Adjusting the numbers:
The future of finance in law firms

EDITED BY ALEX DAVIES

Chapter 7:
Options for law firm financing in difficult times

By Andrew O'Connor and Louis Young, Augusta Ventures

The five typical financing options available to law firms

Even when operating in business-as-usual conditions, the typical "thin reserves" business model adopted by many law firms leaves little headroom for the unexpected. When faced with a major stress event such as the impact of COVID-19, the legal services industry found itself particularly exposed. With clients seeking to preserve their own cash by delaying payments, or deferring projects, income for many law firms will be down. With significant fixed costs of well-paid staff and expensive prime location rents, there is considerable overhead that cannot easily be reduced. As many firms are thinly capitalized, the need for suitable sources of finance that have short-term benefit but do not constrain the firm in the long-term has never been greater.

Of the myriad finance options available, five are likely to be under active consideration by law firm leaders – working capital optimization; bank overdraft facilities; internal funds (partner calls); government Coronavirus support; and litigation finance for cases or portfolios. Each has benefits and costs, and some of these levers will be more familiar to management teams than others.

Working capital

Managing Lock-Up is familiar to many law firm partners. Timely issuance of bills and chasing payments are established disciplines. The challenge today is that clients, who themselves are under liquidity pressures, are pushing back on paying bills already issued. On top of this, partners may also be reluctant to chase unpaid bills, let alone issue new ones, to avoid damaging relationships. Some firms may look to use a factoring company to provide immediate cash flow, but this may suggest the firm is distressed. Others may seek to delay payments to their own suppliers, but this risks reputational damage. A balance must be found to secure cash today without causing longer-term damage.

Bank overdrafts

Firms will have established credit facilities with one or more lenders. Where good relationships exist, and covenants allow, it may be possible to seek an extension of agreed facilities in the short-term. Whilst base rates have fallen, banks will apply risk-based pricing to any new facilities granted, which may mean costs are prohibitive. Firms will also need to consider the long-term impact of liabilities taken onto their balance sheets – debts will one day need to be repaid and such repayment will generally be guaranteed by the partnership. For many firms, bank facilities will be low down the list of preference but may be the default choice where limited knowledge of alternatives exists.

Partner finance

Often seen as a last resort, seeking funding from partners remains an option for many. For some firms, this may be in the form of delaying or reducing partner distributions. This will probably be unpalatable but is usually speedy to implement. Other firms may look to tap partners to inject further equity. This is likely to be particularly difficult in current circumstances due to the personal impact it will have on colleagues in both the short- and long-term. Partner finance is politically unpopular but is likely to be on the agenda of many management teams who have not yet explored other options.

Government support

In many jurisdictions this is a rapidly evolving area with numerous options, the benefits and costs of which are yet to become clear. Facilities coming on stream include grants for furloughed and sick staff wages, deferred VAT bills, loans for small and medium-sized enterprises and debt facilities for larger business backed by government treasuries and central banks (though in practice the collateral for these lines of credit may not vary from the bank's required pre-scheme). Managers should explore all options but be aware that these facilities are unlikely to be long-lasting, nor cover the full extent of lost income. There is also likely to be pressure at some point to repay these facilities, particularly if it is later shown that there was little medium- to long-term effect on the performance of the firm.

Litigation finance

A perhaps unfamiliar option, here clients or the firm take funding from a third party to cover legal bills and costs of either their clients or of the firm itself. Funding is generally structured so that it is non-recourse, meaning that it does not encumber the balance sheets of law firms or their client. This method guarantees payments to firms in the short-term and may add a competitive edge in winning work today and for the future. There are few downsides for the law firm providing it ensures a reputable funder is introduced to its client or to its management board, to protect valuable relationships. Firms may seek to introduce such funding on a case-by-case basis or engage firm-wide on a portfolio of cases.

Law firm leaders are undoubtedly considering all the options available to them. Whilst familiar levers will initially rise to the top of the list, thought should be given to those that firms may yet to have fully engaged with. Litigation funding is likely to be one of these. With such funders in the UK having raised significant sums in recent years, support is likely to be available at both the speed and quantum that firms need to both shore up for today and ensure the firm is on a solid footing for tomorrow. When considering all the options for immediate cash needs, leaders should keep an eye on longer-term impact, in both financial and reputational terms.

Litigation finance as a risk-free option

Insurance for a huge variety of commercial risks has been commonplace for centuries. However, the historic principles of Champerty and Maintenance barred a third-party from funding legal cases in many jurisdictions and legal risks were not widely and legitimately transferrable until a few decades ago. Most governments, often with the assistance of the courts through case law that is supportive of third-party funding, have now adapted the rules in the name of enabling access to justice, and the litigation funding industry was born. Today, such funding is increasingly in demand from claimants and their lawyers, and by investors alike.

