Litigation financing: Risk vs. reward

Necessity is the mother of a litigation loan. Be smart about it and read the fine print

BY DAVID COOK

Many plaintiffs' attorneys make a career of handling modest personal-injury cases, and when they are fortunate enough to sign-up a big case that is likely going to trial they refer that case to a larger, more prominent, and typically better-financed firm.

For some, however, the day comes when you are ready to handle the towering case with its exhaustive discovery, battalion of pricey experts, demonstrative exhibits, and the trial of the century. And maybe the epic appeal. While your trial tactics dazzle, your finances drizzle. Money makes the [legal] world go around.

Financial tools are a priceless, but poorly understood, commodity. Law schools decline to offer a course that teaches the basics in financing a big case or the burgeoning case load. Trial lawyer associations likewise rarely offer CLE courses that explain or instruct in the financing of large dollar cases.

Borrowing a million dollars, or a lot more, to finance the office and keep the home front solvent between the grand slam verdicts is an important, if not required, business skill. In particular, this business skill is paramount to the trial bar. Few contingency-fee firms succeed without a litigation lender, particularly when the firm bulks up with associates and staff, expands their premises and marshals goods (IT and IP) and services (contract employees) from the high-end litigation vendors.

Finding a lender

First, you must find a lender. Lenders to trial lawyers are critical to leveling the playing field between insurance or corporate interests with their unlimited resources and the plaintiffs' attorneys who represent the victims. Spending the plaintiff's counsel into the ground is a recognized strategy.

Many commercial banks decline to lend to plaintiff law firms – too risky and they are unfamiliar with the market. You may get a business credit card or credit line from the local bank or even one of the big banks, but those usually top out at around $100K – insufficient for any big case.

You will likely need a sophisticated and flexible lender that specializes in litigation

financing and stands on the plaintiff's side of the litigation ledger. Several advertise in this magazine, and you can Google others on the web. If through trial lawyer associations you personally know a "big time" plaintiff's lawyer, you might ask for an introduction to their lender – you can bet they have one. Be aware that the "lender" you talk to is often a loan broker or other intermediary and the source of capital is often hedge funds.

Once you have found a lender who is willing to advance significant capital to finance your portfolio or the "big case," you and the lender talk terms. If the devil is in the details, be prepared to read the *very* fine print. Consider this article your magnifying glass to read the "fine print."

The first questions

Before, going down the route of litigation financing, you, as the prospective borrower, must confront these questions:

Is this a recourse or non-recourse loan? If I lose the case, am I on the hook for the loan?

Do I have to make payments during the term of the loan, or is the debt due when the recovery is made? Can I afford to make payments? What is the debt service burden? What is the debt service if I default?

If I lose the case, or another attorney takes the case away from me, and the loan is recourse, can I pay off the loan, or am I assuming too much risk?

Are you a good risk?

A good credit score is a plus, or necessity for some loans, but litigation financing borders on "asset-based lending" in which the primary goal of the lender is to collateralize the loan with assets, and not necessarily to evaluate the good credit of the borrower.

Type of loans

A **term loan** offers a fixed sum of money, due on a certain date, which usually requires the borrower to make monthly fully amortized payments. Term loans typically finance capital acquisitions such as computers, office furniture, cars, leasehold improvements and real estate purchases.

A **line of credit** offers, up to the stated limit, funds upon demand. A line of credit finances the operation of the firm's office. Payments of interest are typically due monthly and repayment of principal is due according to some agreed schedule, depending upon whether the lender is a bank or finance lender. This is the most common type of loan for plaintiff firms needing to finance their portfolio of modest personal injury cases or big time mass-tort, class-action or products-liability litigation.

Note that traditional lines of credit are due on a specific date, which is usually annually. Due means that the loan is paid in full. On the due date, some lenders will roll over the credit line into a new line, while others might demand full payment. Expect points, fees and charges if a rollover, or expect to put up more collateral. Expect to turn over financial statements of the firm, the partners and guarantors. These credit line loans tend to "float the firm" as cases move towards settlement or trial. The word "float" also suggests the word "sink."

Capital or Equipment loans. A capital loan enables the borrower to buy specific assets, such as computer systems, high-end copiers, or other expensive hardware. The hardware *and the firm's assets* collateralize these loans. These loans typically run about five years or the economic life of the collateral.

The other alternative is leasing (captive or open market) which might be more (or less) costly depending upon the equipment, its base price, servicing, bargaining skills of the parties, the market for the equipment, and buy-out terms. In purchasing any hardware (or software), keep in mind that last year's model is just a year old, completely functional and often costs less.

