Litigation Finance Whitepaper
Corbin Capital Partners, L.P.

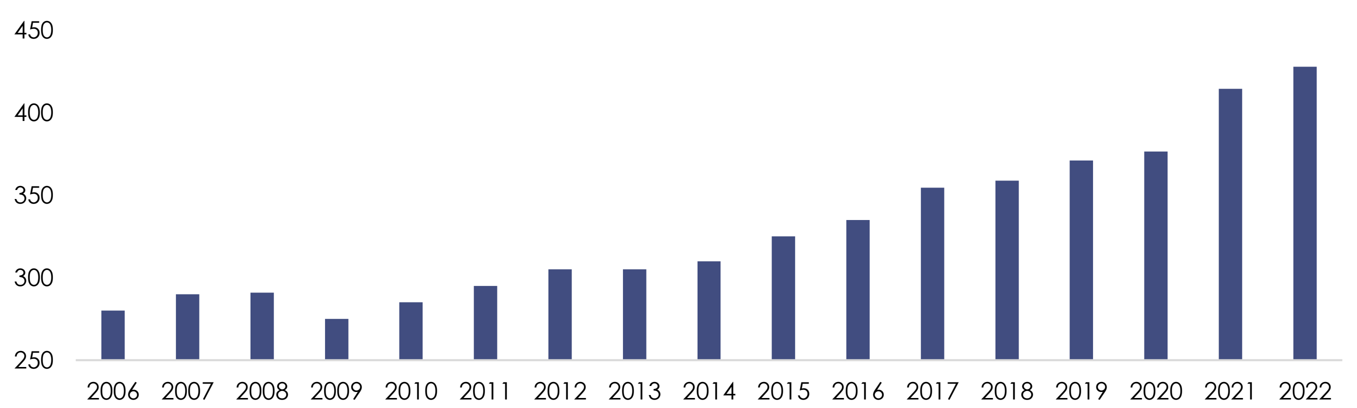
In this paper, we introduce Litigation Finance ("Lit Fin") as an asset class, explain what it is, how it works, and the various ways to access it. We touch on the Lit Fin market generally, and then delve into the asset class's investment thesis and role in a portfolio, challenges and lessons learned, as well as exciting new developments that are improving how investors can participate. Lastly, we discuss our approach and where we think we have an edge.

Litigation Finance Market Overview

Litigation finance is simply the provision of third-party capital to help finance law firms or plaintiffs pursuing legal claims in exchange for a portion of proceeds received. This is an emerging asset class in the U.S. that is generally underbanked and misunderstood, in part because the "collateral" is often difficult to value. It is much easier to ascribe value to a building than a legal claim; hence the real estate market is much better capitalized! However, with the right expertise and approach, we believe this relatively inefficient and fragmented market offers excellent risk/reward opportunities today. Despite more institutional attention and dollars flowing to the space, demand from law firms and claimants for litigation financing far exceeds currently available capital.

The legal industry continues to expand worldwide, mostly due to increased demand and technological developments, and is estimated to be a trillion-dollar market today. The scale in quantity of claims and dollar value is particularly pronounced in mass torts and single-event litigation, as annual costs and compensation paid in the tort system equal ~2.3% of U.S. GDP… and these are just a few of many Lit Fin sub-verticals[1]. The global litigation funding investment market is expected to experience a double-digit annual growth rate through 2035[2].

Figure 1: Legal Service in US ($BN)[3]



There are two main investable buckets within Lit Fin: consumer and commercial litigation. We define the consumer market to include causes of action typically affecting individuals (e.g., personal injury, medical malpractice, pre-settlement finance). Conversely, we define the commercial market as encompassing claims impacting business entities or large groups of people (e.g., business disputes, intellectual property claims, anti-trust, international arbitrations, claims inside of a bankruptcy process, mass torts multi-district litigations, class actions or other mass actions). Consumer is more "retail" and highly regulated while commercial is more "institutional" and less regulated. At Corbin, we typically avoid consumer-related Lit Fin and focus on commercial deals.

