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Family Office Insights

Key Considerations When Structuring a Private Fund That Invests in Litigation Funding

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Third-party funding of disputes has evolved across multiple jurisdictions into a new and dynamic asset class for investors in private markets.

Its relative novelty, for example in the UK, derives from the evolution of law that historically prevented third parties supporting litigation in which they had no connection as defendant or claimant (known as "maintenance"). A stronger form of maintenance is "champerty," being maintenance with a view towards making profit. Changes to the law have enabled third parties to fund litigation, provided certain conditions are met and maintained.

Perhaps unsurprisingly, private funds, such as private equity and venture capital, offer a parallel model that can be applied to litigation funding; in this second article in our firm's series examining the nature and detail of the opportunities that continue to develop around third-party financing and the increasing commercialization of disputes, we explore some of the considerations that arise when structuring a private fund that invests in litigation funding. Other funding models, such as via listed stock market corporations, are also viable but are outside the scope of this article.

Introduction to Litigation Funds and Their Structuring

Managing or investing in a closed-ended litigation fund structure is in both cases broadly similar to investing in any private fund that invests in illiquid assets – such as private equity, venture capital, real estate and infrastructure. Each investment of the fund is the investment into a case that is expected to generate a profit similar to that of capital-appreciating assets in other asset classes.

The "portfolio" of claims that a fund may invest in can vary – from supporting enforcement actions of already-determined cases to large class actions. This variance can impact some of the key commercial terms outlined later in this article, as funding requirements vary.

The choices of how and where to structure litigation funds are subject to the same commercial, legal, tax and regulatory pressures as for private funds investing in other asset classes. The key hallmarks are:

- **Limited liability** – Investors will not accept being liable for fund losses beyond their capital commitment to the fund.
- **Flexibility** – Being able to tailor the structure and terms the investment strategy and the needs of investors.
- **Tax transparency** – Investors generally prefer to invest in structures that do not result in double taxation (where the fund structure and the investor are both subject to tax).

The longstanding preferred choice of structure in private funds is the limited partnership. Its ubiquity is the reason why private fund investors are referred to as "LPs" (limited partners) and managers "GPs" (general partners), even when other structures are, in fact, used.

Limited partnerships protect the investors (as limited partners) by limiting their liability to their capital commitment to the fund – often with a strict requirement that the investors take no part in the day-to-day management of the fund. Limited partnership law is more *laissez-faire* than companies law in most jurisdictions, allowing for more flexibility and freedom to operate economic terms that better reflect the commercial requirements of investors and managers. Limited partnerships are often used as fund vehicles because they are generally treated as "tax transparent," meaning the investors are taxed as if they are the direct owners of the relevant assets and the limited partnership is not itself taxed.

The choice of jurisdiction of a structure is a relatively closed list: investors expect managers to structure in well-known financial centres such as the UK, Luxembourg, the Channel Islands, Delaware or the Cayman Islands. These jurisdictions come with benefits and challenges that must be weighed up – for example, it can be a challenge to actively market non-EU funds across the EU.

It is, therefore, also important to consider financial services regulation, as it must be possible to market the chosen structure (of the chosen jurisdiction) in the jurisdictions where the target investors reside. Generally speaking, regulation of this kind is neutral as to the type of structure; the primary concern of policymakers (where barriers to cross-border marketing do exist) is the jurisdiction of the relevant structure.

Investor Checklist

- Ensure the structure of choice offers and protects limited liability.
- Diligence the tax implications of (i) receipt of proceeds by the fund and (ii) distributions of proceeds to you as investor.
- Negotiate modifications of terms to mitigate tax and regulatory risks (if any), including potentially requiring a parallel or feeder structure.

Managing a Litigation Fund

The business of managing a litigation fund is typically no different from managing any other private fund. For example, in the UK, the main laws governing fund management apply neutrally to the underlying asset class – if you manage a litigation fund, it is still the same laws as if you manage an infrastructure fund. Some structures and arrangements may fall outside the scope of fund regulation if they are, for example, a true joint venture.

