Consumer Tort Litigation Finance: A Niche Opportunity for Credit Allocators

Litigation finance is a private credit asset class that is gaining attention from investors. Performance is driven by a risk factor – judicial decisions – that has low correlation with broader financial markets. In the course of Gapstow's ongoing review of the private credit universe, we are drawn to a unique opportunity in consumer torts, a subset of litigation finance that we believe can deliver a low-double-digit gross return to niche credit investors willing to be pioneers in this emerging investable opportunity.

Litigation Finance Overview

Litigation finance involves the provision of capital by third-party investors to plaintiffs involved in civil litigation. The opportunities vary greatly based on the type of borrower and type of case. Investors can finance both commercial and consumer plaintiffs, as well as their associated attorneys.

Commercial plaintiffs need capital to fund legal costs. In some cases we find a "David versus Goliath" storyline, in which a relatively smaller business with limited financial resources pursues legal action against a larger corporate defendant. Plaintiffs can estimate potential awards based on key facts of the case (e.g. units sold, contract price, royalties, etc.), but negative outcomes resulting in no awards are always possible. The higher risk can provide attractive returns in positive rulings, but can also result in total principal loss if the case is lost, which is a real concern because of the concentrated number of cases.

Consumer plaintiff borrowers can work with specialty finance companies and banks that make loans or cash advances secured by expected proceeds associated with tort litigation cases. These advances offer plaintiffs early access to a portion of their expected case award. We find consumer litigation finance appealing because the smaller borrowing amounts allow for more predictable cash flows created by bundling numerous cases, and command higher rates of interest.

Attorneys also use litigation finance, but to facilitate ongoing business by borrowing against future earnings. This can free up working capital that they can use to foster new client acquisition and business growth. However, many attorneys also have access to more traditional funding sources, such as commercial lines of credit, at much lower rates. This competition, combined with the better credit quality of the borrower, puts downward pressure on rates for attorney litigation financing, making this market a less attractive opportunity for higher-yield oriented investors.

In this paper, we discuss the key characteristics of consumer litigation finance and describe the role institutional capital can play. Before moving into investment specific characteristics, we will review the basic architecture of the tort litigation industry.

Consumer Tort Litigation Overview

Tort litigation refers to civil lawsuits that one party brings against another for personal loss or harm. An individual or group of individuals can bring these actions against another individual or a larger public/private entity. Within tort litigation, cases fall into one of two categories: mass torts or single-event torts.

Mass Torts

Mass torts[1] occur when numerous plaintiffs take action against one or a few corporate defendants. Law firms use mass media to aggregate plaintiffs, resulting in a coordinated proceeding in which an entire group of plaintiffs sues a defendant. This coordination, however, does not result in equal awards across the entire group. The award amount varies based on the extent of individual damages. Examples of more notable mass torts in recent years include:

- Transvaginal Mesh (TVM) is an implant used to treat certain pelvic disorders in women. It has caused a range of complications, and plaintiffs have filed over 60,000 lawsuits against seven TVM manufacturers.
- Syngenta GMO Corn is a genetically-engineered corn strain falsely labeled as an approved export. China and other countries rejected exports of the strain, leading to a drop in corn prices and significant monetary losses for US farmers. Thousands of farmers have filed lawsuits against Syngenta as a result.
- Xarelto is a blood thinner linked to uncontrollable internal bleeding and patient deaths. Users of Xarelto have filed lawsuits against the drug's manufacturers, Janssen Pharmaceuticals and Bayer HealthCare Pharmaceuticals.

Single-event Torts

In contrast to mass torts, single-event torts involve just one plaintiff or a small group of plaintiffs. While each case is unique, they usually fall into one of several categories. The most common types of single-event torts are:

- Motor Vehicle Accidents
- Labor Law Disputes
- Premises Liability
- Medical Malpractice
- "Slip and Fall"
- Product Liability

The Consumer Tort Lending Opportunity

In a consumer tort case, the time between first filing a suit and receiving the ultimate settlement can range from several months to two years or longer. (The large majority of cases settle rather than go to trial.) This can be a challenging period for financially strained plaintiffs, whose injury (or cause of action) often leads to additional expenses or lost income, from missed work or lost job. They may struggle to pay medical costs, rent/mortgage, or other bills, and have few other borrowing or

[1] Although mass torts and class action lawsuits both involve large groups of plaintiffs, they are not identical. The key difference between the two turns on whether the group of plaintiffs can be certified as a "class." In order to achieve class certification, the group of plaintiffs must have suffered a similar harm. Once certified, the class action proceeds as a single case. In a mass tort, by contrast, the plaintiffs share a similar cause of action, but the range of harms is usually too broad to proceed as a class. The most common mass tort cases involve defective drugs and other products, and the various negative effects of these products make the cases unsuitable for a single class. Therefore, in a mass tort, each plaintiff must file his lawsuit separately rather than collectively.

financing options. (Their attorney is most often working on contingency, so they do not pay that cost upfront.)

