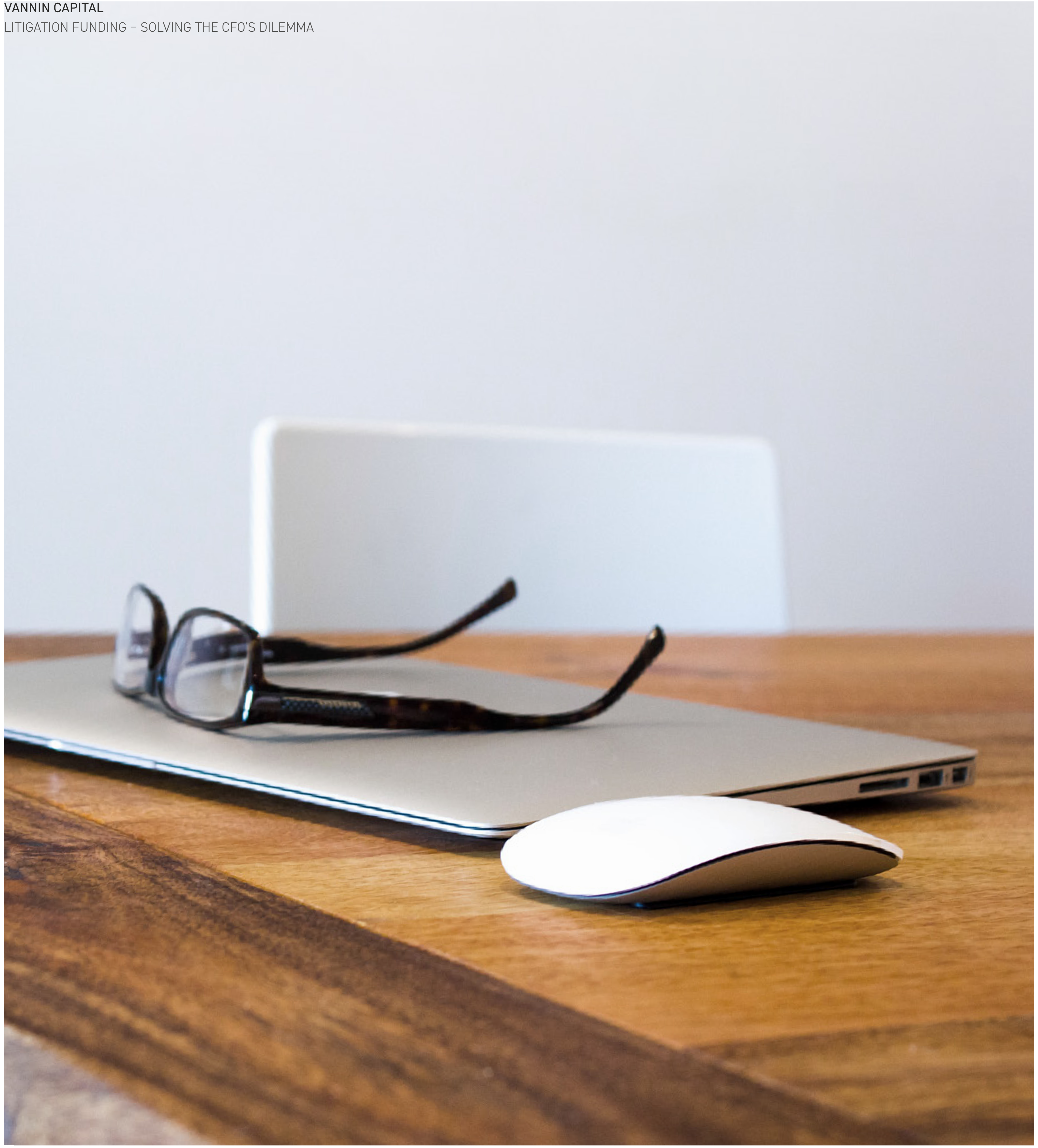


Tim Allen
Partner

PwC

Andrew Jones
Managing Director

VANNIN CAPITAL

LITIGATION FUNDING > SOLVING THE CFO'S DILEMMA

What is the dilemma?

Much has previously been written about the benefits of third party non-recourse litigation funding. Some of these are obvious: shifting the risk of adverse litigation outcomes, access to justice for impecunious claimants and bolstering the quality of a legal team.

