Legal Funding Services

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Legal Funding Services
Niche Specialty Finance Segment Attracting Attention

The legal funding services industry is a collection of related investment businesses that allow investors to participate in the financial outcomes of the U.S. legal system. The industry is built on a shift in perspective – legal claims are assets that can be harvested.

Annual volume in the consumer and commercial segments of the legal funding services industry is estimated between $3 to 4 billion. The penetration rate is low in the industry. This niche specialty finance industry is growing, and significant enterprises are emerging, but the market remains fragmented. Favorable industry dynamics and compelling economics of legal funding are characteristics that appeal to a broad range of potential investors. Capital is flowing into the sector, which has led to a more robust effort by legal funding professionals to originate transactions and communicate the benefits of this financial tool to plaintiffs and their attorneys.

Legal funding services firms have many attractive attributes:

- **Increasing demand for a valued product:** A number of established trends are leading to an increase in demand for legal funding services:
  - The universe within which legal funding firms operate includes law firms with annual revenues exceeding $300 billion in the United States; the top 100 firms generated $81 billion of revenues in 2014. The legal funding industry generates estimated annual volume of $3-4 billion, split between the consumer and commercial markets; penetration rate in the industry is quite low, at approximately 1%.
  - In the consumer personal injury market, plaintiffs often experience financial pressure to accept a "low ball" settlement from the defendant's insurance company. According to the Legal Finance Journal, the average time to reach settlement of a personal injury claim in the United States is about two years; the timeframe can be much longer if a case goes to trial. Legal funding allows the plaintiff to pay health and living expenses and provides time and resources to negotiate a more favorable settlement.
  - In the commercial litigation sector, legal funding services provide litigants with a way to convert intangible/contingent assets into cash while reducing legal and duration risk from judgements going through the appeals process.
  - Law firms value legal funding because it can meaningfully increase outcomes for otherwise cash-strapped plaintiffs and accelerate cash flows from cases that are subject to lengthy appeals and other delays.
- **Attractive asset class:** Legal funding transactions sourced by highly skilled originators generate internal rates of return of 18% to 40%. Successful transactions generate 1.5x – 1.8x the funded investment over a reasonable term (generally, two to four years). These assets often have binary outcomes (strong return or complete loss), so sophisticated underwriting is important in order to keep loss rates at acceptable levels. Finally, the performance of legal funding investments is not correlated to any other asset class and is not directly impacted by general economic activity. This lack of correlation increases the attractiveness of the asset class to institutional investors.
- **Significant barriers to entry:** The legal funding services industry has high "intellectual barriers to entry" including the required knowledge of case law, familiarity with differing decision-making in various legal jurisdictions and legal settlement negotiating strategies. In addition, strong relationships with transaction sources (usually law firms) are required for success; these relationships are not easy to build quickly.

Market Commentary – November 2015

Investment activity in the sector has accelerated recently, with both consumer and commercial litigation funding firms raising significant amounts of capital. Legal funding firms have sourced senior debt, subordinated debt and equity capital from a broad range of providers (commercial banks, non-bank lenders, hedge funds, institutional private capital, high net worth individuals, family offices, etc.). Legal funding firms have raised over $1.4 billion since early 2013, and there have also been at least four legal funding companies sold in the past two years.

We anticipate further growth in the legal funding sector, particularly in commercial litigation. In the corporate sector, internal legal expense budgets are "first line" targets for cost reduction initiatives, which has led general counsels to push their law firm vendors to cut billings by structuring alternative fee arrangements. Commercial litigation funding is one of the tools that help address these forces – by offsetting legal "spend" and monetizing contingent legal claims.

Legal Funding Services – Industry Structure

The legal funding services industry has two major sub-markets that display significantly different attributes:

Commercial Legal Funding	Consumer Legal Funding
• Plaintiffs receive funding to finance the ongoing expenses of pursuing cases or to monetize an expected settlement • Lawyers receive funding to accelerate cash flow and cover current expenses in litigating a case • Cases can be large and complex; amounts funded are also large (often over $1MM) • Types of cases include verdict or judgement on appeal, whistle-blower suits, breach of contract, securities fraud, patent or copyright infringement, product liability, etc. • Somewhat "lumpy" business with potential for concentration risk • Low regulatory risk – plaintiffs are corporate entities, not individual consumers	• Plaintiffs receive funding to cover living or medical expenses pending dispute resolution • Cases tend to be straight-forward, with the defendant supported by third-party insurance • Types of cases include personal injury (automobile accidents, "slip and fall" cases, etc.), worker's compensation and malpractice • High volumes of relatively small (under $10,000) advances reduce concentration risk • Consumer finance portfolio analysis tools such as static pool analysis can be applied to the business • Subject to intense regulatory scrutiny by consumer protection authorities (attorneys general, state legislatures, state consumer finance regulators, etc.)

