to traditional markets. Quite unknown until recently, litigation funding first emerged just above a decade ago in common law countries that were familiar with contingency-based fee arrangements. It has now spread more widely, and numerous other jurisdictions have welcomed this practice. We are still at the premises of this asset class though, which still has many prosperous years ahead of it before nearing maturity.

According to several specialized market studies, the sector is estimated at a size of \$17 billion+ in 2024 and is expected to continue to grow at an estimated 10%+ compound annual growth rate (CAGR), which could bring it to over \$60 billion by 2037.

From a macro perspective, it is important to understand that litigation, and therefore litigation funding, is not just a trend. Abuse and disputes are everywhere, and with them comes the potential for litigation. Whether in an expanding economy or a recession, the demand for litigation remains and can even be exacerbated in times of turmoil.

Litigation funding is therefore always relevant.

Despite this, many investors remain unfamiliar with litigation funding, making it an intimidating prospect for those new to the space. For those just beginning to explore this asset class, it's essential to understand the mechanics of litigation funding and how it can serve as a valuable addition to an investment portfolio.

This guide was put together to introduce the asset class to investors in the most accessible manner and to answer the initial questions that come to mind. Our hope is that by the end of this guide, investors feel more at ease with litigation funding and have a deeper understanding of the asset class.

KEY TAKEAWAYS:

- Litigation funding is when a third party funds the costs of a lawsuit on behalf of a plaintiff in exchange for an agreed upon return.
- Litigation funding generally has a strong social impact as it promotes access to justice.
- Litigation funding is a growing asset class that is still far from having reached maturity.
- Litigation funding is an asset class that offers high returns and is uncorrelated to traditional markets.
- Litigation funding can take different forms based on the strategy pursued by the funder and the risk-return profile.

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What is “Litigation Funding”?

Litigation funding or third-party funding (“TPF”) is when a third-party that is not involved in a dispute pays for all or part of the costs of a party to the dispute in exchange for an agreed return.

This form of financing is often non-recourse, meaning that the funder bears all the risk if the case is lost. On the other hand, if the case is won, the funder obtains an important part of the damages that are awarded (on average about 30% or 4x the funder’s investment).

Usually structured as close-ended private-equity type funds, litigation funds invest their capital in single-case funding, portfolio funding, or law firm lending.

The duration of the fund and the returns will depend on the specific strategy that is chosen by the funder. Fund durations can vary from 3 to 10 years, with some very few funds being open-ended with a certain liquidity.

Returns are in the double-digits.

How big is the litigation funding market?

The litigation funding market has been experiencing significant growth over the past couple of years.

What used to be an extremely niche and unknown industry has gradually captured the attention of the legal and financial sectors alike, making it one of the most in vogue asset classes in the world of alternatives. High returns for investors and non-correlation to traditional markets have made it a very attractive asset class, notably at times when other sectors have been underperforming.

The consequential influx of new capital into the market has been one of the drivers of litigation funding's growth, but there are others.

Positive regulatory developments across jurisdictions have contributed to making litigation funding more widely available. Courts and legislators have increasingly had to tackle litigation funding, which has forced them to provide a better framework and clearer guidelines, thus bringing more certainty to the sector. Most jurisdictions have opted to support the concept of litigation funding, which they view as beneficial, whilst managing the challenges that come with it.

Increased awareness within the legal profession has also contributed to litigation funding's growth. As more funders enter the market, and the practice of litigation funding spreads, law firms that had been unaware of the possibility of resorting to funding, have gradually discovered this practice. With this has come an increase in the demand for funding from law firms and claimants, thus driving its growth further. With more competition in the market, funders have also had to diversify the types of funding they provide (single case funding, law firm lending, portfolio funding, etc) to offer more bespoke solutions to firms and claimants.