Lit Fin exists in large part to provide access to justice in "David vs. Goliath"-type situations. It should be no secret that our judicial system is not solely meritorious -- the deepest pockets have a significant advantage. For example, imagine that a start-up developed a great innovation, patented it, tried to sell it and a large multi-national corporation acted with duplicity to infringe on the intellectual property. Or imagine a partnership/JV dispute where a minority partner has been wronged. Funding such litigations could easily cost millions, possibly tens of millions. Financing meritorious cases with strong alignment is a core tenet of our strategy. Funders are not incentivized to spend their time or money on bad cases, particularly when most case funding is non-recourse and solely dependent on the legal outcome. However, it's not just the little guy who needs funding. One might be surprised to find that large corporations often avail themselves of this type of financing, and increasingly so.

Many Fortune 500 companies are sitting on valuable legal claims but often need to make hard budgeting decisions. Third party financing allows them to monetize those claims in a way that is most accretive to their bottom lines. Spending part of their carefully constructed budget on legal bills in pursuit of non-core litigation is not something the public or private markets will typically reward. The cash spent will negatively impact near term cash flow and projections, whereas any positive outcome is likely to be disregarded as a one-time event and thus excluded from any forward-looking EBITDA/valuation projections. In short, they will get penalized for spending the money and not get much valuation benefit for a positive outcome. If companies can preserve their cash and instead use third-party capital to monetize claims, it is a win-win for the companies, their investors and the funders. Our estimation is that at most 1-2% of all cases receive any litigation funding. As the asset class matures, and awareness around it broadens for key decision makers at the helm of both private/public companies, we expect significant growth.

Why is this an attractive asset class?

A key appeal of the asset class is the uncorrelated nature of the returns. The outcome of unique legal cases rarely correlates with factors driving equity or fixed income markets. Corbin experienced this in the darkest days of the COVID-19 pandemic as some of our Lit Fin investments generated material cashflows, delivering precious liquidity despite a near shutdown in many capital markets. Thus, this niche asset class is appealing for many as a differentiator within a broader, more conventional portfolio. Further, when building a portfolio of Lit Fin investments, there should be minimal covariance as individual positions should not rise and fall together. Thoughtful portfolio construction will yield investments that are both uncorrelated to the broader markets and that do not have positive covariance with each other.

Secondly, expected returns are high. Relative to other uncorrelated strategies (e.g., music royalties), Lit Fin has more potential to generate outsized returns. The expected return on a legal asset is not tethered to the legal spend required to create an outcome; outsized damage amounts are possible with relatively low spend, unlike other asset classes where your return potential is more tied to the capital at risk.

The combination of low correlation to the broader markets and asymmetric return potential makes for a compelling asset class. We also like that once you dig deeper into the opportunity set, there are many different sub-verticals, each with a different risk and return profile.

Figure 2: Litigation Finance Risk Spectrum

Some segments of this market are much less risky than others (as you can see in Figure 2 above). Let's work our way up the risk curve:

- ***Post-settlement financing***: The case has been settled and we are looking to lend at ~50% LTV against future receivables and/or cash in a box. The law firm involved may have spent 3-4 years working to secure a material settlement, but it can still take 1-2 years to monetize because many proceedings (mass torts in particular) have a significant administrative post-settlement phase whereby potentially thousands of individual claimants need to be categorized by illness, degree of harm suffered, medical record verification, etc. on a master grid to determine award amounts. The law firm may want to pull forward some of those proceeds to pay its team or invest in the next big case and is often willing to offer financing in the low-to-mid-teens. This is not the juiciest return profile, but we believe funders are being overpaid for the risk. The cousin of "post-settlement" is "near-settlement" –not pictured above but is riskier and prices higher as the settlement is not inked yet.

