

G. Litigation Funding and Predictive Analytics*

I. Litigation Funding

1. A short introduction to Litigation Funding

- 1 What started out as a simple mechanism for the transfer of risks has meanwhile grown into a veritable miracle bag of offers: “classical” litigation funding, i.e. the assumption of the costs of litigation in return for a part of the proceeds, has morphed into and is now supplemented by arbitration funding, settlement funding, claims purchase, monetisation of claims and awards, law firm funding and even in-house legal department finance, all of the above- summarized under the term “Legal Finance”. The core idea is to provide access to justice for parties who cannot afford the risk of litigation and/or to offer intelligent solutions for parties who do not want to afford this risk¹.
- 2 The reasons for this development are the ever-increasing market acceptance of legal finance by the legal profession, including in-house legal departments as well as the needs and logic of the capital markets. From an investors point of view, the funding of legal risks represents nothing but a new asset class. This asset class in- turn is characterised by the fact that it has neither capital markets nor cyclically correlated risks and is therefore interesting: *“Litigation exists in an economic vacuum, and changes in interest rates, currency values, and housing prices don’t seem to have an effect on court proceedings. Also, investors like the natural exit and liquidity – the average case lasts around 28 months, giving the investment a short-term life cycle”*².

2. Internal Processes

- 3 a) The original offering of litigation funders is simple: the funder takes over all the costs of litigation, i.e. typically the costs for lawyers, courts and any expert witnesses, and participates in the actual proceeds of the litigation with a previously agreed-upon quota. If the lawsuit ends with a dismissal of a claim or if the disputed amount cannot be enforced, the funder receives nothing. This means that funders must not only consider the legal risks, but also take the counterparty’s credit risk into account, which may fluctuate over the duration of the litigation. The level of participation depends on the quality of the risk, in particular, the prospects of success: the better the risk, the lower the ratio of participation tends to be. Typical rates range between 30 % to 20 %, in individual cases also staggered, partly combined with floor and cap mechanisms. Also known are interest rate mechanisms pertaining to the expected or actual duration of litigation or multiples of the assumed cost risk, and finally also hybrid forms of all the

* By Thomas Kohlmeier. Thomas is managing partner of Nivalion AG, a Swiss based Litigation Funder with offices in Zug and Munich, www.nivalion.ch. Nivalion specialises in high volume litigation and arbitration funding, legal finance concepts and funding of legal tech offerings.

¹ A detailed description of the legal intricacies and respective problems in common law and civil law jurisdictions would go beyond the scope of this article, in this respect see the instructional foreword by Leslie Perrin in: Third Party Litigation Funding Law Review, p. 5, The Law Reviews 2017, 1st edition ISBN 978-1-912228-03-4.

² Peter Sorrena in <http://www.tearsheet.co/2016/06/17/hulk-hogan-gawker-and-the-future-of-litigation-finance>.

above-mentioned approaches. The areas of law in which funders are investing are widespread and range from cartel damages to mass tort to IP-related litigation³.

b) This business model of litigation funders is crucially dependent on the ability to correctly assess the inherent value of the funded lawsuits or other legal risks used as collateral for financing. This means first and foremost an intensive examination of the merits of the respective case, but also further considerations pertaining to the structure of portfolios regarding the duration of the proceedings, prospects of enforcement and so on. The proverb according to which “in court and on the high seas one is in God’s hands”, does not usually correspond to a funder’s internal underwriting processes. Rather, for the overwhelming majority of litigation funders, their underwriting activities are structured at least as a two-stage process: First, an examination, mostly by in-house lawyers of the funders, is carried out to determine whether the case meets the respective investment objectives and underwriting guidelines. Additionally, if an individually determined exposure – here understood as the sum of the assumed risk – is met, external lawyers specialising in the respective legal issues and, where necessary, other experts, are consulted to complement and enhance the funder’s due diligence process.

The procedure of risk analysis regularly used is a combination of legal and mathematical risk assessment⁴. With this procedure, underwriting decisions can be put on a comparable footing in different cases. The results of this method are then incorporated into the funders’ valuation models, which in turn take into account their respective interest requirements on the invested capital. Risk analysis and evaluation form the basis for the pricing strategies in individual cases or portfolios.

