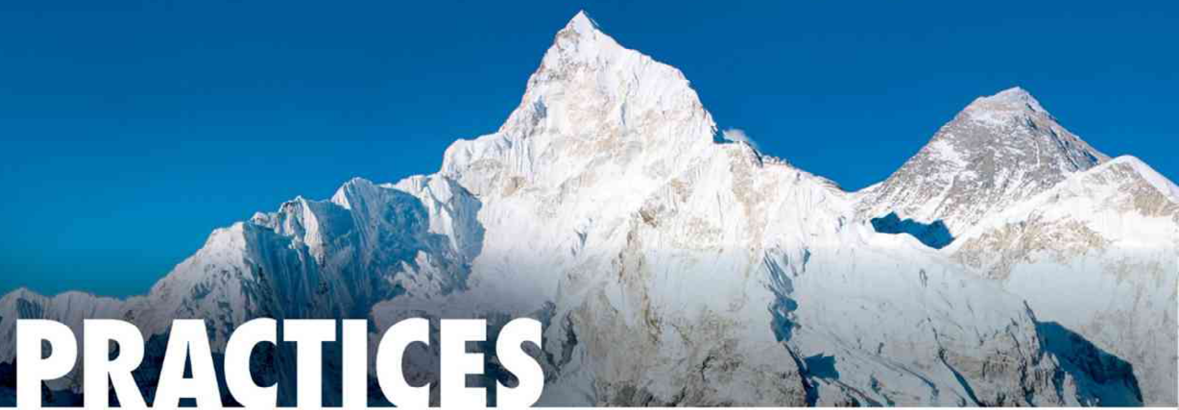
Morgan Lewis

# ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE



## Manager and Investor Perspectives

## NEW YORK

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# Recent Developments in Litigation Finance and Insurance: What Debt Investors Need to Know

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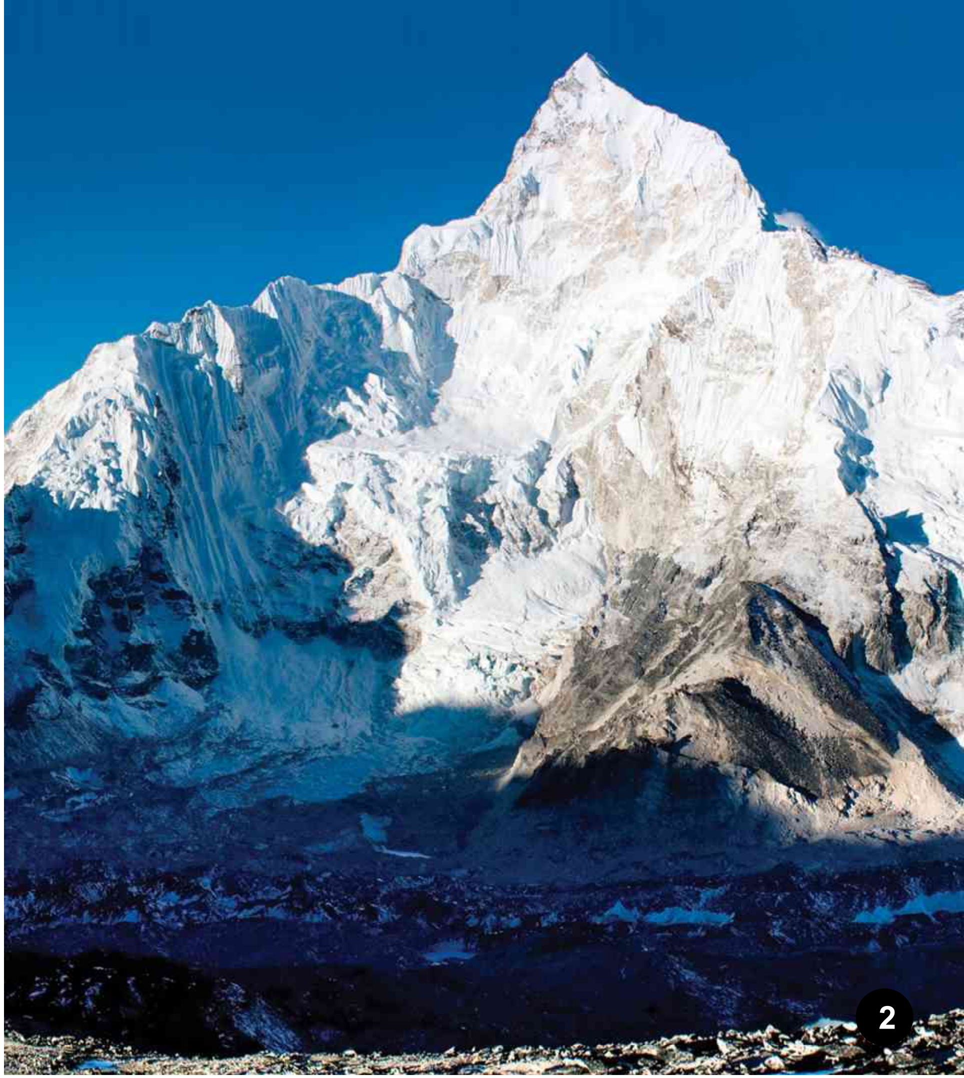