- ***Lending to law firms backed by a diversified pool of cases***: These loans generally price in the mid-to-high-teens or higher; depending on which law firm is involved and how aged and diversified their cases are. Litigation finance investing is very much a horse and jockey bet. Investors have to select the right cases and law firms as well as understand, for mass actions especially, where the law firm sits in the broader eco-system as there can be a fair amount of dispersion in terms of case value obtained by different law firms. The firms in a leadership position (i.e., driving the strategy for the litigation and doing the actual litigating) will command higher dollars, while inferior firms with fewer resources and less control will often be forced into lower settlement amounts.
- ***Lending to law firms backed by 1-2 mass tort cases:*** If funders' collateral in a loan consists of just one case (albeit with thousands of individual underlying claimants) they are taking more risk for which they should be compensated (e.g., high-teens to low 20s pricing) unless the case is sufficiently far along to be considered near or post-settlement.
- ***Post-judgment claim monetization:*** In these situations, the case has been won (i.e., a judgment has been rendered) but it remains subject to appeal. Most cases are not overturned on appeal, so the investment is somewhat de-risked, but this is still further up the risk curve and return expectations should roughly anchor around a ~2X multiple on invested capital. Those return expectations can and should decrease with insurance, which we will discuss in more detail below, but generally speaking, insurance providers are quite active in this market (across a variety of sub-verticals) and this can be an important hedging tool.
- ***"Debtquity" or equity-like investments in a portfolio of cases:*** This can be an investment in a law firm backed by a pool of early-to-mid-stage commercial cases (e.g., 5-6 cases) with return expectations around ~2X-3X multiple on invested capital subject to a minimum IRR threshold. On the mass torts side, this can take the form of fee sharing arrangements with law firms in certain jurisdictions that are backed by numerous earlier or mid-stage torts. We like the term "debtquity" because the waterfall typically reflects a return of the funders invested capital first and then a split of the upside with the law firm.
- ***"Debtquity" or equity-like investments in binary single cases***: This is similar to the "debtquity or equity-like portfolio investments" opportunity mentioned above but is more binary as funders are taking single case risk. Therefore, higher returns are required (~2X-5X+) in consideration for the enhanced risk.

For both single case and portfolio bets, the return profile also depends on the pond funders are fishing in. For example, IP and international arbitration claims typically command a higher premium as they are generally perceived as having more duration and risk. For single cases, sometimes it's possible to buy all or part of the claim from the plaintiff directly and create more upside as the funder would step into plaintiff's shoes and potentially keep more of the proceeds. And for all of the boxes above, there is room to adjust the risk/return spectrum depending on the stage of the underlying legal risk and structuring elements (e.g., can you get personal or limited guarantees from the counterparties, insurance, etc.).

The high-risk/high-reward profile of the more equity-like Lit Fin investments often draws parallels to venture investing. However, there are two key distinctions worth noting. First, legal assets don't need a capital markets solution or another investor to create an exit (there will ultimately be a final judgment). Second, investments in legal assets can be staged so that future commitments are contingent on achieving certain case milestones (e.g., surviving summary judgment). This staging allows funders to see a case develop before committing material dollars, thereby minimizing losses and amplifying bets on cases that are going well.

Innovations and Regulatory Changes

The Lit Fin asset class is not immune to regulatory intervention, shifting landscapes, new market entrants, and general societal trends like technology advancements. On balance, we believe these trends are generally accretive for the asset class.

On the regulatory front, there have been significant developments. The U.S. legal industry has historically not permitted equity financing from non-lawyers into law firms. This is partly driven by ethical concerns around independence, perceived conflicts, and confidentiality, but also because of concerns from state bar associations about the impact on quality of services being provided, which has led to bans on law firm ownership. There has also been a general wariness of non-legal professionals being too involved and potentially exerting too much control. We have seen some innovation, as it is now possible in certain states (e.g., Arizona) for non-lawyers to take equity interests in law firms and more states have adopted permissive views on the ability of non-lawyers to share fees with lawyers. We have recently taken advantage of such structures to better express risk and capture upside.