Essentially, funders’ underwriting processes are all about answering the question of how, for example, the competent court will decide – are there already decisions by this panel in comparable matters, are there positive or negative precedents, commentary literature, scientific contributions, etc. on the decisive legal questions⁵ – and are therefore nothing else but about the recognition of patterns.

II. Predictive Analytics

1. A short introduction to Predictive Analytics

a) A quick look at Wikipedia provides a definition as follows:

“Predictive analytics is an area of statistics that deals with extracting information from data and using it to predict trends and behaviour patterns...The core of predictive analytics relies on capturing relationships between explanatory variables and the predicted variables from past occurrences and exploiting them to predict the unknown outcome”⁶.

b) This approach is of course by no means new; well-known examples include credit scoring methods used by banks to calculate the risk of credit defaults (and accordingly to grant or deny loans), NatCat models of reinsurers or “other customers also like” lists of suggestions from retail companies.

Like any other ventures that deal with risk transfer, funders would like to assess the risks they assume as accurately as possible. This often leads to a conflict of interests

³ Enumeration not conclusive.

⁴ See Risse/Morawietz, Prozessrisikoanalyse, 1. Auflage 2017, C.H.Beck ISBN 978-3-406-71480-1.

⁵ For this reason, commercial funders are as a rule typically not interested in funding fundamental decisions or the development of new legal territories. Occasional exceptions, such as the – unsuccessful – funding of a mass collective lawsuit against Facebook in Austria are more likely to be motivated by marketing considerations than anything else.

⁶ https://en.wikipedia.org/wiki/Predictive_analytics.

between the inquiring parties' needs for quick decisions and the accuracy required from the funder's internal point of view. To most funders, it would surely be an enticing vision to have faster yet safer underwriting processes, and not to overlook any relevant decision parameters by means of software-based systems.

2. Problems and approaches to solving them

- 11 a) The "One Ring" to bind all risks, or, as funders would rather have it, to assess all risks correctly, does not yet exist, or has at least not yet been forged. As described above, funders must generally assess both the risks associated with the collectability of the cases (hereinafter referred to as "credit risk") and the legal merits of the specific cases.
- 12 With regard to the credit risk, funders are in a more comfortable position, as they can fall back on the offers of third-party service providers already employing predictive analytics methods⁷.
- 13 As to the assessment of the merits of a case, the situation is currently less pleasant. Said assessment is regularly a combination of the most comprehensive research possible and the most accurate transfer of the research results on to the respective case. On the national and international level, the legal field is characterized by a multitude of different output formats in which relevant information is available. A wide range of different institutions and market participants distribute this information, from venerable legal libraries to online research tools of legal publishers.
- 14 In the area of "high-end" litigation funding⁸, it is more difficult to find comparable data for each case in comparison to other fields of application of predictive analytics, simply because these cases tend to be highly individual. A software-based solution, which finds both relevant decisions (i.e. "relevant samples") at the push of a button, and carries out a risk assessment of the content for the specific case, is therefore not yet apparent.
- 15 b) However, a very exciting development can be seen in the emergence of legal tech vendors, who are currently still predominantly active in the area of consumer protection, and who generate a wealth of data through their business models. These data can be and of course, are already used for the purposes of predictive analytics. Various offers regarding the enforcement of claims arising from flight delays⁹ or class actions¹⁰ are serving as first examples. According to their own data, some of these ventures are already looking back on five- to seven-digit numbers of conducted procedures and served customers¹¹. It comes as no surprise that these providers are already combining their offers with litigation funding to expand their services and chain of value creation. Many of these providers see themselves as comprehensive solution providers anyway, and risk analysis is dramatically easier for them than it is for providers in the field of high-end litigation funding: if you have the experience of thousands of similar cases and therefore statistically reliable findings on success rates and duration of these cases, it takes no genius to figure out very granular offers that balance investors' interest rate requirements and default risks.
- 16 c) The forging of the One Ring, i.e. development of software-based solutions seems to be considerably more advanced in Common Law jurisdictions than in Civil Law jurisdictions. Proof to that might be the sheer number of existing offers in the respective

⁷ See for instance www.creditreform.com, or Dun & Bradstreet, www.dnb.com, with the advertising message "uncovering truth and meaning in data".

⁸ The funding of litigation or arbitration cases with very high claims, typically starting from a claims value of 10 Mio. € onwards.

⁹ www.flightright.de and others.

¹⁰ www.myright.de and others.