Less obvious, but arguably more important for corporate claimants, are the financial, reporting and operational benefits that can be reaped when using a third party to fund litigation – namely the immediate improvement of EBITDA and cash flow, greater certainty over forecasts of legal spend and the potential to turn a legal department from a cost centre into a profit centre. A corporate may also be able to pursue claims that would not otherwise be pursued due to budget constraints, at no incremental cost to the business.

In this article, Tim Allen, a partner and accounting expert in the Disputes practice at PwC and Andrew Jones, Investment Director at Vannin Capital, explain how these benefits work and why it is that a CFO should be at least as interested in the utilisation of litigation funding as a Head of Litigation or a General Counsel.

As explained in this article, a professional funder and accountant working together can provide a solution to the dilemma faced by many CFOs: how to shelter core business performance from the impact of uncertain legal costs, without compromising on the quality of advisers and the protection of legal and commercial interests?

But how does this work in practice?

The benefits described are perhaps best illustrated through a series of worked examples.

	Year 1 (£)	Year 2 (£)	Year 3 (lose) (£)	Year 4 (win) (£)
Revenue	100	104	108	108
Core Operating Profit	6.00	6.24	6.48	6.48
Core Operating Margin	6.00%	6.00%	6.00%	6.00%
Legal cost	-1.25	-2.50	-1.25	-1.25
Opportunity cost	-0.08	-0.23	-0.30	-0.30
Adjusted Operating Profit	4.68	3.52	4.93	4.93
Adjusted Operating Margin	4.68%	3.38%	4.56%	4.56%
One off gains	0.00	0.00	0.00	100.00

Table 1 – Example 1 new claim is self-funded

1. The self-funded claim

In this example, we consider the impact of a company pursuing a new outbound claim (i.e. where the company is the claimant) based on the following assumptions:

- The quantum of the claim is £100m and the proceedings are expected to last three years at a total external cost of £5m;
- Initial annual revenues are £100m, growing by 4% each year;
- The core business consistently delivers an operating margin of 6%;
- The opportunity cost of allocating capital to pursue the claim is 6%; and
- If the claim is successful, proceeds are assumed to be received shortly after the award.

In this instance, the "above the line" costs associated with pursuing the claim are recognised immediately as an expense and impact Operating Profit in each year while the proceedings are ongoing. Capital allocated to fund the claim cannot be used for core business activities, thus further reducing profitability.

Pursuing the claim not only distorts the performance of the core business, but also depresses the market valuation of the company by a multiple of the costs incurred.

If the claim is successful, the proceeds are recognised as a one-off "below the line" gain and will likely only impact the perceived valuation of the company on the basis of injecting additional cash into the business. In short, these are impacts that a prudent CFO will want to avoid.

2. Funding the same outbound claim through a third party funder

Using the same scenario as in Example 1, we now consider the accounting impact to the company of financing the new claim with non-recourse funding provided by a third party litigation funder.

	Year 1 (£)	Year 2 (£)	Year 3 (lose) (£)	Year 4 (win) (£)
Revenue	100	104	108	108
Core Net Profit	6.00	6.24	6.48	6.48
Core Net Margin	6.00%	6.00%	6.00%	6.00%
Legal cost	0.00	0.00	0.00	0.00
Opportunity cost	0.00	0.00	0.00	0.00
Adjusted Operating Profit	6.00	6.24	6.48	6.48
Adjusted Operating Margin	6.00%	6.00%	6.00%	6.00%
One off gains	0.00	0.00	0.00	76.00

Table 2 – Example 2 non-recourse funding of a single claim

In this example, the company no longer bears the "above the line" legal costs of pursuing the claim. The Operating Profit (excluding one-offs) reported in each year is reflective of the core performance of the business, likely boosting its valuation.

As with Example 1, the future benefits of a successful claim offer no benefit to the profitability of the company in Years 1 and 2. If the claim is successful, the company recognises a reduced one-off gain, but given the preservation of profitability during Years 1 and 2, a reduced net claim receipt will have a limited impact on the change in the valuation of the business.

Although the company gives up a portion of its eventual (but uncertain) gain as a premium to its funder, the funding arrangement has meant that there has been zero cost incurred in generating that gain. An in-house legal team has therefore utilised funding to generate profit.