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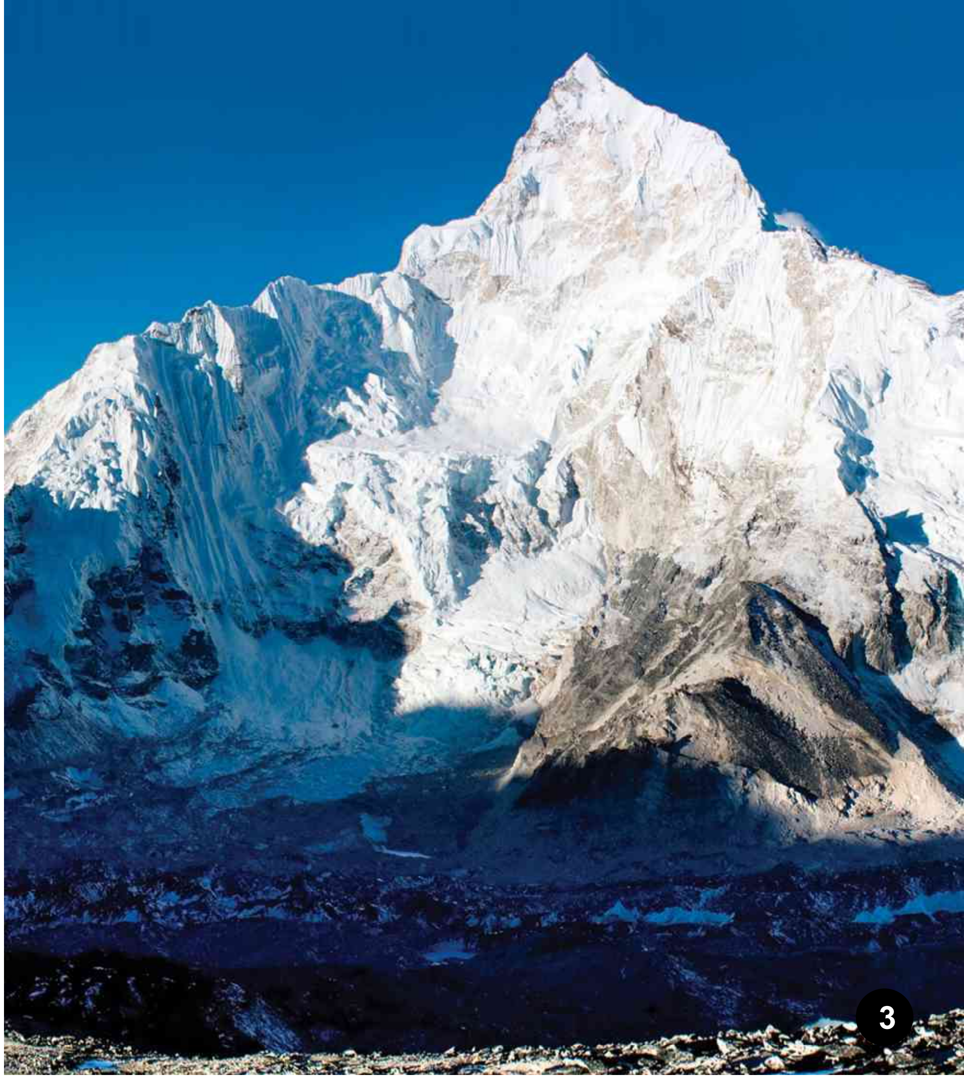


# Thesis

Recently developed insurance products potentially make litigation funding transactions attractive to traditional debt (including leveraged loan) investors.

