Portfolio finance as a tool for law firm business development

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In portfolio finance transactions, a litigation finance company provides capital to a firm, usually a law firm but sometimes a litigant, in exchange for a negotiated share in whatever proceeds the firm receives from a portfolio of cases. The cases in the portfolio typically are cross-collateralized, which means that the litigation finance company's return comes out of the aggregate proceeds of the entire portfolio.

Thus, greater than expected proceeds from some cases in the portfolio can compensate for less than expected proceeds from other cases in the portfolio. In theory, as compared to a single-case financing, portfolio finance is less risky for the litigation finance company and less expensive for the funding recipient.

Law firms often think of portfolio finance as a way to defray out-of-pocket expenses and lock in some fraction of hourly revenue for a defined portfolio of cases that they are handling on a straight or partial contingency basis.

But there are other potential uses for the capital that law firms take out of a portfolio finance deal. For example, some firms might prefer to invest in growing their business.

This expert analysis explains why investment of litigation funding proceeds in business development may be beneficial to both the law firm and the litigation finance firm.

CLOSED PORTFOLIO VS. OPEN PORTFOLIO

In a typical portfolio finance agreement, the litigation finance company should be largely indifferent to how the law firm uses funding proceeds so long as funds are not used in a way that jeopardizes the viability of the law firm or its ability to see the cases in the portfolio through to conclusion.

Put another way, the litigation finance company cares much more about the strength of the cases in the portfolio than it does about how funding proceeds are used.

This is especially true when the litigation finance company's return is based on a static portfolio of cases — that is, a defined group of cases that the litigation finance company and the law firm agree will be the basis for the funder's return, with no cases added or removed from the portfolio.

But portfolio finance agreements need not be— and often are not — limited to a static group of cases. Rather, many portfolio finance agreements start with a defined portfolio of cases but allow for cases to be added to the portfolio over time. In other words, the portfolios are "open" rather than closed.

A portfolio finance agreement could be structured such that the funder's return comes only from cases that are added to the portfolio after the agreement is signed. Such an arrangement, however, would be too risky for most litigation finance companies and likely too expensive to be sensible for a law firm with strong prospects of success.

There are several reported examples of litigation finance companies entering into portfolio finance agreements with newly formed law firms. But the law firms in those cases typically have not started from a cold stop.

Rather, they have been formed by lawyers with track records of success and books of existing cases that served as the initial portfolio for the financing agreement.

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Open portfolio agreements can have potential advantages over closed portfolio agreements. For example, in exchange for $5 million in funding, a litigation finance company may accept fewer cases or lower-value cases in the initial portfolio than it would otherwise require if the parties agree that new cases will be added to the portfolio over time.

Or the litigation finance company may have more tolerance for high-risk, high-reward cases in the initial portfolio if there is a mechanism for adding similar cases in the future.

The main advantage of portfolio finance is that it diversifies risk. A starting portfolio of six high-risk, high-reward cases may appear much less risky to a litigation finance firm if there is a strong likelihood that several similar cases will be added over time. If cases can be added, the litigation finance company may be willing to offer more funding at closing than it otherwise would.

NEGOTIATING OPEN PORTFOLIO AGREEMENTS

Although open portfolio finance agreements have several advantages over closed

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agreements, law firms considering such agreements should keep several points in mind.

First, the strength of the initial portfolio remains vitally important. Even though the litigation finance company will take some comfort in a potential pipeline of future cases, the law firm should be prepared to make a persuasive case for why the existing portfolio is likely to generate enough proceeds to allow for return of capital and at least some return to the litigation finance company, even if the law firm's efforts to develop new cases are not successful.

Second, the litigation finance company will want as much information as possible on the pipeline of cases that may be added to the portfolio. An established track record of developing successful cases in related areas is reassuring but may not exist.

At a minimum, the law firm should be able to explain the areas in which it expects to develop new cases to add to the portfolio, why it believes it can develop cases in those areas, the expected timeline for developing the cases, and the potential value of the cases.

Third, the law firm should expect more questions about how financing proceeds will be used than it might receive in a closed portfolio arrangement. There are many possible uses of funding proceeds that are logically connected to business development. Funds might be used to attract a partner from another firm with a complementary book of business, to acquire another firm, to open a new office, or even to advertise.

From the perspective of the litigation finance company, there is no best way for a law firm to use funding proceeds. Best use almost always depends on the nature of the law firm's practice and the types of cases it is trying to develop.

Regardless of how proceeds are used, litigation finance companies want to see a rational connection between the request for funding and the business plan for developing new cases to be added to the portfolio.

Fourth, unlike a closed portfolio agreement, an open portfolio agreement requires that the law firm and the litigation finance firm agree on the parameters of cases that can be added to the portfolio, the mechanism for adding those cases, and the financial consequences of doing so.

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Variations on how parties can structure open portfolio finance agreements are nearly limitless. The simplest case is if:

- The law firm represents mainly or exclusively plaintiffs on full contingency agreements.
- The law firm and the litigation finance company want to use all the law firm's existing cases as the initial portfolio.
- The parties want to add any new cases that the law firm files to the existing portfolio.

In this simple example, the only added complexities as compared to a closed portfolio agreement are the need to agree on the period during which newly filed cases will be added to the portfolio and the funder's return on newly filed cases. The litigation finance firm could have a larger or smaller economic interest in newly added cases as compared to cases in the initial portfolio.

Often, the negotiated outcome depends on whether another bank or litigation finance company retains a secured interest in receivables from the law firm's existing portfolio of cases.

But that's the simple case. A large law firm, or even a small or medium-sized law firm with a relatively diverse practice, may not want to include all its cases in a portfolio financing agreement.

Indeed, because of varying fee agreements with clients and the sheer size of many law firms, an all-encompassing portfolio finance agreement often is impractical. Thus, many portfolio finance agreements have a mechanism for adding some but not all newly filed cases.

To avoid disagreements, the litigation finance company and law firm must carefully define which cases may be added and how.

Will cases that meet pre-defined criteria be added automatically? Will the litigation finance company have a right of first refusal — that is, will the law firm have an affirmative obligation to present cases that meet the criteria for inclusion? Will the litigation finance company have a corresponding obligation to increase funding if it agrees to add a case?

The answers to these questions can significantly affect the overall economics of the funding agreement. And all these factors add complexity to the drafting of portfolio finance agreements. When carefully executed, portfolio finance agreements can produce significant benefits for law firms and litigation finance companies alike. WJ