An **overdraft loan** is another form of a line of credit and covers overdrafts to the law firm's checking account. Watch out for these arrangements because the bank might charge per-transaction fees (often a fixed fee or a percentage of the overdraft, whichever is *more*) and again impose interest when the funds are advanced.

A more exotic finance instrument is a **letter of credit** issued by the law firm's bank to a third party. The letter of credit serves as a guarantee to the seller that it will be paid regardless of whether the buyer ultimately fails to pay; these are more common in foreign transactions.

Loan provisions

Rollovers and rockets. Be alert to whether you can roll over the loan when due. This is very important. A loan with a very short maturity is called a rocket loan. A loan without a rollover provision invites a default. This is big and very bad trouble.

Guarantors. Expect that all firm partners or shareholders will execute a boilerplate — and "lawyer proof" — personal guaranty. Guarantors make the best bill collectors because the guarantor will hammer the primary obligor, the law firm, to pay off the debt from the firm resources. Together with their community-property spouse, the guarantor will rue the day they signed the guaranty because they subjected their community property to potential judgment or foreclosure. Regardless, personal guarantees may be the only way to get a loan for the firm.

Collateral. Most lenders demand a security interest in the firm assets including fees from clients. Some lenders might demand a deed of trust in the principal's homes or firm-owned real estate. If there is a default, the lender will liquidate the firm's accounts receivable and collect fees due from third parties such as in mass litigation. This really kills your cash flow.

A bank lender will also demand the depository relationships for the operating and trust accounts of the attorney. They often reserve the right in a default to levy upon the firm's operating account. Again, there goes your cash flow.

The bank will file and record UCC's [financing statements], which means that the loan becomes a very public record. Do you want competitive firms or defense counsel to know that you are highly leveraged?

Access to firm records. Absent attorney-client-privileged communications, the lender will have access to every scratch of paper, including billing records. In very significant loans, the lender parks a gnome or two in the firm's accounting department on a monthly, weekly or daily basis. This person is the financial cop on the beat. Your privacy is gone, very gone.

Interest and penalties

Rate of Interest. Rates of interest from a bank start at about 3% over prime for the *most creditworthy* customers. Litigation financiers peg their rates at 17% to 24% plus the LIBOR interest rate (currently 0.54%) or much more. If the loan is $1,000,000.00, the annual interest could easily exceed $240,000 per year or $20,000 a month.

Usury does not apply. A lender licensed by the California Department of Business Oversight (F/K/A the Department of Corporations) is not bound by usury. This is called a California Lender's License. [California Financial Code Section 22000 seq.]

Payments. Payments are first applied on interest and the balance to principal. A high rate of interest means that each payment pays down interest first and the balance pays down principal. Some bank lenders knock down a percentage point if payments are made automatically each month from an account maintained by the lender.

Compounding of Interest. Some loans automatically add interest to principal even if the loan is current. The effective rate of interest exponentially increases by about 3% to 5% per year. Other loans add the accrued interest to principal in the event of a default, which balloons the effective rate of interest on an annual basis. Even if the default is cured, the loan still compounds the interest. A long standing default might yield an effective rate of interest in excess of 30%. This means that the loan balance triples every three years. Compounding of interest is common in high interest loans, including most litigation loans. This is very expensive.

Default Interest. You may wince at this one: In the event of default, the lender could increase the interest by another 5% to 7%, or more, which would increase the total interest burden in excess of 30% on an annual basis. The $1 million loan accrues interest at $300,000 a year or $25,000 per month or more, given compounding. Default interest is an expectation in every loan.

Penalty points. Most loans impose penalty points in addition to compounding, default interest and the base rate. Penalty points might exceed 5% of the missed payment per each missed payment. The penalty points might be added to the principal and compounded. These are very common terms.

Payment of Third-Party Expenses. Loan agreements entitle the lender to hire their own attorneys and accountants, pay for life insurance on the borrower's life, and incur other expenses under the loan agreement – and charge the borrower for everything. These payments might even include payment of third-party attorneys to assist in the collection from clients of the borrower's earned legal fees because these fees are the collateral of the lender. You are also paying from the proceeds of the loan for the lender's lawyer to draft the loan documents. Expect your lender to hire Muck, Muck and Muckity, LLP. [Est. 1820]

Loan fees and points

In initiating the loan, the lender charges the borrower a "loan origination fee" [expressed as "points"] that ranges from 1% to 5%, plus the legal fees in drafting and closing the loan, and other incidentals. The points are to pay a commission to the loan broker, as most litigation loans are made through brokers and not directly with the lender. If the loan fees and points are rolled into the loan balance, the borrower is paying interest on interest.