As we can see, broader awareness and acceptance of litigation funding across the legal, financial and regulatory sectors have all been at the root of litigation funding's significant growth. Furthermore, this asset class is still expected to continue to grow steeply over the coming years and is still considered far from mature. Due to the confidentiality of many of the funded cases around the globe, it is hard to gather the information required to put an exact figure on the size of the current market, but it is said to be around \$17 billion in 2024, and market studies have forecasted it to grow to above \$60 billion by 2037.

What are the key benefits of litigation funding?

The key takeaway regarding litigation funding is that it promotes access to justice.

Access to the justice system is very expensive and time consuming. This alone is enough to deter individuals with deserving claims from seeking legal advice. Oftentimes, individuals are also simply not aware that they have a legal claim or may believe that their claims will not be successful against an opposing party with much deeper pockets.

Litigation funding therefore levels the playing field.

By doing so, it encourages fair settlements. When both parties find themselves on a more equal footing, they will be more prone to find a reasonable settlement rather than go through lengthy legal proceedings. This is especially true when one of the parties is in a weaker financial position, in which case the “stronger” opposing party can easily try to force an unfair settlement that the “weaker” party cannot afford to fight back.

There are a number of other benefits attributed to litigation funding:

Litigation funding offers claimants the possibility for better legal representation. Since the driving factor behind the choice of counsel isn't cost, claimants can get access to more qualified and better suited legal counsel.

Individuals or corporations that are supported by a funder will also be able to put the capital that they otherwise would have spent on litigation to better use.

Furthermore, litigation funding is a great risk management tool as it is in principle non-recourse, meaning that if the case is lost, no amount of money will have to be paid to reimburse the costs of funding.

What are the main types of litigation funding?

To understand litigation funding, it is important to comprehend the different forms that are available. The three main types of funding that are offered by litigation funders are:

Single-case funding

The funder provides funding for a legal claim on a one-off basis in exchange for an agreed return if the case is won. This type of funding is non-recourse, meaning that if the case is lost, the funder carries all the risk and cannot recoup its investment.

Portfolio funding

The funder provides a funding package that covers multiple cases of a company or law firm. This form of funding allows for greater diversification than traditional single-case funding.

Law firm lending

The funder provides a loan to a law firm to allow them to grow their business or take on a larger volume of cases. Under this scenario, the funder receives interest in return for the loan and in some instances, a participation to the upside of winning cases.

The form of funding that is provided by litigation funders will depend on their risk appetite, return objectives and overall investment strategy.

For example, litigation funders that take a more opportunistic approach may decide to invest in several forms of litigation funding, funders with a high risk/return objective may invest solely in non-recourse single-case funding, while more conservative funders may only invest in law firm lending.

For investors that are new to the asset class, the more conservative approach of funders providing loans to law firm will likely be more adequate, while more seasoned investors may opt for a higher yielding, yet riskier, single-case funding strategy.

What is the difference between law firm lending and single-case funding?

Funding law firms or the claims themselves? These might sound similar, but in essence they are two very different activities. They differ, amongst others, in terms of the due diligence process that is carried out and in terms of the risk-return associated with the strategy.

Due Diligence Process

When a funder decides to directly invest in claims, the key focus will be on the claim itself. As part of its due diligence process, a funder will first and foremost look at the merits of the case, or in other words, whether the case will succeed in court. A funder will also analyze the likelihood of enforcing the claim (i.e., whether the amount of damages awarded will be paid) and will look at the economics of the case (i.e., the required investment considering the potential damages to be recovered).

On the other hand, in law firm lending, the primary focus is on the law firm and its financial health. A strong focus will therefore be placed on the structuring of the loan. That is not to say that a single-case funder will not evaluate the strength of the law firm (that is of course an important factor to consider when evaluating the chances of success of the claim), nor that a law firm lender will not evaluate the strength of the

firm's cases (which will be decisive in the law firm performing well), but the key focus is not the same.

Risk Return

Single-case funding is inherently riskier than law firm lending as it is binary in nature. Furthermore, it is in principle non-recourse, meaning that if a case is lost, a funder cannot reclaim its investment. The funder therefore bears the financial risk of losing the case. However, in exchange, the potential returns in single-case funding are often substantial.