In both sectors, the return on investment is wholly dependent on the outcome of legal action – if the defendant wins the case and the plaintiff/law firm receives no proceeds from the defendant, the legal funding firm has a loss on the investment. Legal funding transactions are usually non-recourse to the recipient of the funds and are generally not extensions of credit.

Organizations in the commercial legal funding sector tend to resemble specialty investment firms, with a limited number of highly skilled professionals originating and evaluating cases. Organizations in the consumer legal funding sector tend to resemble consumer finance companies, with large numbers of employees focused on customer service, origination and servicing.

Consumer Legal Funding

The target customer of consumer legal funding firms is usually a low-income or middle-income consumer with a limited "financial cushion." This places consumer legal funding in the consumer alternative financial services universe, which includes many distinct segments:

One of the primary issues facing plaintiffs in a personal injury case is the need to fund living expenses while pursuing litigation since the typical personal injury case takes two to three years to settle (or much longer if a case goes to trial). Many personal injury plaintiffs suffer from a reduction in income due to an inability to work while recovering from injuries sustained in an accident. The financial pressure experienced by the plaintiff can lead to quick settlements at amounts that fall short of reasonable or expected compensation. Consumer legal funding firms invest in a portion of the consumer plaintiff's contingent claim, providing money for living expenses while the plaintiff's counsel pursues the case. Consumer legal funding firms generally advance 5% – 15% of the expected case settlement. Additional time to negotiate a settlement can often lead to material improvement in plaintiff outcomes. A typical plaintiff can recover more than two times the initial settlement offer with the assistance of legal funding.

Consumer Legal Funding Market Participants

In some respects, the consumer legal funding sector is a cottage industry. There are scores of small firms or sole practitioners funding transactions in small geographic regions via local or regional networks of plaintiff's attorneys. There are a few larger-scale players, however. The bigger firms operate nationally; the top four market participants account for roughly $250 million of annual funded volume. Market observers estimate the total annual market volume at $1 billion.

Oasis Legal Finance	• Owned by an affiliate of D.E. Shaw & Co. L.P.; firm was launched in 2002 • Largest provider of consumer legal funding in the U.S.; HQ in Chicago area • Major user of direct response television (DRTV) advertising.
Golden Pear Funding	• Owned by the Cohen family, which also owns Cohen's Fashion Optical (100-store optical retailer) • Rapidly-growing participant; business concentrated in the northeast; HQ in the New York City area • Originates through a large and robust plaintiff's attorney network
LawCash	• Owned by its two founders; established in 2000; HQ in New York City • Operates in 47 states, but concentrated in NY, NJ, FL, TX and CA • Affiliated with Esquire Bank of New York, an institution focused on the banking needs of the legal profession
J.G. Wentworth Company (NYSE: JGW)	• Major player in structured settlement payment purchasing; also has a legal funding business; major television advertiser in structured settlements • Micro-cap public company; recently purchased a residential mortgage firm (WestStar Mortgage) • Also offering 3rd party prepaid debit cards and personal loans

Legislative and Regulatory Environment for Consumer Legal Funding

Since the target customers for consumer legal funding firms are individuals that are experiencing financial hardship, various regulatory bodies have taken notice of the industry. As the availability of legal funding leads to longer and more expensive settlement negotiations for insurance companies, the insurance industry has been actively lobbying to restrict the activities of consumer legal funding firms. The U.S. Chamber of Commerce has also actively lobbied against the consumer legal funding industry to represent the interests of insurance industry members of the chamber.

Despite the efforts of insurance companies and the U.S. Chamber of Commerce, the legal and regulatory environment for the industry is relatively stable. The American Legal Finance Association has led the lobbying effort and has succeeded in presenting the benefits of the legal funding product to several state lawmakers and regulators. In 2014, several states addressed legal funding in state legislature and generally passed laws that were friendly or neutral toward the industry. Only Tennessee has passed legislation that requires registration by legal funding firms, restricts rates and fees charged by legal funding firms, and provides rescission rights to the consumer.

