Asset recovery as an asset class: a litigation finance opportunity for private capital

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Abstract

This article makes the case for litigation funding of asset recovery matters. Litigation finance is a rapidly expanding asset class. Investors are attracted by an appealing risk-reward profile. The performance of the asset class differs depending on the category of claim. This article explains how the asset recovery category of claims are an attractive investment opportunity for litigation funders through analysis of the following metrics: outcome risk; scope of investable opportunity; case origination; diligence; capital requirements; signalling effect; downside protection; investment horizon; and macroeconomic correlation.

Introduction

Litigation finance is a growing asset class.[1] Capital commitments are increasing year on year.[2] These trends extend to litigation funding of asset recovery and asset tracing services.

This is a relatively recent phenomenon. The third party litigation funding sector is nascent, in that it did not get started in any serious way until English courts started to narrow the scope of application of the 12th century rules against champerty and maintenance in the early 2000s (in cases such as *R (Factortame) v Secretary of State for Transport*[3] and Arkin v Borchard Lines Ltd[4]).

This notwithstanding, it was not until approximately five years ago that litigation funders began to look more carefully at asset recovery cases. Previously, “collection risks” were not favoured by funders. Rather binary investments on finely balanced “win-lose” questions of liability or quantum of damages attracted most of the available capital earmarked for investment in litigation. This has begun to change for the reasons set out below.

For context, a typical litigation finance transaction in a major common law legal market might be structured as follows: a law firm refers a matter to a litigation fund; the fund then engages in a bilateral transaction directly with the plaintiff/claimant or through their counsel;[5] and the fund provides the client with limited-recourse finance (i.e. unlike a traditional loan, the funder loses its investment where the claim fails).[6] A variable return pricing structure is used—where the claim succeeds, the fund will receive the principal plus a percentage of the settlement or award.[7] The benefits of litigation finance are multiple-fold. For the client, typically a corporation in a commercial dispute, litigation finance moves risk and cost off the balance sheet. It also makes capital available for other commercial objectives and creates an opportunity for the legal department to become a profit centre.[8] For the law firm, litigation finance is a risk management tool, and a source of cash to provide client deliverables.[9] For the litigation fund, litigation finance offers substantial risk-adjusted returns. Studies indicate that typical returns exceed 20% per annum.[10] This article focuses on the benefits to litigation funds.

Different categories of claims generate different risk-adjusted returns for litigation funds. This article identifies how the asset recovery category of claims is uniquely attractive to capital allocators across the following metrics: outcome risk; scope of investable opportunity; case origination; diligence; capital requirements; signalling effect; downside protection; investment horizon; and macroeconomic correlation.

Outcome risk

In predicting the outcome of legal claims, risk can be divided into three categories: liability, damages and enforcement, and collection.

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[1] Litigation finance refers to third party funding of legal costs in exchange for a portion of proceeds of a successful claim. Giugi Carminati, “Litigation Finance: A Modern Financial Tool for Corporate Counsel” (12 December 2022), *American Bar Association*, *https://www.americanbar.org/groups/business_law/resources/business-law-today/2022-december/a-modern-financial-tool-for-corporate-counsel/*.

[2] ResearchNester, “Litigation Funding Investment Market Size & Share” (August 2023), *https://www.researchnester.com/reports/litigation-funding-investment-market/2800*.

[3] *R (on the application of Factortame Ltd) v Secretary of State for Transport, Local Government and the Regions* [2002] EWCA Civ 932; [2003] Q.B. 381; [2003] B.L.R. 1.

[4] *Arkin v Borchard Lines Ltd (Costs Order)* [2005] EWCA Civ 655; [2005] 1 W.L.R. 3055; [2005] C.P. Rep. 39.

[5] Lee Drucker, “Transaction Structures in Litigation Finance” (February 2015), *Lake Whillans*, *https://lakewhillans.com/articles/transaction-structures-in-litigation-finance/*.

[6] Burford Capital, “Introduction to Legal Finance” (September 2023), p.4, *https://www.burfordcapital.com/introduction-to-legal-finance/*.

[7] Craig Arnott, “Pricing risk, structuring agreements and the cost of legal finance capital” (October 2019), *Burford Capital*, *https://www.burfordcapital.com/asia/insights-news-events/insights-research/pricing-risk-structuring-agreements-and-the-cost-of-legal-finance-capital/*.

[8] Carminati, “Litigation Finance: A Modern Financial Tool for Corporate Counsel” (12 December 2022), *American Bar Association*; Bob Koneck and Alex Lempiner, “Forum: Litigation finance as a multi-tool for corporate law departments” (7 November 2022), *Thomson Reuters*, *https://www.thomsonreuters.com/en-us/posts/legal/forum-fall2022-litigation-finance/*.

[9] Burford Capital, “Introduction to Legal Finance” (September 2023), p.2.