# *Traditional* Litigation Funding

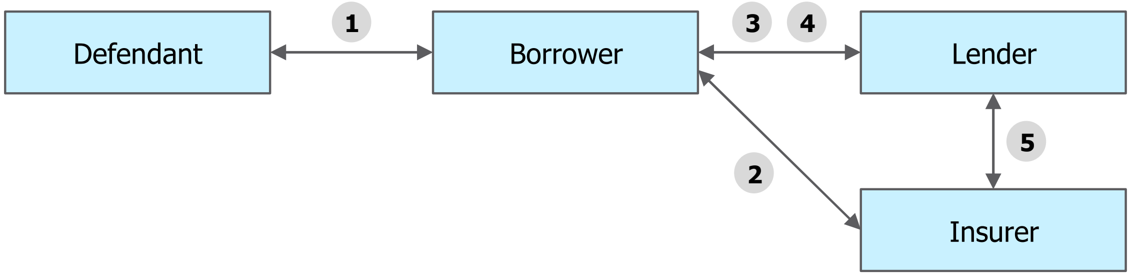
- Asset class well-established in the US and globally
- Traditional transactions include:
  - Plaintiff funding: providing funding to a plaintiff in a litigation in return for a portion of the award proceeds
  - Law firm funding: providing funding to a law firm in return for a portion of the contingency fee award
- Limited recourse: recourse only to litigation proceeds or the contingency fees
- Equity-type returns: return formulas typically based on a multiple of investment and/or a percentage of the award
  - Returns *not correlated* to the market
- *Not well-suited to traditional debt/leveraged loan investor (equity-type risk, underwriting requires litigation analysis)*

# Insurance Products for Litigation Funding Transactions: *Judgment Preservation Insurance and Portfolio Risk Insurance*

- Insurance 1.0 Judgment Preservation Insurance (JPI)
  - Ensures policyholder will receive a sum certain even if judgment overturned/vacated
- Insurance 2.0 Portfolio Risk Insurance (PRI)
  - Ensures policyholder/plaintiff will receive a sum certain for a certain portfolio of litigation risk
  - Potentially available *prior* to judgment (given the portfolio* risk)
- *When these insurance products are <u>combined</u> with a financing (loan) secured by the policy, the resulting loan transaction is potentially well-suited to traditional debt/leveraged loan investor (debt-type risk/returns, underwriting requires analysis of insurance policy, and transaction generally requires less diligence/analysis of the litigation)*
- These insurance products fall generally into a product grouping referred to as "contingent risk"

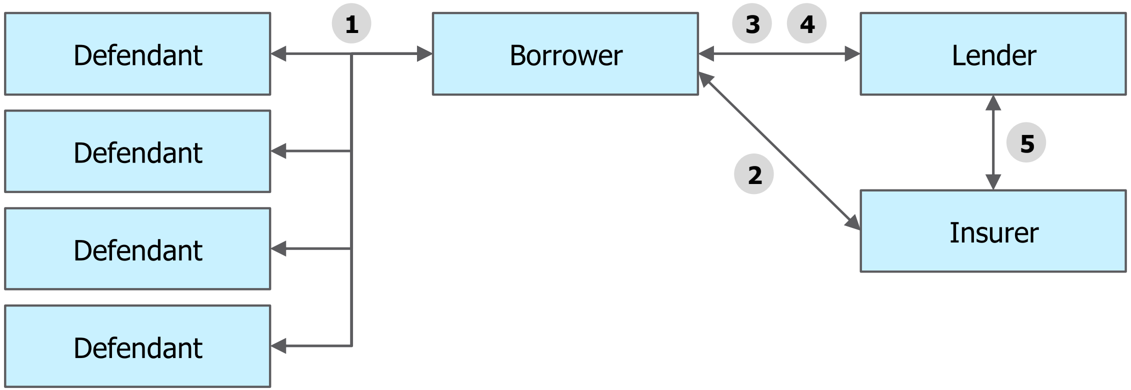
* While insurance for *pre-resolution, plaintiff*-side litigation claims are generally only available for a *portfolio* of litigation risk, *defense-side* insurance policies, which may limit or cap liability (especially for mass-tort or class action claims), are policies that are available pre-resolution. These defense-side insurance policies are generally not related to a financing.