In the UK, fund management is a regulated activity requiring authorisation from the Financial Conduct Authority (FCA). For first time managers, this is a lengthy process and will also require development of lengthy compliance policies, organisational structures and "regulatory capital" to be set aside. Potential managers looking to get into business can use authorised third parties to market and manage the fund until such time as authorization is complete.

Industry Regulation

As noted above, the business of managing a litigation fund is regulated in much the same way as any other private fund investing in illiquid asset classes. There is another consideration – the regulation of the business of being a litigation funder.

In the UK, litigation funding is self-regulated by the Association of Litigation Funders (ALF). It was established to improve transparency and promote best practice, but membership is optional. However, compliance with the ALF code of conduct is cited in some English law judgments as being evidence that the funding is not champerty; there is a balance to be struck when considering this issue. Prospective entrants to the market should note that the ALF only admits members who have immediate access to funds, so it would not be possible to join before you have closed your first fund.

Commercial Terms of a Litigation Fund

The terms of a litigation fund will address a range of economic, governance and operational aspects. The key concepts are:

Management and fund costs – The manager will be paid a management fee to cover the cost of doing business: to source, diligence and agree litigation funding arrangements, to oversee and ensure maximum returns from investors from a case, and to operate and manage the fund itself. The fund will also cover its expenses on both set up and on day-to-day operations.

Management fees are typically expressed as an annual amount, calculated with reference to the total size of the fund (e.g., 2% of the fund commitments). After the fund stops entering into new arrangements, it is likely the economic calculation of the fee will step down to a percentage of total amounts invested (with the result that it tapers down as cases are "realised").

Carried interest – A manager is typically incentivised to succeed by being allocated a proportion of investor profits realised. This is known as carried interest and is often payable only after (i) investors have received back all capital invested in the fund and (ii) a certain return rate has been received by investors (the "preferred return").

The preferred return is typically an amount equal to interest calculated at a rate of 8% *per annum*, compounding annually, of the investors' drawn capital. After the preferred return is met, the manager receives a "catch up" allocation to ensure that they have participated in all profits. Carried interest rates are typically 20% of investor profits.

Commitments and contributions – On admission to a fund of this nature, investors make a legally binding commitment to contribute capital when called by the manager. Their commitment could be, for example, £1 million. The manager would call that capital when required (typically as part of a *pro rata* capital call with the investors), such as when fulfilling funding obligations with respect to a claim. Investors generally cannot be obligated to make aggregate contributions in excess of their commitment, exceptionally doing so, for example, where paying interest on amounts owed under a capital call that were advanced late.

Closed-ended – A fund of this nature is "closed-ended," meaning there is only a certain window in which the manager can seek new commitments from investors. This is often 12 to 18 months after the first date on which investors are admitted to the fund (this first date being known as the first closing date, with closing dates numbered sequentially until the final closing occurs).

Investment period – The investment period is the time-limited window in which the manager can enter into funding arrangements on behalf of the fund. The end of this period may be, for example, the fifth anniversary of its final closing. Investors may still be required to advance commitments after the investment period to fulfil funding obligations incurred before the end of the investment period.

Fund term – The duration of a fund of this nature is specified in its constitutional agreement, and a duration (or term) of 10 to 12 years is common. The purpose is to time limit the period in which investors are holding their indirect investment in a case, but fund terms are often extended to ensure an orderly winding down where there are slower-moving cases yet to realise proceeds. In exceptional circumstances, the investment may need to be restructured or recapitalised with a new funding vehicle.

How Might We Help?

This article has outlined some of the key concepts involved in structuring a litigation fund, drawing on the commercial context in which other private fund investments are made. Naturally, however, specific circumstances apply to litigation funding which ought to be considered by new entrants to this quickly evolving, dynamic market. Our lawyers can, of course, help, and in the event you would like to discuss any of these matters further, please do not hesitate to reach out to us.

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