



CORPORATE M&A AND DISPUTE RESOLUTION

Legal finance: A new market

1. Legal finance: what is it?

With its roots in the late 1960s, legal finance allows companies to access new sources of funding enabling them to exercise their rights in the event of litigation (through recourse to courts and arbitration tribunals)¹.

¹ Legal finance, also referred to as litigation funding or third-party funding, has been gaining prominence in various jurisdictions as an agile way of responding to the traditional financing alternatives offered by the market to companies during the course of litigation. Our experience and contact with this market tells us that the countries with the best track record are the common law countries, mainly the United States of America, Australia and the United Kingdom.

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Through this instrument, a third party provides funding to a company to enable it to begin or continue to pursue an action, and to ensure the enforcement of its rights. Moreover, the third party assumes the risk of failure of the action fully and without recourse.

The use of legal finance transforms contingent assets (or legal assets) of companies into assets with a positive impact on their balance sheets. Moreover, it is a source of liquidity for the company receiving the financing.

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These legal assets may consist of (i) litigation rights, that is, rights whose existence is challenged or whose enforcement requires recourse to the courts, for example, as the result of a breach of contract; or (ii) credit rights resulting from court judgments or arbitration awards that have not yet been enforced.

The "transformation" or "revaluation" of these assets is done in one of the following ways: (i) financing, (ii) monetisation, and (iii) recoveries.

In the first, the finance provider bears (without recourse) the costs arising from litigation and, in return, it receives part of any gains (normally around 30%) that result from a favourable outcome in the litigation. In contrast, in monetisation, the aim is to advance to companies, on a non-recourse basis, part of the gains that may arise from a favourable outcome of a particular dispute. Finally, in recoveries, the funder may alternatively finance the costs associated with the enforcement of a given judgment in exchange for part of the proceeds, monetise the economic rights arising from it, or simply acquire them.

Therefore, even if the companies that receive financing are the immediate beneficiaries of this type of operation, the financing of legal assets is an innovative and financially attractive alternative that allows finance providers to diversify their investments.

In this type of operation, the lawyer is a key player who actively contributes to the strategic alignment of the financing plan. The lawyer also carries out the due diligence process to analyse the risks of the financing, analyses its tax impacts, structures the contractual instruments regulating the relationships to be established between finance providers and the parties receiving finance, deals with the cases, and provides specialised legal advice.

In a post-COVID-19 context and anticipating the inevitable emergence of *legal finance* in Portugal, PLMJ has set up a multidisciplinary team to structure and handle this type of operation. The team includes lawyers from various practice areas, principally, Dispute Resolution, Corporate M&A, Private Equity, Tax and Capital Markets².

² In this context, PLMJ held a webinar on legal finance (on 28 October 2020), and issued publications on the topic (see the article (in Portuguese) by Iñaki Carrera and Pedro Menezes Cardoso, "Legal Finance como instrumento de corporate finance", available [here](#); and the interview (in Portuguese) with Joaquim Shearman de Macedo and Duarte Schmidt Lino, available [here](#)). PLMJ also dedicated a special episode of the PLMJ podcast to legal finance (on 26 March 2021, available [here](#)).

2. Legal finance products

As mentioned, legal finance makes it possible to transform legal assets into assets with a positive impact on companies' balance sheets through (i) financing, (ii) monetisation, and (iii) recoveries.

(i) Litigation rights financing

Typically, the financing of litigation rights operates through a contract made between the holders of these litigation rights and a third party finance provider who bears (without recourse) the costs arising from the litigation. This is done in exchange for a percentage of any gains obtained by the company receiving the finance if it wins the litigation.

This form of legal finance has typically been used on a "single case basis". The costs associated with a single judicial or arbitral dispute are financed in return for a percentage of any gains resulting from potentially winning the case.

However, to mitigate the risk of financing on "a single case basis" finance providers have resorted to portfolio financing. This involves combining several disputes with different levels of risk in a single investment in order to perform a "cross-collateralisation" of their investment. In other words, this allows them to compensate possible losses in one case with gains made in other cases.

(ii) Monetisation

Monetisation translates into the possibility of the financed companies receiving an advance, on a non-recourse basis, of part of the (economic) rights that may arise from the favourable outcome of a certain litigation case. This allows companies to obtain additional liquidity by monetising those assets.