Lenders that understand the needs of tort litigation plaintiffs have designed lending products that offer early access to expected case proceeds. These products differ depending upon whether the plaintiff and the defendant have reached a settlement. We discuss such "post-settlement" and "pre-settlement" lending below.

Post-Settlement

It is a common misconception that plaintiffs receive swift disbursement of settlement proceeds after case resolution. In reality, a post-settlement period of 3-12 months often exists between resolution and cash disbursement. In mass tort litigation, this delay is caused by the administrative complexity associated with the large number of plaintiffs.

After a case settles, defendants agree to a defined financial award, making the certainty of payment receipt high (barring any issues like specific plaintiff fraud). Additionally, the award amount is either determined or determinable within a narrow range. In many cases, defendants actually issue "settlement letters," detailing each plaintiff's award amount. This level of certainty presents an attractive opportunity for experienced lenders.

Lenders typically structure post-settlement products as full-recourse loans, with no interim interest or principal payments. The borrower's ability to repay depends upon receipt of case proceeds, making these interim payments impractical. During underwriting, lenders review settlement letters issued by defendants and lend against a portion of the individual plaintiff's expected case proceeds. Given the higher certainty of payment, these loans provide attractive risk-adjusted returns that can range high-single- to low-double-digits.

Specialty finance companies have historically been the largest consumer tort lenders. Sourcing is accomplished through targeted advertising campaigns or relationship-driven networks of legal and industry professionals. Advertising campaigns require a significant upfront investment and lead to high plaintiff acquisition costs. The network approach has lower plaintiff acquisition costs, but takes years to build and significant effort to maintain.

In addition to specialty finance companies, traditional banks are beginning to originate those loans, but to a lesser degree. As the legal lending practice becomes more institutionalized, we expect banks to become more involved in this space. Presently, there are few banks that lend directly to plaintiffs, although many banks lend to the attorneys representing these plaintiffs in a format similar to other commercial loans. This attorney lending has a different customer base, but it signifies interest from banks in the market and helps them build the appropriate capabilities.

Pre-Settlement

Pre-settlement lending occurs before legal resolution, and thus involves a much higher degree of uncertainty around case timing and resolution. Duration can vary from a few months to several years, with limited predictability. Most pre-settlement lending involves single-event torts, which have more predictable and less complex judicial outcomes than mass torts.

Although pre-settlement lending involves more uncertainty than post-settlement, systematic case evaluation can mitigate risk. With $1.5 trillion of tort cases from 2005-2010 alone[2], case outcomes have become fairly predictable for experienced lenders. We estimate that lenders can expect a positive case resolution in over 90% of cases to which they lend.

Lenders structure pre-settlement products as non-recourse bullet cash advances, which only require repayment for cases that settle in favor of the plaintiff. Unlike post-settlement borrowers, pre-settlement borrowers may lose their case, resulting in full principal loss. Because of the higher degree of risk, the rates on these advances often exceed 30% per year (often presented as a monthly rate ranging from 2-3%).

Pre-settlement consumer products are almost exclusively offered by specialty finance companies.

Collateralized Lending

Lenders find both pre- and post-settlement products particularly attractive because they resemble secured lending transactions, but earn interest rates closer to unsecured consumer credit. Future case proceeds can be pledged as collateral, just as trade receivables are often pledged in merchant financing. When underwriting a loan/advance, a lender files a lien against case proceeds and requests an acknowledgement letter from the client's attorney to protect its interest. The lien "perfects" the lender's claim as recognized under the Universal Commercial Code. Legal statutes require attorneys to request payoff letters --- formal notices detailing the total amount the plaintiff owes --- from lien-holders after receiving case proceeds. This mechanism, along with the attorney acknowledgement letter, solidifies a lender's claim. (Importantly, the lender collects repayment directly from the plaintiff's attorney, avoiding the uncertainty of collecting from the borrower.)

The Role of Institutional Capital in Consumer Litigation Finance

We believe that directly originating these litigation lending products is impractical for institutional investors, and suggest working with existing specialty finance or bank lenders. With high growth in consumer tort litigation finance, many specialty finance lenders are now seeking institutional capital beyond their own equity or capital from friends and family. The growth of specialty finance companies is limited to their available funding sources (debt and equity). After reaching balance sheet capacity, they must raise additional funding to continue origination. Although raising equity is a simple solution for both parties, they often prefer lower-cost debt capital.

Institutional investors can consider two methods to gain exposure to consumer litigation finance. The first involves purchasing loans/advances directly from litigation finance originators. The second involves structuring a lending facility to provide a lender with additional balance sheet funding. Both of these methods attain exposure to the asset class but involve very different processes.