[10] Thomas Healey, Michael B. McDonald and Thea S. Haley, “Litigation Finance Investing: Alternative Investment Returns in the Presence of Information Asymmetry” (Spring 2022) 24(4) *The Journal of Alternative Investments* 110□122, *https://www.pm-research.com/content/iijaltinv/24/4/110*.

These risks are excluded in sequence as a claim progresses. In most instances, enforcement occurs post-judgment/post-award. However, in fraud or other asset flights risk cases, pre-action and "during the pendency of an action" asset identification investigations (leading to pre-emptive asset freezes) can invert the traditional sequence of risk management events on its head, with interim asset preservation measures resulting in a possibly secured claim of sorts before the claim has been fully ventilated at trial and won. This strategy—to front-end load the asset recovery elements of a claim—is most often seen in high-risk collection cases where there is little sense spending millions of dollars on costs to obtain a hollow piece of paper called a judgment or arbitral award.

However, traditionally, by the enforcement and asset recovery stage of a dispute, liability and quantum of damages are determined. Risk is limited to enforcement risk. It follows that the return on invested capital in an asset recovery matter will typically be more predictable—or more spread across a suite of risks—than other categories of claim.

Scope of investable opportunity

Litigation funders typically target high-value commercial claims. Litigation is expensive and very few litigation funds operate below a claim value threshold of $1 million.[11] Investigation, pleadings, discovery, pre-trial, trial and prospective appeal involve high fixed and variable costs.[12] High costs require high claim values to generate sufficient return on invested capital. Moreover, wagering on how a judge or jury will resolve complex issues of liability and quantum of damages is binary—wins and losses can be "close run things".

Asset recovery matters present a different risk proposition. Establishing liability on the part of a defendant in a brazen fraud or breach of fiduciary duty case is oftentimes clear-cut and not difficult to prove. Also, in fraud cases, the measure of a victim's loss is ordinarily capable of being established by reference to objective wire transfer or payment records.

With asset recovery, each asset that is discovered presents its own collection risk: (1) how is it held? and (2) can the asset be amenable to execution even though it may be held by a corporate or trust structure? If 10 assets worth $50 million each are discovered to be held in 10 separate LLC structures (such as ten large farms), then each asset forms its own collection risk. And the risk of loss to a fund is now spread across ten bets. In contrast, in traditional binary investments on litigation claims, there is heavy concentration of risk on one decision or one complex issue of fact or law perhaps. The "spread of risk" across a number of different assets presents an opportunity for litigation funds to better manage their risk and expand their scope of investable opportunities.

Reducing the claim value threshold has an ancillary benefit: diversification. A lower capital commitment requirement permits funding of a larger number of claims, and a correspondingly more diversified investment portfolio.

Case origination

Case origination takes several forms. Prospective cases generally come from attorney referrals, inbound inquiry, and advertising. Relationships between litigation funds and frequently collaborating law firms are particularly important.[13]

Clients in complex multi-jurisdictional asset recovery matters are typically represented by a niche set of specialist firms, such as the 86 members of ICC FraudNet in 76 countries.[14] These firms frequently collaborate, often with the principal firm in a jurisdiction like the BVI sub-instructing local counsel in all relevant jurisdictions.

The asset recovery law firms present a streamlined case origination solution for litigation funds. First, complex asset recovery is usually multi-jurisdictional, and often involves less developed legal markets where the litigation finance market is unsaturated. Second, the collaborative hub-and-spoke model of a principal sub-instructing local counsel allows litigation funds access to a range of relevant relationships at lower cost.

Diligence

Litigation funders typically perform extensive diligence before committing capital. Processes vary widely. Diligence can often take between 30 and 90 days.[15]

Asset recovery matters will typically involve less diligence. First, firms operating in the complex asset recovery space are often technical specialists. Second, in contrast to the liability and damages stages of a complex commercial dispute (which may be heavily dependent on findings of fact; the credibility of witnesses; and finely balanced issues of law), the enforcement and asset recovery stage of a case is typically governed more by objective facts surrounding what is an asset, how it is held and where did it come from? This reduces diligence cost and case selection risk.

What matters most in asset recovery is finding one or more assets as an anchor or a risk management tool. If $100 million has gone missing in a fraud, and $20 million of real estate held by a company owned by the fraudster

[11] See, for instance, Christopher Hodges, John Peysner and Angus Nurse, *Litigation Funding: Status and Issues* (Oxford: Centre for Socio‐Legal Studies, Oxford, January 2012), p.104, *https://www.law.ox.ac.uk/sites/default/files/migrated/litigation_funding_here_1_0.pdf*.
[12] Hodges, Peysner and Nurse, *Litigation Funding: Status and Issues* (January 2012), p.104.
[13] Healey, McDonald and Haley, "Litigation Finance Investing: Alternative Investment Returns in the Presence of Information Asymmetry" (Spring 2022) 24(4) *The Journal of Alternative Investments* 110‐122.
[14] ICC FraudNet, "What is ICC-FraudNet" (2024), *https://www.iccfraudnet.org/what-is-fraudnet*.
[15] John Pierce and David Burnett, "The Emerging Market for Litigation Funding" (June 2013), *The Hedge Fund Journal*, *https://thehedgefundjournal.com/the-emerging-market-for-litigation-funding/*.

can be pre-emptively frozen, a fund can readily justify putting $5 million at risk to support a search for a further $80 million of value to target for recovery.