The consumer legal funding sector will continue to attract legislative and regulatory attention due to the perceived vulnerability of the consumers that need the product and the staunch opposition of the insurance industry that wants to maintain its negotiation advantage in settlement discussions. The Consumer Financial Protection Bureau has apparently not focused on the consumer legal funding sector, probably due to the lack of a significant number of consumer complaints regarding the industry.

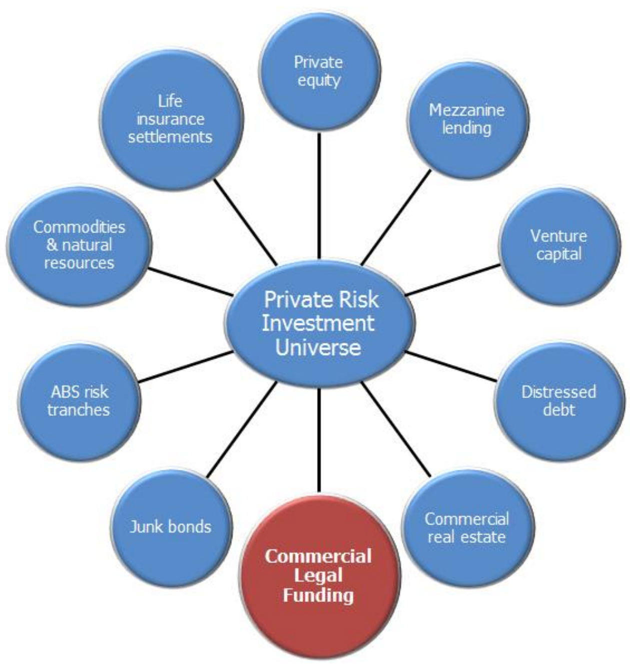
Commercial Legal Funding

Commercial legal funding provides valuable services to litigation participants:

- *Corporate plaintiffs:* Monetizes intangible assets and off-loads ongoing legal expenditures necessary to pursue cases. Reduces or eliminates the burn rate of the corporate legal department.
- *Law firms:* Accelerates cash flow and better matches revenues to expenses
- *Corporate litigants (plaintiffs and defendants) and law firms:* Implements success-based alternative fee arrangements when legal services providers insist on billing hourly

Corporate customers of legal funding firms have begun to embrace this corporate finance tool because it allows contingent, intangible and otherwise unrecognized assets to be converted into cash that can be redeployed into productive uses. Commercial legal funding also removes legal and duration risks from judgements that are going through an appeal process. Commercial legal funding also serves the role of equalizer, leveling the playing field for commercial plaintiffs that lack sufficient funding to pursue meritorious litigation.

The returns on commercial legal funding transactions, combined with the average size of each deal, causes this asset class to fall within the private risk investment sector.



Market Commentary – November 2015

Commercial legal funding transactions are medium term assets; the typical investment horizon is two to four years. The expected average internal rate of return is 25%. The performance of commercial legal funding transactions is uncorrelated with public securities markets, other private risk investments and the general economy. The lack of market correlation is one reason investors are increasingly interested in this industry.

The total annual volume of the commercial legal funding industry is not well documented. The New York City Bar Association estimated $1 billion of annual commercial legal funding volume in 2011; Halcyon Asset Management pegged the number at $3 billion in 2014. It is clearly expanding rapidly, and the demand for capital still exceeds the supply.

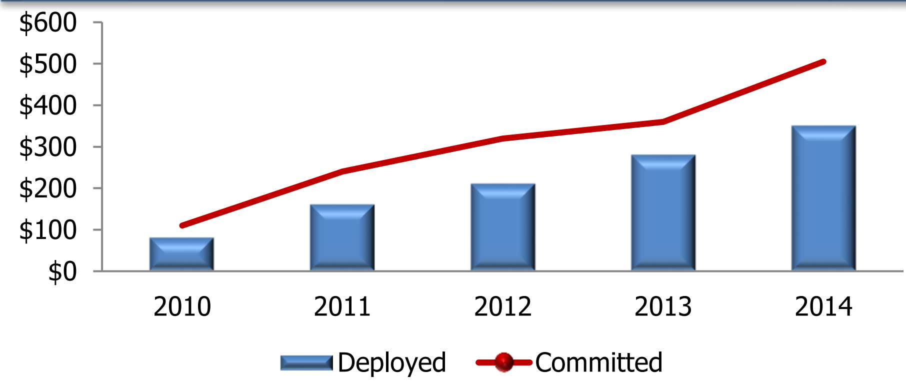
Commercial Legal Funding Market Participants