¹¹ Flightright advertises "2,000,000 times successful" service, www.flightright.de.

jurisdictions: Common Law sees offerings like Bloomberg Litigation Analytics¹², Blue J/ TR Tax¹³, Elexirr¹⁴, GovPredict¹⁵, Lexis Lex Machina¹⁶, LexPredict¹⁷, Premonition,¹⁸ and others¹⁹. Apart from Predictice²⁰ there are currently hardly any comparable solutions to be found in Civil Law jurisdictions²¹.

For a practical demonstration of what is already possible today to support legal research see www.casetext.com²². The software recognizes the content of legal texts and promises to suggest relevant decisions within seconds. The offer of Ross/EVA goes in a similar direction²³.

It is only a matter of time until the further development of NLP-based technology combined with ever-increasing computing power and data availability will lead to a largely software-based risk analysis, even in the legal environment.

III. Already foreseeable and future effects on the business models of Litigation Funders – and the Legal Market in general

1. Turning Risk into Value?

a) The business model of litigation funders is based on their special know-how, which enables them to organise the risk transfer asked for by their counterparties in the first place and allows them to negotiate risk-appropriate prices for this transfer. Experienced funders have a knowledge lead over their customers in which risks to take and which to avoid. As soon as predictive analytics methods become widely available, this knowledge advantage will diminish, and the contracting parties will have a much better informed and thus stronger position in the negotiation of the litigation funding agreement. Where plaintiffs are currently still applying for support from funders, funders will medium term have to pitch for the funding of individual cases much more than today. This, in turn, will possibly lead to increased competitive pressure and falling margins for the funders. For funders, however, this development also holds the chance that even if the business model will initially be disenchanted, it may at the same time develop more towards volume business. Where today's business is characterized by small numbers of funded cases with high margins, we will see significantly higher numbers of cases, with improved underwriting accuracy, but lower margins. And it is also likely that the

¹² <https://www.bna.com/litigation-analytics/>.

¹³ <https://www.bluejlegal.com/>.

¹⁴ A peculiarity insofar as elexirr (previously known as LawBot) is a legal chatbot hosted on Facebook messenger. It calculates a users' chance of success in winning a legal claim and refers them to a network of law firms best suited to deal with their claim.

¹⁵ www.govpredict.com/.

¹⁶ www.lexmachina.com/.

¹⁷ www.lexpredict.com/.

¹⁸ www.premonition.ai/.

¹⁹ Enumeration by no means conclusive.

²⁰ www.predictice.com.

²¹ Please be aware that this could be a wrong impression by the author and will very probably be changing in the near future.

²² The advertising statements there indicate where the development will go: "Be a better, faster legal researcher with the help of the CARA Research Suite: easy-to-use AI technology that helps you quickly discover and deeply understand the cases you need..."

Meet CARA, your automated research assistant. Simply drop a brief into CARA's secure system, and CARA's machine learning and AI technology will immediately go to work, researching Casetext's entire database of U.S. law and surfacing relevant case law in milliseconds."

²³ www.rossintelligence.com, "EVA, the streamlined and intuitive artificial intelligence system that will supercharge your research".

boundaries between insurance business and, in particular, after-the-event (ATE) business will become even more blurred than they already are today.

20 b) These effects will primarily have an impact on funders in high-end business. Legal Techs, and the litigation funders associated with or operated by them, who are currently still active in the consumer sector, will probably be able to escape this development to some extent due to their proprietary services and offers, and the data obtained exclusively thereof. An expansion of their offers towards the business sector is to be expected, as solutions for SMEs are already in an early development stage.

21 c) If this forecast proves to be true, this development will also have an impact on other major players in the legal market, namely legal expenses insurers and lawyers: The (consumer) public is already becoming accustomed to the combination of risk assumption, problem-solving and pay-out (e.g. Flightright, www.flightright.de) in many ways, so that providers of individual isolated solution steps (e.g. legal expenses insurers who “only” cover the cost risk, or lawyers who “only” provide advice) will find it increasingly difficult to compete. Law firms that are currently working on a contingency fee basis will have to be prepared for the fact that their clients will be better informed about the risk of their cases, which might put pressure on contingency fees. This, in turn, will probably increase the need for alternative financing instruments – and here the circle will probably be closing with the further development of litigation funding into legal finance offerings. In the variation of an old proverb: it was never more exciting to be a Litigation Funder than today...!