Law firm lending, on the other hand, is a more conservative approach to funding. Law firm lenders charge interest when providing loans, which is due irrespective of whether cases are won or lost. Furthermore, law firm lending is full recourse. This changes the risk profile of the strategy immensely as the funder (or lender) is entitled to be paid for the funding provided in any event. Consequently, law firm lending returns are in principle lower than in traditional single-case funding.

These different forms of funding present investors with alternatives in terms of the risk-return profile they wish to pursue, thus offering a variety of options to invest in this very attractive asset class.

Why do law firms seek out loans from litigation funders rather than opt for traditional financing?

This is one of the most frequently asked questions from investors trying to understand the litigation funding sector. It is a valid question, as one might expect that more “traditional” financing options would be available. However, for several reasons, these options are usually not suitable for law firms, which is why they turn to specialized litigation funders for their financing needs.

Traditionally, when a company needs financing, it has several options. Notably, it can decide to sell equity or request a business loan or line of credit from a bank.

However, when it comes to law firms, the first option, deciding to sell equity, is not possible. External non-lawyer investors typically cannot buy into the share capital of a law firm due to legal restrictions. Many law firms aren’t even structured as corporate entities. For the most part they are organized as a simple partnership, between lawyers, who are joint owners and business directors of the firm.

As for the second option, securing a business loan or line of credit from a bank, it is very rarely feasible, and when it is, often unsuitable. The issue that banks face when it comes to law firms is how to underwrite the loan. Since the collateral provided by a law firm consists of the portfolio of claims handled by the firm, it is difficult to understand and evaluate its value. That is why litigation funders hire legal professionals who are experienced in analyzing the type of cases handled by the law firms they finance. Bank and other financial institutions generally lack such expertise. Consequently, they often offer smaller loans with additional guarantees, which may not meet the firm’s needs.

Moreover, traditional bank loans are typically inflexible and unable to address the specific financing needs of law firms, such as covering legal costs, expert fees, or attorney fees. Litigation funders, on the other hand, provide tailored solutions that better match these unique requirements.

Law firms therefore now quasi exclusively seek out funding from litigation funders, which has driven the significant growth of law firm lending over the past few years. Clearly, this type of funding fills a crucial niche, offering solutions that traditional finance simply cannot match.

How do litigation funders use insurance to mitigate risk?

To manage and mitigate risk, certain litigation funders use insurance when funding legal cases. Insurance also serves as a powerful tool to reassure investors and make litigation funder's investment proposal more attractive to them.

After-The-Event (“ATE”) insurance or adverse costs insurance is the most widely used form of insurance. It protects against the risk of having to pay for the opposing party's costs if a case is lost. This form mitigates the risk of having to suffer additional financial losses (other than the invested capital) in the event of an unsuccessful claim.

Capital protection insurance protects against the risk of losing invested capital in the event of an unsuccessful claim. This type of insurance is crucial as it addresses the primary risk in litigation funding—the potential loss of the entire or part of the invested capital.

Considering the additional protection insurance offers, why don't all litigation funders resort to it?

One of the reasons is that it is not always possible to get insurance. Since insurance in the litigation

funding sector is quite recent, it is not widely available. Only certain insurance companies feel comfortable covering this type of risk, and the type of insurance provided (ATE, portfolio, capital protection) varies from one insurance company to another. Additionally, in some jurisdictions, this type of insurance may not be available at all due to the sector's relative immaturity.

Another reason is that, as we all know, insurance comes at a cost. Given that the litigation funding insurance market is still in its early stages, premiums tend to be quite high. For litigation funders that have applied rigorous due diligence and are confident in their case selection, the added cost of insurance may not outweigh the benefits.

Despite these challenges, insurance remains a valuable tool for managing the risks inherent in litigation funding. It enhances the attractiveness of funding proposals and supports the long-term sustainability of funding operations. Therefore, when available, litigation funders should strongly consider incorporating insurance into their risk management strategy.