# Transaction Example No. 1: Judgment Preservation Policy Financing (Insurance 1.0 – Post Judgment)




1. Borrower obtains [500M] judgment again Defendant.
2. Borrower obtains [250M] JPI policy from Insurer.
3. Borrower obtains [125M] loan from Lender. Lender recourse is limited to litigation proceeds (if judgment *is not* overturned) and insurance proceeds (if judgment *is* overturned).
4. Borrower provides Lender with security interest in the judgment, related claim, insurance policy, and proceeds thereof.
5. Lender named designated loss payee and/or additional insured under insurance policy.

# Transaction Example No. 2: Portfolio Risk Policy and Financing (Insurance 2.0 – Prejudgment)




1. Borrower has a "portfolio" of litigation risk it seeks to insure. The above example could reflect, for example, a patent "campaign" against multiple unrelated defendants. The same structure could be used with a law firm borrower seeking to insure and monetize a portfolio of contingency fee cases, or a litigation funder seeking to insure and monetize a portfolio of funded transactions.
2. Borrower obtains [250]M portfolio risk policy from Insurer, insuring its receipt of not less than [250]M.
3. Borrower obtains [125]M loan from Lender.
4. Borrower provides Lender with security interest in claims, insurance policy, and proceeds thereof.
5. Lender named designated loss payee and/or additional insured under insurance policy.

# Why Insurance-Backed Litigation Funding Is Attractive to Borrowers, Lenders, and Insurers

**Borrowers**

- **Lock-In Returns**. Insurance (without financing) may be a rational/attractive economic decision in order to "lock in" an anticipated return from a "contingent" legal asset.
- **Monetization**. Insurance, coupled with financing, may allow for current monetization of litigation assets at attractive rates. Financing costs, when wrapped by insurance, may be substantially lower than what a Borrower could obtain from a litigation funder on an "unwrapped" litigation asset (even after accounting for the cost of the premium).
- **Limited Recourse**. Recourse only to litigation proceeds and/or insurance proceeds and not to Borrower generally.

**Lenders**

- **Attractive Returns**. PIK interest typically runs [14-20]% range.
- **Senior Secured Position**. Lenders secured by both the litigation claim and the proceeds thereof and the insurance policy and the proceeds thereof.
- **Uncorrelated Asset**. Performance not tied to business operations or market conditions.

**Insurers**

- **Attractive Premiums**. Premiums ("rate-on-line") typically [10-20]% of insured amount, depending on the nature and coverages of the policy.
- **Success Fees**. Some policies provide additional payment to Insurer upon a litigation "win," providing Insurer with possible additional upside. This upside is sometimes provided in return for a reduced premium payment.

# Who Provides the Debt (aka the "Leverage")?

| PROVIDER | CONSIDERATIONS |
| --- | --- |
| **Traditional Litigation Funders** | • Traditional litigation funders are uniquely positioned to analyze legal risk and have been active in this space. However, the returns on insurance-wrapped deals are less than unwrapped deals, and given a traditional litigation funder's cost of capital, "wrapped" returns are not always attractive to traditional litigation funders. |
| **Hedge Funds** | • Certain multi-strategy hedge funds have the resources to analyze and close these transactions and have been active in the space. |
| **Direct Lenders** | • While direct lenders typically focus on underwriting metrics based on cash flow, financing, and other business operating metrics, certain direct lenders have the resources to analyze and close these transactions and have been active in the space. |
| **Commercial Banks?** | • Certain commercial banks have been active in this space for certain types of transactions. Banks have the competitive advantage of lower-cost capital, but have regulatory considerations and business constraints that non-regulated financial institutions may not have. |