Commercial legal funding is a developing industry in the United Kingdom, Australia and the U.S. with a limited number of sizable operators and many smaller enterprises. The United Kingdom and other commonwealth countries legalized legal funding in the late 1960's, so some of the largest market participants built their businesses outside the United States (although many have moved into the U.S. now that the market has opened up). Most of the participants in the industry are less than ten years old, although there are a few players that began operating over twenty years ago. Total market penetration appears low but is increasing. The top players have broad geographic market coverage. Since the U.K and Australian markets developed more rapidly than the U.S. market, the larger publicly-listed firms trade on the London Stock Exchange and the Australian Stock Exchange. The larger private firms in the U.S. are often funded by committed capital pools; smaller firms sometimes fund on a deal-by-deal basis. Profiles of four larger industry participants are presented below:

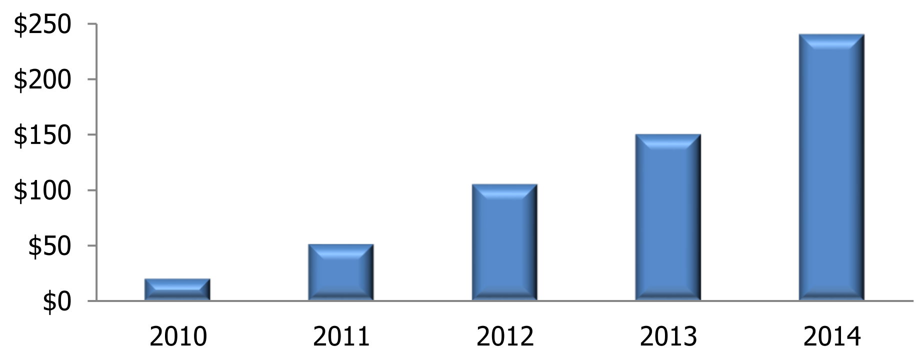
Burford Capital Ltd. (LON: BUR)	• Launched in 2009; listed on the London Stock Exchange's Alternative Investment Market shortly after launch • Based in the U.K but operates globally, with a growing U.S. presence • Very successful – operating profit grew from $1.9MM in 2010 to $60.7MM in 2014; YTD June 2015 operating profit up 56% over YTD June 2014
Gerchen Keller Capital	• Launched in 2013, HQ in Chicago; has raised committed capital of $1 billion in three separate funds and "sidecar" arrangements with investors • Average funding is $7MM per transaction • GKC uses the private equity fund model; very attractive average IRRs on resolved transaction
IMF Bentham Ltd. (ASX: IMF)	• Microcap stock traded on the Australian Stock Exchange; Over 30 professionals • Launched in 2002; very active in funding Australian class action cases; has funded over 175 cases through to completion • Significant New York office; active participant in U.S. litigation funding market
Juridica Investments (LON: JIL)	• Launched in 2007; cases have generated $276MM in gross proceeds since inception; focused on anti-trust and intellectual property cases • Based in the UK; listed on the LSE; active in the U.K and U.S. • Reported a loss in 2014 due to unrealized loss on investments & payment of a high performance fee to an affiliated portfolio manager

The commercial legal funding industry gained traction in the past five to ten years, with a number of firms launching and taking off rapidly. Burford Capital is the most visible and successful of the emerging legal funding firms that launched in the past decade. The following charts illustrate Burford's rapid growth since inception in 2009.

Burford Cumulative Committed and Deployed Capital ($ mm)



Burford Cumulative Gross Recoveries ($ mm)



Source: Company Reports

Legislative and Regulatory Environment for Commercial Legal Funding

The rise of commercial legal funding has renewed interest in the arcane and nearly-forgotten prohibition on champerty. A champertous agreement divides the proceeds of litigation between the claim's owner and a third-party providing financial support to pursue the claim. The prohibition arose in medieval Europe to stop the meddling in legal matters that gave rise to speculative and corrupt lawsuits. In ancient times, wealthy people would manipulate courts and sponsor legal actions to attack personal or political enemies. The prohibition on champerty inhibited third-party commercial litigation funding.