Is litigation funding considered an ESG type investment?

Environmental, Social and Governance (ESG) considerations have received a lot of attention over the past couple of years when it comes to investments. With the growing number of opportunities available on the market, investors are searching for differentiating factors, “responsible investing” being a very attractive one.

This growing demand has naturally brought with it a strong influx of funds and other investment products described as ESG investments. Hoax or reality, it is often hard to decipher whether such products actually meet the required standards. This has caused a lot of skepticism and the feeling that ESG is often nothing more than a label.

When it comes to litigation finance, however, it is often hard to deny its compelling ESG aspect since its very essence has a strong social component to it- providing access to justice.

Arguably not all litigation investments will be made in the pursuit of social justice and certain claims will have a much stronger social aspect to them than others, but for investors that want to make “responsible investments”, litigation finance offers plenty of opportunities to do so.

Some of the most notable cases in which litigation funds invest that

have a strong ESG component to them are consumer cases. These cases often involve a “David vs. Goliath” type battle, where a great number of individuals (or victims) have been harmed by large corporations and their unethical behavior. Having litigation funders support their cause by financing the costs of litigation, levels the playing field and allows these harmed individuals to seek redress for the damages they have suffered. Litigation funders that take on these cases are inherently pursuing a certain form of social justice and have a notable ESG component to their strategy.

Certain litigation funders have pushed their ESG pursuit even further. Their investment guidelines may mandate that they only take on ESG type cases, such as cases that are in the pursuit of social justice, human rights, or environmental causes, for example. Other funders may take the number of ESG cases in a portfolio under consideration when determining the terms of their funding agreements, to drive the onboarding of more ESG cases. Needless to say, if litigation funders want to include “responsible investing” as part of their fund’s DNA, they have plenty of ways to do so.

How is the litigation funding industry regulated?

Today, the litigation finance market is predominantly a “grey zone”. There is no universal regulatory framework governing litigation funding.

As a result, the way regulators have opted to tackle the matter, varies greatly from one jurisdiction to another. Some states have legislated on the matter, while others have left it up to the courts to decide on the limitations to impose on litigation funding agreements. In some jurisdictions, there are merely industry best practice guidelines in place.

The extent to which litigation funding is permissible and its applicable framework therefore varies greatly around the globe. It even varies widely within countries. The United States, for example, which is currently the biggest market for litigation funding, has no federal regulation that applies to litigation funding and has left it up to the states to deal with this matter.

Two of the main concerns that regulators and courts have had to address when it comes to litigation funding are: ethical concerns and disclosure issues.

These concerns relate to the potential involvement of funders in the litigation. Since funders will have a financial interest in the outcome of the case, regulators want to make sure that the legal team that is required to act in the best interest of the client will not let itself be influenced by the funder’s agenda. This can be especially problematic, considering that the funder typically covers the legal team’s fees.

To avoid such conflicts of interest, some regulators or judicial bodies have decided to impose disclosure of funding agreements at the time of filing of the legal proceedings. This enables them to review the funding agreements for fairness and avoid potential conflicts of interest. Such requirements are not a standardized approach, however, and vary across jurisdictions.

The prevailing observation is that as the litigation funding market continues to grow, there is an increase in oversight from regulators around the world. Clearer guidelines and more detailed regulation are welcome as they will offer more clarity on how funders should operate and will result in greater transparency and predictability. This evolution is essential for shaping the future of litigation funding.



Meet the Author

Partner, Blue Lakes

Laureen Müller-Moret is a partner and our litigation finance specialist at Blue Lakes. She is a civil and common law educated lawyer who qualified to practice law in both Switzerland and New York. Having worked on the arbitration team of a major US law firm for several years, she was first introduced to litigation funding when clients searched for third parties to fund their disputes. Seeing an opportunity to combine finance and the law, Laureen decided to get involved in litigation funding. Now deeply passionate about the subject, her objective is to familiarize others with this asset class and demystify a sector that seems overly complex.

Want to learn more about litigation funding?

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