Technological advances have hit the mass torts space profoundly. With more "digitization" it is much easier and cheaper to find claimants for mass torts. Previously there were TV ads and 1-800-lawyer call centers and billboards, but now law firms can run digital campaigns at a fraction of the cost and use technology to better stay in touch with claimants throughout the life cycle of a tort, thereby reducing fallout and maximizing returns. You likely saw a lot of Camp LeJeune ads online. Not all of that is positive, however, as bigger cases with more dollars at risk tend to be more complex and take longer to settle. But overall, we believe these are positive developments for both claimants (more of whom now can access recourse for significant harms) and funders (who have benefited from the creation of investment and financing opportunities as the investable universe has grown).

Insurance companies entering the litigation finance ecosystem is another recent and interesting development in our view. While some may view insurers as competitors to be wary of, we mostly view them as adjacent to funders and a useful tool to mitigate risk and help create a tighter band of expected returns. Insurance companies will typically protect principal and sometimes returns on diversified mass tort dockets, offer post-judgment insurance, and wrap entire existing pools of commercial cases. Some are even starting to provide insurance on blind pools (before any investments are made) subject to eligibility criteria around diversification and satisfaction of concentration limits. The insurance angle provides more ammunition for funders as we think about how to construct and structure these often very bespoke investments. The combination of downside protection via insurance and an investment with significant convexity is a powerful construct. We believe every funder should be thinking about what insurance products are available and how they can use them to improve risk/reward.

Lastly, artificial intelligence/large language models will surely have a material impact on the asset class in the coming years, from simple tasks such as scraping dockets to source certain types of new cases to more complex functionalities like:

1. Predictive analytics (using data, statistical algorithms, and machine learning to identify the likelihood of future outcomes)
2. Document review (analyzing medical records, emails, prescription data, and contracts to build a case)
3. Case management (automate scheduling, track deadlines, and manage communications between parties).

Challenges

There are several challenges unique to this asset class but for us, the biggest is duration. Court cases can extend for many years, especially large, complex cases involving multiple parties and/or mass actions, which are administratively challenging given the life cycle of a mass tort. Funders can mitigate some of that duration risk by being intentional about entry points and by creating structural alignment but there will always be illiquidity risk. The key is to be aware of it, try to mitigate it, and get properly compensated for it.

There tends to be a fair amount of "inside baseball" in the space, particularly in mass torts, making it crucial to understand who the key players are and, as much as possible, the inner workings of the particular law firms. Legal firepower is an obvious differentiator but perhaps not the most important one. How well capitalized is a firm? What is their operational infrastructure/case management system like? Where does the law firm sit in the ecosystem?

Are they driving the car or are they in the backseat? These considerations impact a firm's ability to prosecute a case and drive an outcome. A good investor is tapped into the market and can discern who is and isn't a reliable partner. Coming from a traditional credit background, it can be eye opening to see how some law firms operate on a spreadsheet, without a CFO and, without a formal cash management/budgeting process. In sum, law firms are often not the most buttoned up borrowers. Additionally, there are challenges with enforcement as the collateral can be cumbersome to monetize in a work-out scenario. Therein lies the opportunity, as many law firms are not "bankable" from traditional channels. The takeaway for funders is, do your diligence.

Collectability should also be at the forefront of underwriting. Funders can have a great case and a great legal team, but if the defendant is notoriously difficult to collect from, not able to afford the underwritten quantum or generally not solvent, all your efforts are moot. Consideration must be given at the outset to ensure there is a reasonable path to settlement, collectability, and an ability to pay.

Lastly, despite the conviction one can develop in a case or group of cases, it is important to remember you are often at the whim of a judge or jury and that unexpected outcomes do occur. This also speaks to having the right partners (law firm/client) involved who are realistic about their definition of a good outcome and are not going to hold out for the last dollar. Some of this alignment is often addressed via structuring (e.g., minimum IRR thresholds so that if the case goes longer a funder gets a bigger portion of the proceeds) to incentivize an earlier resolution even if below the ideal settlement range the plaintiff/lawyers had in mind. There is a cost to waiting and everyone involved should share that pain. The good news is that ~95% of cases are resolved before the first day of trial[4], but it can be an expensive, long, and winding pre-trial road.