Capital requirements

Funding for asset recovery may require less capital commitment than alternative categories of high-value complex commercial claims.

First, the duration of an asset recovery dispute may be shorter than alternative claim categories because asset recovery traditionally occurs post-judgment/post-award.

Second, boutiques are very substantially represented in the legal market for asset recovery services.[16] This means that teams are leaner. There are limited overhead expenses. Legal costs are lower than in an equivalent litigation practice at larger firms. Moreover, many asset recovery firms will enter into risk sharing engagements where they may work on reduced hourly rates in exchange for a success fee.

Third, complex asset recovery matters are typically multi-jurisdictional, requiring instructing local counsel in foreign jurisdictions. However, litigation finance currently concentrates on funding the recovery of high-value judgments/awards originating in common law jurisdictions. This presents an arbitrage opportunity: the judgments/award are issued in jurisdictions with high-value awards, while the legal costs may be incurred in jurisdictions with lower-cost legal fees.

Signalling effect

Litigation funders are exceptionally selective in allocating capital.[17] In consequence, the fact that a claim is funded has a powerful signalling effect. Put another way, investing capital can, in itself, increase the likelihood of an advantageous settlement.

This is particularly true for asset recovery matters. As set out above, diligence is generally less subjective. From a procedural standpoint, there are less risk factors given that, traditionally, liability and the quantum of damages are determined. Alternatively, in most fraud cases, the risk lies in collection—not in proving that a fraud occurred. This signalling effect is particularly acute where financing includes operating costs of a distressed client, reducing the client's solvency risk and improving the client's negotiating leverage.[18]

Downside protection

Litigation finance is limited recourse in nature (i.e. unlike a loan, the funder loses its investment where the claim fail).[19] Funds can protect their downside by allocating capital incrementally as legal costs are incurred. This downside protection is particularly effective where the dispute process naturally involves several points at what the success of the claim is reasonably determinable.

Asset recovery lends itself to downside protection. Asset recovery matters can be divided into discrete phases of work: Phase I— a preliminary asset inquiry and assessment of the livelihood of success; Phase II—the substantive asset discovery and tracing inquiry; Phase III—pre-emptive asset freezing preservation; and Phase IV—execution and liquidation of frozen assets. Each phase provides counsel, funder and client with substantial insight into the outcome of the claim.

Investment horizon

Litigation funds often finance disputes that last years. Given that asset recovery oftentimes occurs post-judgment/post-award, the investment horizon in asset recovery litigation finance may be substantially shorter than in alternative categories of claims.

In consequence, capital is more rapidly returned to litigation funds. This allows the fund to re-allocate capital to other disputes, increasing their annualised return.

Moreover, assets can be liquidated in steps such that cash may come in to return capital and pay a modest return in year two; while in each of years three, four, five and six other assets may be liquidated—creating a sequence of cash realisation events.

Macroeconomic correlation

Litigation finance is a non-correlated alternative asset class.[20] The outcome of one investment typically does not influence the outcome of another. The volume of commercial disputes tends to be countercyclical. Survey results suggest that senior in-house counsel predict a substantial increase in disputes in the coming two years.[21]

Asset recovery matters, particularly fraud-related complex disputes, fit into this category of countercyclical claims. For limited partners (investors in litigation funds) this presents a useful hedge against macroeconomic factors.

Conclusion

As the litigation finance asset class matures, litigation funds are developing specialist strategies. The search for greater risk-adjusted returns is competitive. For the reasons set out in this article, litigation funds should pay special attention to asset recovery claims. This unsaturated market presents a uniquely attractive investment opportunity.

[16] Chambers and Partners, "Asset Tracing & Recovery (Law Firms)" (2023), *https://chambers.com/legal-rankings/asset-tracing-recovery-law-firms-global-wide-58:2393:15649:1*.
[17] Sentry Funding, "Benefits of Litigation Funding" (February 2022), *https://sentryfunding.co.uk/insights/benefits-of-litigation-funding/*.
[18] Marla Decker, "Litigation Finance: Pricing" (July 2020), *Lake Whillans*, *https://lakewhillans.com/articles/litigation-finance-pricing/*.
[19] Burford Capital, "Introduction to Legal Finance" (September 2023), p.4.
[20] Pierce and Burnett, "The Emerging Market for Litigation Funding" (June 2013), *The Hedge Fund Journal*.
[21] Burford Capital, "New research offers inside look at how businesses are managing litigation in uncertain economy" (22 June 2023), *https://www.prnewswire.com/news-releases/new-research-offers-inside-look-at-how-businesses-are-managing-litigation-in-uncertain-economy-301858084.html*.