3. Funding a portfolio of inbound and outbound claims

Finally, we consider the benefits of a portfolio funding arrangement whereby a funder advances funds against a portfolio of cross-collateralised cases which could incorporate both outbound and inbound claims (i.e. where the company is the defendant).

Increasingly, corporate clients with large portfolios of disputes are seeking to lay off the risk and the cost of those portfolios to a third party funder.

The financial and accounting benefits of a portfolio arrangement would of course depend on the precise structure of the funding arrangements and the composition of the portfolio, but they could include (amongst other things):

i) reduced costs and cash outflows relating to legal costs across a range of claims;

ii) an incremental revenue stream if non-recourse funds can be used to fund internal as well as external legal resources; and

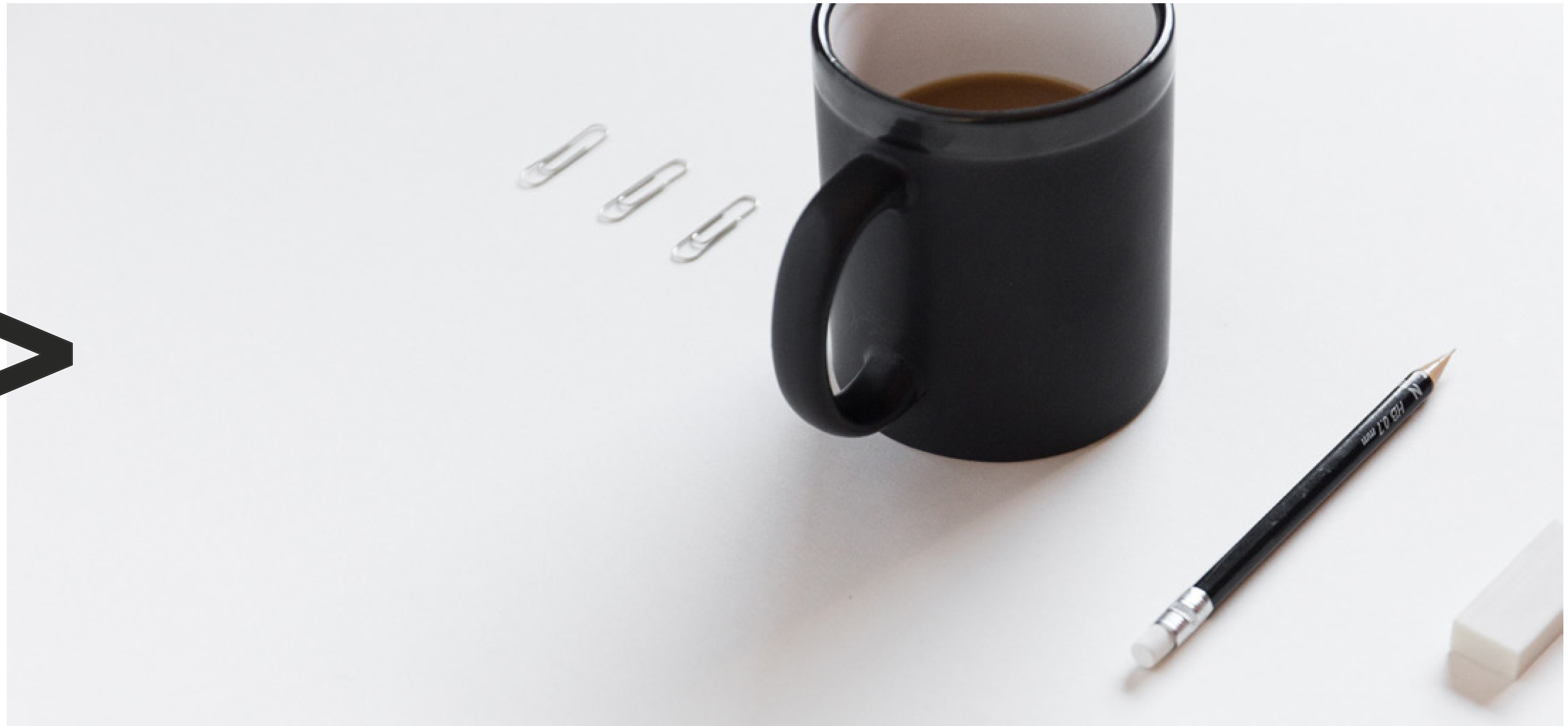
iii) a lump sum cash injection.