# What Risks Are Typically Assumed by the Lender?

| RISK | MITIGANT |
| --- | --- |
| **Defendant Credit Risk** (assuming Borrower wins claim) | • **Diligence**. Diligence Defendant's ability to pay.<br>• **Insurance Policy**. [Insurance policy can be structured to cover this risk.] |
| **Denial of Claim Due to Policy Exclusion** | • **Well-Constructed Policy**. Well-constructed policies contain few exclusions.<br>• **Alignment of Incentives**. Lenders create alignment with Borrower through the loan agreement to ensure Borrower complies with policy terms (recourse). |
| **Insurer Credit Risk** | • **Ratings**. Tower includes highly-rated insurers only.<br>• **Pricing**. Insurer credit risk included in financing spread for Borrower. |
| **Litigation Duration Uncertainty** | • **Head Room**. Lenders advance portion of insurance coverage in order to leave head room over the initial debt amount to account for anticipated accretion of PIK interest.<br>• **Fixed Term**. For portfolio insurance transactions, policy may have a fixed term allowing for a definitive maturity. |
| **Borrower Bankruptcy** | • **Secured Position**. Lender obtains first-priority perfected security interest in the judgment, related claim and claim proceeds, and insurance policy and insurance policy proceeds. |

# Who Provides the Insurance?

- Approximately 30 insurance providers in the global market (US, London, Bermuda)
- A-rated
- Dedicated specialty underwriting teams with designated capacity

# How Does the Insurance Tower Work?

- **Insurance Tower**. The aggregate insurance coverage provided by all insurance providers is described as the "insurance tower." The tower will have a number of layers. The "primary layer" is the layer that pays out the first "loss." The loss is absorbed by the *primary layer* first, then by the first excess layer, the second excess layer, etc. In other words, the loss is not absorbed by each layer *pro rata*, but by each layer *sequentially*. The insurance premiums paid to the primary layer are more than the premium paid to the subsequent layers, given the increased risk associated with the primary layer given it absorbs the "first loss."
- **Primary Policy**. This is the policy that is written for the primary layer. There will be a separate policy for each layer, which will be substantially identical to the policy for the primary layer.
- **Primary Layer**. The first layer of the insurance tower, which absorbs the first loss.
- **Excess Layers**. Each of the layers after the primary layers, usually referred to as "first excess layer," "second excess layer," etc.
- **Several Liability**. Each insurer covers its own "loss" in the tower.
- **Quota Share**. Within a single layer, there may be multiple insurers, each with a quota share. Within a layer, each insurer pays its proportional "quota share" of the loss within such layer.

**Insurance Tower**

| |
|---|
| 7th Excess Layer |
| 6th Excess Layer |
| 5th Excess Layer |
| 4th Excess Layer |
| 3rd Excess Layer |
| 2nd Excess Layer |
| 1st Excess Layer |
| **Primary Layer** |

# Key Issues in Structuring/Negotiating the Insurance Policy

- Amount of Policy Relative to the Anticipated Award
- Pricing (“Rate-On-Line”)
- Insurable Risk (not derivative)
- Exclusions
- Settlement
- Assignability
- Representations Letter

# Key Issues in Structuring/Negotiating the Financing

- Amount of Financing (and accretive PIK) Relative to Insurance Coverage ("Head Room")
- Recourse Triggers
- Collateral Issues and Bankruptcy Risk
- Lender's Remedial Options
- Litigation Funding – Related Issues
  - Disclosure
  - Control of litigation
  - Ensuring sufficient funding for litigation counsel
  - Ensuring an "alignment of incentives" for all parties

# Key Takeaways

New insurance products are opening the litigation funding market to new market participants, including traditional leveraged debt investors and even commercial banks.

Contingent risk policies are being used in a variety of novel ways.

- Judgment Preservation Insurance
- Portfolio Risk Insurance
- Defense-side Litigation Insurance
  (Mass Tort/Class Action caps on exposure)