[2] U.S. Tort Cost Trends - 2011 Update; Towers Watson

Direct Asset Purchases

Purchasing loans/advances provides institutional investors with direct exposure to the asset class. Among many considerations, institutional investors should consider how duration affects cash flow. As previously mentioned, these loans/advances are structured with bullet repayments and uncertain maturities. Institutional investors must ensure that these investments meet the liquidity parameters of the vehicles they manage. Additionally, they should consider purchasing a pool with several underlying vintages, which can create a more regular stream of cash flows.

We believe that this approach is best suited for investing in post-settlement loans. The shorter duration of these loans makes portfolio construction and liquidity planning more feasible. The loans are also a standard financial asset that can be pledged as collateral to potentially obtain leverage to further enhance returns.

Specialty finance and bank lenders benefit from these transactions because they are able to free up balance sheet capacity and continue their origination activity. Staying active in the market enables them to earn origination fees on new business and, more importantly, to maintain their reputations with borrowers and customers, which can suffer if the they are forced to cutback lending activity due to capacity constraints.

Providing Secured Credit Facilities

As another approach to investing in the asset class, institutional investors can provide specialty finance lenders with a credit facility secured by a specific pool of collateral, perhaps with the litigation lender holding an equity or first-loss position, which provides downside protection.

We believe that this approach is better suited for pre-settlement advances, given their unpredictable duration and higher default risk. Institutional investors can negotiate the terms of the facility to suit their own preferences, and structure the liquidity, amortization, servicing, and other terms in an appropriate way. However, the senior secured position of this type of financing will lead to lower returns than those of the advances themselves.

Specialty finance lenders may find this arrangement more advantageous as well because the additional funding enables balance sheet growth, rather than simply freeing up balance sheet capacity (if they keep the first-loss position). With newly available funding sources, lenders can continue origination and hold more loans, reaping the benefits of both origination fees and excess interest income.

Gapstow Capital Partners: Firm Overview

Introduction

Gapstow Capital Partners is an alternative investment firm focused on identifying compelling opportunities in the public and private global credit markets. Our specialization in credit allows us to develop deep expertise which spans all borrower segments, including Corporations, Households, Commercial Real Estate Sponsors, Financial Institutions and Sovereign Entities. To best capture these opportunities, Gapstow allocates capital to third party managers and also makes direct investments in a select set of specialized strategies such as new issue CLOs and community bank equity.

Key facts:

- Founded in 2009; based in New York
- 13-person firm, including 7 investment professionals
- Approximately $1 billion under management

Contact Information

Gapstow Capital Partners
654 Madison Avenue, Suite 601
New York, NY 10065
www.gapstow.com
InvestorRelations@gapstow.com, or 646.735.3465

Important Notes and Disclosures

Disclosures and Disclaimers

This document is being provided on a confidential basis and is for informational purposes only. The information set forth herein should not be construed as an investment recommendation or tax advice nor does it constitute an offer to sell or the solicitation of any offer to buy interests in any security. Offers may only be made at the time a qualified offeree receives the related confidential information memorandum for a specific fund describing the offering. Any interests in securities of any funds shall not be offered or sold in any jurisdiction in which such an offer, solicitation or sale would be unlawful until the requirements of the laws of such jurisdiction have been satisfied.

Private equity and hedge fund investments ("private funds") are speculative in nature and involve a high degree of risk. There can be no assurance that investment objectives will be achieved and investment results may vary substantially over time. Investments in private funds are not intended to be a complete investment program for any investor. There is little secondary market for an investor interest in private funds and none is expected to develop. Private funds are generally not registered in the United States under the Investment Company Act of 1940 and accordingly are not extensively regulated. Opportunity for redemption and transferability of interests is restricted; investors may not have access to capital when it is needed. Leverage may be employed in some private funds, which can make investment performance volatile. Valuation of the securities in private funds may involve uncertainties and the exercise of judgment, which could adversely affect the value of any investment. An investor should not make an investment in private funds unless the investor is prepared to lose all or a substantial portion of the investment. The fees and expenses charged in connection with this investment may be higher than the fees and expenses of other investment alternatives and may offset profits. Funds that are recently formed have limited operating histories upon which investors can rely. For a comprehensive list of risk factors, an investor must review the related confidential information memorandum for this specific fund, which will be made available upon request.

This document may not be reproduced in whole or in part, and may not be delivered to any person without the prior written consent of Gapstow Capital Partners. All views and opinions contained herein are current as of the date of this document and are subject to change. Gapstow Capital Partners has no obligation to update the information contained in this document. Any reference to past performance is not indicative of future results. No representation is being made regarding the future returns in any funds or group of funds described herein or with respect to any potential experience of a Gapstow Capital Partners client.