The company receiving the finance can use the capital it obtains through monetisation to meet the costs and charges arising from bringing a claim. However, it can also use this capital for the company's economic activity.

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This approach has several benefits. It allows an immediate flow of cash, just when it is most needed. It also allows immediate access to capital rather than waiting for cases to be resolved, and this mitigates the company's exposure to risk.

(iii) Recoveries

Winning a case is not necessarily synonymous with compliance with the law. It is not uncommon for losing parties not to comply with court judgments and arbitral awards. Therefore, they need to be enforced.

In this field too, legal finance can serve as a financing instrument to enforce these judgments and awards. We are talking here about recoveries, as a product of legal finance, where the finance provider provides capital to meet the costs associated with the enforcement of the judgment, and then receives a part of the proceeds, monetises part of this right that has already been recognised by the courts, or even assigns it.

In general, companies resort to this legal finance product when they prefer to have the money immediately available. Although the return is lower compared with the other legal finance products, this product may, nevertheless, be beneficial.

"Although the immediate beneficiaries of this type of operation are the companies being financed, the financing of legal assets is an innovative and financially attractive alternative that allows finance providers to diversify their investments."

3. Legal finance and the company in crisis

What we have set out in the points above makes it even more important to take into account the economic effects of the crisis caused by the pandemic. This has had a considerable negative impact on companies' cash flows and it has increased, in equal measure, the cases (and risks) of insolvency, fraud, breach of contract and violation of rights. At the same time, it has increased the risk of litigation between the various economic operators.

Few businesses or companies are "pandemic-proof" and, given the (global) interdependence of economic operators, the insolvency of one company may have a snowball effect on the associated chain of suppliers, creditors and other parts of the supply chain that feed the business.

Internationally, we are seeing an increase in companies resorting to insolvency to gain some breathing space while facing unexpected financial challenges caused by the impact of COVID-19.

For this reason, by 2021, it is anticipated that recourse to legal finance, particularly in the context of insolvency and corporate recovery, will grow exponentially.

Legal finance opens up a window of opportunity both to reduce the coming wave of insolvencies and to maximise the satisfaction of creditors' claims against companies in crisis. It is an effective alternative form of financing for companies and of investment for finance providers. It also introduces financing and monetisation solutions for assets that were, up to that point, "dormant" on companies' balance sheets.

Thus, legal finance is an alternative to taking traditional cost-saving measures, especially for companies in a situation of revitalisation, recovery or insolvency. Besides this, it enables them to resort to external funding to maximise their assets and, consequently and simultaneously, generate immediate liquidity.

Through legal finance, the costs and charges associated with litigation are borne by the finance provider. This allows the company receiving the finance to transfer all or part of the risks associated with filing a legal action. Not only does the finance provider bear the costs of filing the legal action, but it does so on a non-recourse basis. Therefore, the risk of failure of the legal action is transferred permanently from the company to the finance provider.

Legal finance can thus be used in insolvency to finance any type of action that creates a significant recovery opportunity for the insolvent estate. In this context, legal financing maximises the capital of the insolvent estate. It also allows for a faster and more efficient recovery for creditors and, in the end, a result that would otherwise be difficult to achieve.

In short, recourse to legal finance appears to be an extremely attractive option for both creditors and insolvency professionals, because it makes it possible to file actions that might otherwise not have been pursued. Moreover, legal financing provides an innovative risk allocation alternative and encourages (distressed) companies to resort to judicial and arbitral proceedings to enforce their rights. Finally, obtaining capital in this way makes allows a faster and more effective allocation to satisfy creditors' claims and, at the same time, makes it possible to recover and revitalise companies.

4. Final Notes

The pandemic has considerably affected the cash flow of companies. It has also increased the number of cases (and the risk) of insolvencies, fraud, breach of contract and infringement of rights and, to the same extent, the risk of litigation between the various economic operators.

Anticipating an increase in the risk of litigation between economic operators, there is a pressing need to mitigate the costs for companies in money and time that are commonly associated with going to court, and to democratise access to justice.

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In this context, legal finance emerges as an undeniably useful alternative that safeguards the interests of companies by bringing them liquidity quickly, without great risk, and increases the chances of satisfying creditors' claims. At the same time, it is an attractive investment option for finance providers. ■