On the "demand side", claimants with legitimate commercial disputes can readily access third-party litigation funding. Such arrangements differ to traditional insurance policies in that, rather than requiring premiums to be paid in advance of the risk being taken on, no payment is required until a case is won or settled in favor of the claimant. Costs are in fact taken from winnings from the defendants. Should a case be lost, the funder takes the loss without recourse to the claimant, who has no costs to pay. It is worth noting that even in the event of a winning claim, if there is insufficient recovery from the defendant to meet the funding party's costs, the insured will not be liable to the funding party.

Such a risk transfer mechanism can be appealing to claimants in a variety of situations. Many legal disputes are unexpected, so those without legal budgets set aside for litigation can often find third-party funding attractive. So too can those businesses without the significant free cash flow required for funding of often hefty legal fees. That said, funding is increasingly attractive also to cash-rich organizations that wish to manage their working capital and to transfer risks of litigation, turning a potential sizable liability into an asset.

Well-managed funders have effective case management processes in place. Often combining analytical and legal skill, they assess cases on a variety of bases including naturally the legal merits, but also the financial dynamics of the claim, the defendant's ability to pay, and the lawyer's caliber. Such processes act as a filter, often leading to only two to three percent of cases offered to funders being taken on. This ensures the funders a high success rate, often above 70 percent, as is the case with Augusta. The result is strong returns on capital that have not gone unnoticed on the "supply-side" amongst institutional investors.

In today's low yield highly volatile markets, many sophisticated investors are seeking innovative asset classes to diversify their portfolios. Money has flowed in increasing quantum into the litigation funding industry over the past several years, as savvy pension and credit funds seek to access this emerging asset class. Augusta Ventures, for example, raised £150m in 2018 and a further £135m in 2019 from significant institutions. Offers of additional capital are a regular event and seem set to increase given continuing macroeconomic uncertainty, in part accentuated by the worrying advent of the Coronavirus, which has highlighted the uncorrelated nature of the asset class.

The challenge for funders is to manage risk in their portfolios. It is all too easy for ambitious individuals with an understanding of litigation to seek to pile into the industry. From experience, it takes time to build effective risk management processes and to identify optimal segments of the market. The key is to select case types, jurisdictions, and law firms that offer rational, predictable behaviors and outcomes. In much the same way as a commercial insurer relies on past policy data, legal track records need to be analyzed and modelled to understand potential risks and returns for each new claim opportunity.

With hype around the industry growing, both investors seeking to place capital in litigation funders and claimants looking for funding for their cases should carefully consider the appropriate funder to work with. Those participating in the UK-based self-regulatory body ALF – the Association of Litigation Funders – promise to act transparently, fairly, and to ensure appropriate returns for claimants. ALF membership demonstrates a commitment to good governance and fair businesses practices akin to established insurers. Given the low barriers to entry in the industry, it is feasible that poorly managed and undercapitalized litigation funders may be set up. ALF exists to assure both investors and claimants that its members are trustworthy counterparties.

In a little under a decade, litigation funding has gone from a novel phenomenon to a must-have for sophisticated litigation lawyers and their clients. Studies indicate that 80 percent of lawyers expect the funding industry to grow apace into 2021.[1] This trend on the demand side will only cement appetite on the supply side amongst investors. The challenge for those wishing to access the strong returns that are uncorrelated to traditional asset classes is access to proven managers with demonstrable track records and processes. This will remain the case for some time given the timescale that it takes a manager to build and implement systems, and then prove its ability to effectively deploy and recover capital. Those litigation funds set up with the proper processes offer both claimants and investors insurance-like returns and risk transfer. These are attractive in today's uncertain environment and promise to widen access to justice, which is undoubtedly a social good.

The mechanics of litigation finance

Litigation funding solution

The advance of litigation funding over the past decade changes the dynamic by providing a win-win solution for law firms and their clients. It does this by enhancing the value of the counter-cyclical hedge through increasing the quantity of litigation and the quality of law firm revenue.

Litigation funding is not only the preserve of class actions. Augusta's experience in the UK is that most standard funded claims (litigation and arbitration) involve commercial disputes. The majority of those include business-to-business claims for breach of contract, professional negligence, and shareholder disputes.

How litigation funding can help

With litigation funding, the funder pays for legal costs, counsel fees, and disbursements. A major attraction of litigation funding is that it is non-recourse, whereby if the case loses, the funded party pays nothing. The funder generally meets the law firm's costs and claim-associated expenses, and the claim holder can also cover the adverse cost risk (the loser pays the other side's costs) through after-the-event insurance (ATE). In return, the funder charges a commission based on either a multiple of funds invested in the case or percentage of damages awarded upon a successful resolution. Depending on the ratio of costs to damages, the claimant would generally expect to receive around 70-80 percent of the damages, though this is reliant upon the proportionality between the claim size and cost to run.