The rollover and refinancing

When the loan matures, and should you succeed in negotiating a rollover, expect a second "origination" or "rollover fee" [more points] plus third-party expenses. If this loan refinances a prior loan from another lender, expect a separate "origination" and third-party expenses. Do you write a check for these "fees?" No, my friend, they come out of the loan proceeds. Is this a big deal? Yes. Watch.

I am going to lend you, say, $1,000,000. I am going to charge you 24% per annum, compounded. After all the fees and points, you are only getting maybe $925,000 from me in cash, but I am charging you the 24% rate of interest on the $1 million and not the net cash in your hand. Amortize this loan over 24 months, you are paying interest on money that you *never* have had in hand. Fees and points for rolling over a big loan could easily exceed $100,000.00.

Here is another example. At the end of the loan term, you now owe me, the lender, $1 million, which includes $800,000 in principal and $200,000 in accrued interest. I will refinance the loan and roll it over into a line of credit with a bigger balance. The first advance is to pay off the prior $1 million loan. The rate of interest for the new loan is 24%, which you are paying on the prior accrued interest. Ignore my inept math: You are paying 35% on the original loan balance. Don't forget the loan origination fee. Don't forget the loan fees and points.

Prepayment penalties

Perhaps you are thinking of financing your litigation by taking the equity out of your law firm's building and paying off the loan when you settle the big case. If you own pricey real estate in downtown San Francisco that you bought 20 years ago, this could be a real option.

Prepayment penalties are common in commercial real estate term loans. The term is usually 10 years, but amortized over 25 years to make the monthly payments lower, with a balloon payment due at the end of ten years. The lender doesn't expect you to make the huge balloon payment; rather, he expects that you will need to refinance with a new term loan at the end of the 10 years, at then current interest rates. Refinancing approval is likely given appreciation, a

lower loan balance and the "seasoning" of the loan.

Be careful if you plan to pay off that 10-year loan early when the big case settles. In your commercial loan agreement there might be a prepayment penalty equal to the *present value of the future interest*. *Present value* means the value of the obligation if liquidated today even though due at a later date. Prepayment penalties are common in real estate.

Prepayment penalties effectively lock a borrower into a long term loan at the original current rates, precluding the borrower from a refinance at the lower rates that may be available at a later date. Read the loan contract very carefully to determine if you are stuck with a prepayment penalty. Some lenders might charge a higher rate but waive the prepayment penalties.

Prepaid interest

This is a big one. An amortized loan means that payments made over time include payment of principal and interest. A lender may demand that the borrower prepay the total interest under the loan at the outset. Assume the initial loan balance is $1 million, and total interest (not at present value) is $300,000.00. The net cash balance due the borrower at closing is $700,000.00. So you are borrowing a million, but you are only getting $700,000 in cash to finance the litigation. Don't forget about loan fees and points. This is a touch overly simplistic, but the illustration is accurate.

What happens in the event of a default

Absent the cooperation of the borrower, the lender can file a collection action that would authorize a writ of attachment or possession. These writs enable the lender to reach the borrower's bank accounts, accounts receivable, and legally seize the law office personal property. The lender would be able to garnish borrower's bank account (or seize the fund) and likewise garnishee the client.

If the borrower is a traditional fee-for-service law firm, the better strategy is that the lender gets a money judgment and sues the firm's clients to compel payment of fees (called a creditor's suit).

Many lenders would seek the appointment of a receiver; that is even more draconian and very expensive. (Six figures for the receiver and counsel are common). If the loan is secured, the lender grabs all collateral, including all unpaid and pending fees.

Non-economic covenants

You will find these terms buried in Paragraph 23, fifth page, down at the bottom of the page. A non-economic covenant is an affirmative requirement of the borrower owed to the lender. This is the usual cast of characters: Minimum revenue per month or per year; total number of partners; minimum amount of billing per partner (or contingency fees earned from settlement of cases); cash flow minimums each month or quarter; minimum cash on hand; retention of certain "rainmakers"; maintenance of E&O, general liability and worker's compensation insurance; office rent and bills paid on a timely basis.

These do not sound too bad, but a breach of a non-economic covenant kicks in the default rate, penalty rate, and compounding of interest. Fearful of a pending implosion, the lender can call the loan due.

Arbitration, Waiver of Jury Trial Rights, Reference, Forum Selection and Choice of Law

These terms can exceed the usual garden-variety oppression. Forum selection is a big deal because you confront the expense of litigating on the other side of the moon, like New York City. Presume Delaware, North Dakota, or New York laws favor lenders — they do! Don't gloss over choice of law. That loan agreements favor lenders and not borrowers is a reasonably accurate statement.