Corbin's Approach

We approach the space very much with a private credit mindset and background, supported by our 20-year history in credit investing, so capital preservation and downside management are core tenets of how we view the world. About 80% of what we target in litigation finance has more of a credit-like risk profile – either in form, structure, or collateral characteristics (i.e., portfolio transactions, diversified pools, late stage/close to settlement, insurance wrappers, key-man life insurance policies etc.). At the same time, we want to be opportunistic about asymmetric situations and will occasionally consider them so long as they are appropriately sized. That approach has allowed us to drive outsized returns in Lit Fin deals. Conceptually, we aim to allocate some of the credit P&L (an amount we are comfortable losing in terms of total return impact to the portfolio) and apply it to these higher return potential opportunities – again, appropriately sized and structured. This methodology has been accretive so far but to be clear, the bulk of what we do and the majority of our dollars in this space looks and feels more credit-like (i.e., the blue boxes from Figure 1 above).

Being conservative around our underwriting assumptions for both case values and expected holding periods is critical. Regardless of the investment, we prefer to enter in the later stages to help manage duration. Unfortunately, sometimes you think you got to the ballpark in the 7th inning but, despite best efforts, it's actually still the 4th inning. Regardless, we have other ways to mitigate the extension risk (e.g., cash sweeps while maintaining seniority in the waterfall, IRR maintenance provisions, rate step-ups over time, etc.) to incentivize an earlier resolution and earn a greater return/avoid IRR degradation.

With rare exceptions, we focus our efforts in the United States. It is important to play in the sandbox you know where there is more settled precedent, where rule of law is respected (i.e., less subject to political risk) and where you know the quality law firms/players. We have a higher bar to venture abroad but have done so selectively. One such example was a UK based lawsuit against a group of major banks involved in the LIBOR-rigging scandal. We were comforted by the fact that some of those banks had already paid fines and/or admitted guilt in the United States for similar conduct and we trusted the quality of our law firm partner in that transaction.

In terms of types of cases we target, see below:

Figure 3: Litigation Finance Segments

This figure mainly divides the world into consumer and commercial litigation as previously discussed, with our focus being commercial. Within commercial litigation, not all sub-sectors are created equal. We have a higher bar for IP (which can be complex, technical, and susceptible to longer duration) as well as international arbitration (notoriously lengthy and often plagued by collection issues). Conversely, we gravitate towards situations inside of bankruptcy processes as that tends to shorten duration. Business disputes and mass torts are some of our most common types of investments and recently we are seeing an uptick in anti-trust activity.

We believe our sourcing capability is our biggest differentiator. We fund law firms and cases directly, but we employ a partnership model for most of our investments, working alongside other funders on specific deals. We like this approach as we have built a deep bench of trusted partners, most of whom have their own dedicated Lit Fin focus areas. This results in a wide funnel across themes, risk-profiles, and partners to pluck individual deals that best fit our criteria. The ability to leverage 20+ partners and sift through deal flow to find the most compelling ideas is quite powerful and has contributed immensely to our success. Our investors then enjoy the benefit of a one-stop-shop to access the space. We lean on our network to better underwrite as well, as it can be a great resource for color on a particular situation or counterparty.

Conclusion

At this stage, litigation finance is still a somewhat esoteric and evolving asset class. That being said, the rule of law and legal assets are an integral part of commerce, which bolsters our conviction in litigation finance as a deep and global asset class with plenty of room to grow. We believe Lit Fin is a differentiated vertical that deserves careful consideration by allocators looking to diversify their portfolios and enhance return potential. We are extremely proud of our success in the space to date and are quite excited about the opportunity set going forward.

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