With funding, businesses can pursue meritorious claims while benefiting from:

- Increased liquidity – cash is retained to meet immediate business needs as opposed to paying legal fees;
- Positive P&L impact – funding keeps ongoing litigation costs off a business' profit and loss as the expense is borne by the funder;
- Risk mitigation – the risk of adverse cost can be covered by a funder indemnity or funded ATE insurance policy, resulting in avoiding having to report a contingent liability on the balance sheet;
- Claim expertise – the funder acts as a project manager, collaborating with the law firm so reducing management time;
- Independent claim diligence – the work the funder undertakes provides assurance on the strength of their case as a funder's legal team undertakes thorough due diligence prior to funding to ensure the claim has merit; and
- Control – at all times the claim owner retains control of the litigation.

Financing also means that law firms can attract more opportunities that benefit their relationship with their clients by introducing the option of non-recourse litigation funding. The funder is aligned with the business as they want a positive outcome and would prefer to spend more on good advice, where required, to achieve a successful resolution. The law firm avoids potential client conflict over billing, as the funder deals with invoices based on pre-agreed budgets. The result is that the quantity of work for law firms should grow to offset falling advisory revenue and the quality of work is attractive as law firms are not forced into aggressive fee caps or fee deferrals. The use of funding shifts the risk from the business and law firm to the funder.

Without funding, the alternative is a lose-lose. Businesses fail to exploit and monetize good meritorious claims and law firms are left with litigation resources being potentially underutilized. Let litigation funding help you access valuable and scarce cash in these challenging times.

Commercial models for utilizing litigation financing

As outlined above, litigation funding provides a mechanism for balancing litigation risk between a claimant, law firm, and funder. There are various commercial structures available to achieve this objective and it is important that all parties seek to ensure that risk is balanced as efficiently as possible. Outlined below are the key features of the three typical models of litigation finance.

Model one – single case funding

Under a single case structure, a funder provides a facility to a claimant to pay the cost of conducting a single dispute. The facility amount is determined based on an agreed budget and the facility is drawn down each month by the claimant to pay approved invoices submitted by their legal team.

If the case is successful, the funder's investment and success fee is repaid in priority from the proceeds of the successful resolution and, if the case is lost, the funder's investment is lost. The terms of the funder's success fee will vary depending on the risk profile of the individual case; however, the success fee is commonly equal to either (or a hybrid) of:

- A multiple of the amount of funds drawn from the facility at the date of resolution; or
- A percentage of the gross proceeds received from the respondent.

In considering the commercial dynamic of single case funding, it is important to note that this model exposes the funder's investment to a simple and relatively binary outcome (the case is either won or lost) and the funder's success fee will reflect this risk.

Model two – portfolio funding

Under a portfolio arrangement, a funder pays the cost of conducting multiple cases through a single facility. This model creates an efficient solution for clients seeking to pursue several claims simultaneously – for example, clients with multiple cases across an entire business or a discrete set of claims relating to a particular project.

The defining feature of a portfolio arrangement is that the funder's investment is "cross-collateralized" across all the cases included in the facility. Unlike a single case investment where the outcome is binary, the funder's risk is now spread across the outcomes of multiple cases and the funder is repaid from the cases that resolve successfully. This dynamic can substantially lower the risk profile of the funder's investment which, most relevantly from the client's perspective, should result in a lower success fee than funding on a single case basis.

In addition to enhancing flexibility in relation to the commercial terms of funding, depending on the size and composition of the portfolio, cross-collateralization also allows funders and clients to consider options to streamline the standard of diligence required for a case to be approved for investment.

The emergence of portfolio funding has allowed the funding industry to efficiently cater to the commercial needs of sophisticated clients by providing a more strategic "business-wide" solution to their litigation expenditure. Consistent with this commercial approach, depending on the preference of the claimants, funders may also consider including in the facility an amount of working capital finance to be used to support the business of the claimant.

Model three – law firm funding

The two models outlined above contemplate funders providing finance to claimants directly. As a rapidly growing alternative, funders are increasingly providing finance directly to law firms. These facilities are structured to enable law firms to draw on funding to underwrite their operating costs while acting for their clients on a contingency basis. The funding to the firm is still characterized as "non-recourse" as the finance is repaid by the firm from the proceeds of the firm's realized contingent work. The client simply retains their share of the proceeds based on the terms of their contingency arrangement with the firm.

Depending on the terms of the facility and the amount charged by the funder, the law firm will retain a material share of the contingent proceeds upon success, which provides potential for significant upside to the firm while protecting against cashflow pressure and downside risk in the event the case is unsuccessful. In addition to the potential financial return to the firms, balancing risk through a facility can provide law firms with the strategic opportunity to satisfy client demand and grow their practice by acting on a contingency basis.

Conclusion

Proactive cash flow management is critical to the success of any law firm. The cash position of most firms has been refined over time to enhance partner distributions and to manage cash balances as efficiently as possible. This traditional strategy has been challenged by COVID-19. Firms must consider all aspects of their business to determine the financing options most suited to both balancing risk and growing their practices.

Reference

1 Burford: 2020 Legal Finance Report: A survey of in-house and law firm lawyers. www.burfordcapital.com