Inbound claims in particular, complicate the CFO's dilemma even further. These claims cannot be selected or planned. They can generate significant costs, but the company has far less control over when and how those costs will be incurred, and at what level. Crucially, inbound claims must be defended not for the benefit of making uncertain future gains, but to avoid or minimize future losses.

The uncertain timing and value of costs associated with inbound claims can result in a CFO and/or General Counsel having to cannibalise investment and sales budgets, impacting revenue and profitability, with no short term financial benefit generated in return.

The requirement to recognise inbound "above the line" claim costs immediately, and the knock-on effect of having to shift capital away from core (profit generating) business activity, results in a significant reduction in profits as a result of an unexpected inbound claim. Using a portfolio arrangement to insulate the company from the impact of such unexpected costs would not only benefit profitability in the immediate short term, but ensure that (i) scarce capital is focused on investment and activity with long term benefits for the company and (ii) ensure the best advice and professional services can be secured to assist the company.

Further, if a proportion of the funding can be used to finance internal as opposed to external legal costs (for example, the cost of additional in-house legal resource to manage the relationship with the external advisers), this would effectively create a revenue stream for the internal legal team. Not only that, but the utilisation of funding to avoid external costs could have a potentially greater pound for pound impact on the internal budget as the profit margin on external services can be avoided. The in-house legal department can thus be transformed from a cost centre into a profit centre.



Are there any other benefits to third party funding and what are the costs?

To summarise, based on our experience, the key benefits to businesses using dispute resolution funding are as follows:

Increased market value of the business – cash that is spent pursuing claims is not then available for general business building activities, meaning that the chance of growing the EBITDA of the business from the expenditure of those funds will be lost.

Risk shifting – in much the same way that insurance and other hedging products are used in commerce, litigation funding effectively shifts the entirety of litigation risk from the claimant to a third party.

Unlocking value – each potential claim is an asset of the company. In a world where growth is scarce, the importance of extracting value from all available company assets has never been higher.

Reduced drain on legal budget – with the costs of running the claim outsourced to a funder, the legal budget can be more effectively deployed on core activities.

Time savings – if Vannin Capital's team are used to help run the case, management and legal team time may be used more effectively on other activities relevant to the business.

Improved settlement prospects – the fact that Vannin Capital is involved can send a powerful message to the respondent that an independent commercial entity, which only invests in meritorious claims (including an independent senior lawyer engaged by Vannin Capital confirming the strength of the claim) considers that the case has a strong chance of success. Involving a funder can give the other parties reason to pause and reassess their defence and their own advice on prospects, particularly when they understand that the claim is fully funding through to trial.

Expert assistance – as a professional dispute resolution funder, Vannin Capital brings to bear its considerable litigation and arbitration experience and can add real value by, if requested to do so, providing strategic input as the case progresses.

The role of lawyers – the quality of a claimant's legal team is crucial to achieving the best outcome in a case. In Vannin Capital's experience, using a top-tier legal team (lawyers and barristers) will get a better return, more quickly.

Alternative uses of funding – funding can also be structured whereby meritorious claims (i.e. where the company is the claimant) could be used as collateral to secure funding for ongoing operational cash requirements or as a way of crystallising a proportion of uncertain future gains sooner.

Costs – the "cost" of obtaining all of these benefits is not really a cost at all, at least in an accounting sense. Rather, the company will be giving up a proportion of future uncertain gains (some of which may otherwise not be pursued), which will only arise in the event of a successful litigation outcome and which in the short term carry no financial benefit for the business

And finally… how can an accountant help?

Evaluation of the value of claims – assessing the potential value of a claim is an essential part of the decision-making process relating to any dispute. An accountant can provide an early independent assessment of the range of claim values and the support and evidence which would be required to support this quantum robustly. This could help define the costs and challenges associated with pursuing a claim.

Effective use of capital – working with the CFO and General Counsel, an accountant can help assess the most effective use of capital within a corporate's legal function, considering the most beneficial mix of funding sources, such as third party funding, which could potentially transform the legal practice from a cost centre into a profit centre.