The default echoes

The loan is due. The firm defaults. In foreclosing on the receivables, the lender demands the clients pay their outstanding balances to the lender and not the firm. This is a total freeze-dry moment with the client. The lender files suit. Suits are public and always embarrassing. The lender sues the guarantors or forecloses on the real property collateral, i.e., the homes of the partners.

In firms that span generations, or plaintiffs' firm where even name partners come and go frequently, former partners who are still guarantors on the loan may advise the lender where the firm buried the "gold doubloons" to enable the lender to collect from someone else. Inter-firm lawsuits are common.

Defaulting on a vendor bill generates a collection suit that is survivable. Defaulting on a capital loan, secured by firm assets and partners guaranties, is not survivable.

The roulette of borrowed money

Who is your financier adviser? Answer: Polonius: "Neither a borrower nor lender be; for loan oft loses itself and friend, and borrowing dulls the edge of husbandry."

This advice was good 400 years ago and is good today. Borrowed money is expensive. Babysit borrowed money. The borrower has to return the money, plus a big pot of interest. Spending the money on a non-earning asset (i.e., furniture, lease deposit, etc.) turns liquid assets (the loan proceeds) into illiquid assets (physical assets). Spending money to pay for personal expenses vaporizes the liquid assets (the loan proceeds). Cost cutting is paramount before strapping on any debt. Litigation financing is "peaks and valley financing." It succeeds assuming many peaks.

Math bullies – an example

Spend the borrowed money on working assets. Working assets are products and services that generate income. A portfolio of 100 personal injury cases, each worth $50,000.00 (gross recovery, net fee of $16,650.00, recoverable case costs of $2,500 per file, and $5,000 of employee time) are working assets because these cases generate revenue. Presume only 50% of the cases are successful.

Assuming a recovery at 50% of the files, the gross fees are $825,000.00 for the entire portfolio. Given that 50% of these

cases produce no recovery, the $2,500 in costs per file are lost and therefore a $125,000 loss on unrecovered costs.

Assume 100% financing for total case costs and time that requires a $750,000.00 loan, and 25% interest from a litigation financier, the total loan costs are $187,500. The net fees, after the unrecovered costs and the accrued interest, are $512,500. Deduct office costs, rent, taxes, insurance, car and advertising: little, or nothing, is left over.

Risks galore

Cases against Big Pharma, Big Tobacco, Big Auto, or Big anything means big expenses. Class action suits generate millions in costs. Big cases, and particularly big cases that generate a huge fee, attract the best, brightest and most ambitious.

When a small to mid-sized firm lands the big case, the firms must commit someone's capital to litigate the case through a multi-year campaign (in the worst case, this might include a 7-year federal court haul). Third-party financing might finance the firm in its quest, but at a big price and bigger risk. Should the case fail, or the attorney is ousted at the hands of others, the loans become due but the case is gone.

Given these risks, pause, not ambition, is the best strategy for the lender and borrower. Pushing back from the table might be the best outcome – referring the case to a larger, better financed firm. Make a business decision, not one born of ego.

Briefly touching on the issue of ethics, some opinions suggest that the client should be informed of the lender's role in financing.

Is repayment Sisyphean?

In the end, if you want the money, you are stuck with high risk and difficult terms. Maybe. You might haggle here and there. Bargaining is always good. You might shop around for a better deal. You might knock a few points off the interest rate. You might negotiate an automatic rollover. You might ask for more control over third-party expenses. And in any event, you, the borrower (or your CPA), need to track your loan balance. Every month. Staple an odometer to the loan.

Read the loan documents very carefully before you sign. Bring it home for your spouse's *very* informed blessing. Ask the right questions of the lender. Ask questions of yourself: What happens if the firm breaks up, a key player can't perform, or the big case grows little feet that enable it to scurry out the back door at the heels of fleeing associates?

Embrace the risk

Absent the multi-million-dollar bequest from dear old Aunt Sally, one day you will need to borrow some real money if you intend to be a litigation powerhouse. Litigation lenders are willing to lend you real money. Litigation lenders are willing to assume some risk. You must be ready to embrace this risk along with the opportunity it brings: that means reading and understanding before you sign, accepting the risks put before you, and being careful with the money.


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David Cook is the founding partner of Cook Collections Attorneys*, San Francisco. He wrote the Amicus brief in* Singer v. Malin for Survivors Network of those Abused by Priests, Kosnoff Fasy PLLC, Christine Lozier, Peace over Violence, Protect Mass Children, Law Firm, Charlie Stecker, Taylor & Ring, and the Zalkin Law Firm, P.C. *Cook is a prolific writer of magazine and journal articles, focusing on solvency, collection and enforcement. The ABA published Cook's* The Debt Collector's Handbook *in 2014.*