In the United States, the laws against champerty have relaxed significantly. At least 18 states recognize the champerty doctrine in some form; other states have abolished it. Case law in states that still prohibit champerty seem to have defined the activity more narrowly – anti-champerty statutes in New York were "never intended to prevent the honest purpose of protecting some other important right of the assignee" in the opinion of the Court of Appeals.

The American Bar Association prohibits lawyers form accepting compensation from a third-party to represent a client unless the client gives informed consent. Most users of litigation funding are quite able to give informed consent, so the ABA's objections to litigation funding have faded. Litigation funding firms can avoid difficulties by remaining passive investors in the litigation – the parties to the case determine its strategy and direction.

Commercial litigation funding does not draw the scrutiny of consumer protection watchdogs, but the U.S. Chamber of Commerce has been a vocal opponent of the commercial legal funding industry, claiming that it encourages "frivolous litigation". This is unlikely – savvy investors would not deliberately invest in a frivolous case since the chances of a positive outcome would be slim.

The most recent "shot across the bow" for commercial legal funding firms came from Senators Chuck Grassley (R., Iowa) and John Cornyn (R., Texas). Senator Grassley is head of the Senate Judiciary Committee; Senator Cornyn is the Senate Majority Whip. This pair is calling for more transparency in the litigation finance industry and sent letters in August 2015 to the three largest firms (Burford Capital, Bentham IMF and Juridica Investments) demanding detailed information on the cases the companies have funded over the past five years.

Capital is Flowing into the Legal Funding Industry

For the past two years, the legal funding sector has attracted significant amounts of capital. Lenders, equity investors, and business acquirers have all found compelling reasons to invest. The table below provides information on some of the transactions in the industry since 2013.

Consumer Legal Funding Transactions

Date	Target	Buyer / Investor	Transaction
Jul-15	Golden Pear Funding LLC	Not disclosed	$60MM subordinated debt
Apr-15	Golden Pear Funding LLC	Not disclosed	$150MM senior debt facility
Mar-15	US Claims	Not disclosed	$50MM long-term debt financing
Jan-15	Momentum Funding	Victory Park Capital	$30MM growth financing
Jan-15	Case Funding	Javlin Capital	Company sale
Dec-15	Golden Pear Funding III	Whitehorse Finance	$10MM long-term funding @ LIBOR+9.75%
Aug-15	US Claims	Not disclosed	$50MM long-term debt financing
Jul-15	US Claims	Company Sale	Buyer was DRB Financial Solutions
Dec-15	Fast Trak Legal Funding	Victory Park Capital	$50MM senior debt facility
Dec-15	CBC Settlement Funding	Asta Funding (NASDAQ:ASFI)	CBC is a buyer of legal settlements
Nov-15	JGWPT Holdings , Inc. (NYSE: JGW)	Public equity investors	IPO, generating $137MM of proceeds
Oct-15	Imperial Holdings, Inc (NYSE: IFT)	Blackstone Tactical Opportunities Fund	IFT sold its structured settlement business to Blackstone for $12MM
Oct-15	JGWPT Holdings , Inc. (NYSE: JGW)	Capital One (NYSE: COF)	$35MM senior revolving line of credit
Sep-15	Oasis Legal Finance	THL Credit and Whitehorse Finance	Subordinated term notes priced at 10.5% p.a.

Commercial Legal Funding Transactions

Date	Target	Buyer / Investor	Transaction
Sep-15	Law Finance Group	Various limited partners	$50MM LP equity investment
Feb-15	Gerchen Keller Capital	Various limited partners	$475MM LP equity investment
Jul-15	Burford Capital	Retail investors	$150MM bond offering, 8 years @ 6.25%.
Jan-15	Gerchen Keller Capital	Various limited partners	$260MM LP equity investment
Apr-15	Gerchen Keller Capital	Various limited partners	$100MM LP equity investment

Conclusion

We anticipate continued growth in the legal funding services industry due to:

- Absolute size of the market opportunity – law firms generate $300 billion of annual revenues
- Low penetration rates in the sector – around 1% of total market opportunity
- Attractive risk/reward of legal funding investments – 18% to 40% IRR's
- Increased acceptance of legal funding by corporate entities as a legitimate and effective tool for monetizing legal claims and managing legal risk
- Growth in demand for legal funding by both individual consumer plaintiffs and commercial litigants as the benefits of the product become known to potential users
- Increasing visibility of meaningful public companies (Burford Capital, et al) that generates awareness of the industry

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