For what it's worth

Timothy Scrantom on how lawyers must act as portfolio managers when acting under DBAs

Damages-based agreements – effectively US-style contingency fee engagements where the lawyers are paid only a percentage of the damages recovered in the case – are more than just a new fee-charging technique for lawyers; they will likely usher in an entirely new way to think about litigation risks and opportunities in the UK, at least in large commercial disputes. This new approach – litigation as a monetisation project that needs to be brought to conclusion as quickly, efficiently, and economically, as ethically possible – is sure to impact thinking about the commercial litigation industry generally. The sea change portends an entirely new role for lawyers: portfolio managers assessing the likely risk-adjusted return in a case, akin to venture capital investors' approach to an investment in, say, a development-stage dot-com.

In venture capital markets, an investor decides whether or not to invest in an enterprise with a very uncertain rate of return. The successful ones measure and gauge shifting risks over a wide open playing field. For lawyers operating under DBAs, such 'broken field running' must be accomplished while still maintaining professional responsibilities to the client and the court, and fiduciary attention to the client's cause. At first blush, this might seem like a fool's errand. But it is not.

There are lessons to learn from the American contingency fee system, but more instructive are the experience and track record of third-party litigation funding, and the experience of others who invest in sundry aspects of litigation risk, such as after-the-event insurers. These trailblazers suggest an entirely new way to evaluate, value and mitigate litigation risk, and a new paradigm for litigation reward; one that is geared to financial concepts like cost of capital and risk-adjusted return. They also propose a different perspective on the evaluation and valuation of cases, and a new analytical approach to the economic viability of a case investment, using a new and different set of goals and objectives, strategy and tactics. Under a DBA, the goal – put simply – is to minimise investment relative to return, while maximising the return itself. Such concepts are not readily familiar to most litigation lawyers, but learning the basics is not as foreign as one might think.

LAWYER AS VENTURE CAPITALIST

Contingent fees have been permitted in the US for more than 150 years. Their precise origins are lost in the mist of time, but one thing is clear: there was no single regulatory event that led to their use or acceptance. No big bang. They evolved quietly, by accretion and without much fanfare. There were no academic soothsayers suggesting they take lessons from other investment disciplines. The most apposite comparable disciplines, like high-risk venture capital, did not exist for another 100 years. It could even be said that contingent fee lawyers were the earliest venture capital investors. Because this phenomenon evolved under the radar, so to speak, not much was ever been written about the techniques such lawyers use to evaluate and formulate a case for contingent-fee prosecution. It remains something of a trade secret of a cottage industry. Some might say a black art.

Third-party funding did not borrow contingent fee investment techniques and objectives. Instead, it has developed and defined and articulated them. It began to transform a process that was once exclusively based on professional judgement and gut instinct, into one that was empirical and formulaic. In all likelihood, over time the contingent fee system in the US and the DBA system in the UK will develop more rational and systematic methods from the influences of third-party capital entering the dispute resolution system, whether through direct investment or insurance products. The essential point is this: the lawyer should approach each case as an investor and his overall portfolio of investments as an investment manager. From this perspective will flow the ability to actually get better at picking good cases based on empirical data and experience rather than just touch and feel. This article will not address *how* to do this, but generally *what* to do and how to approach the problem.

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RISK

Prosecuting a case on a DBA basis is all about risk – how it is identified, and its impact (or value) measured from time to time on the dynamic playing field of a disputed claim. Identifying and quantifying risk, and its offspring, opportunity, are the beginning and end of the process. Identifying and capturing alpha (as the fund managers call it) is the name of the game. Cost risk (how much will actually be invested in the project), quantum risk (how much will be recovered), and recovery risk (will the project result in an award that is actually recoverable in full) are key elements. Timing risk is the most underestimated and underappreciated variable in the litigation investment process. Counterparty (client) risk, is the risk most often overlooked.

Counterparty risk is one of the most measurable factors in pre-investment due diligence, yet it is more often than not the risk factor that skews the expected recovery. Claimholders may falsify documents, testimony, or other material evidence in the case; their character may be called into question by the tribunal; sometimes they cannot be relied on to honour their investment contract (here, the DBA); sometimes the risk is seemingly benign, like accepting too low (or refusing) a reasonable settlement offer. Outlier risks, like compliance risk (risk of skirmishes over abuse of process or champerty) cannot be ignored, particularly where they can be raised by the client or the adverse party in the case.

But analysing risk does not tell the whole story. The client's business prerogatives, and the potential for alternative (non-monetary) resolutions, must be a part of every investment assessment process. Some risks can be mitigated or eliminated by good due diligence or other techniques, like insurance or the structure of the investment agreement.

Others can only be identified and measured, watched and re-assessed from time to time. By aligning interests of all stakeholders in the outcome, many risks can be mitigated.

THE INVESTMENT PROCESS

The core concepts in claim investing may be conveniently grouped into psychology, methodology and empiricism. Among the most difficult is the psychological: lawyers like cases for different reasons and, no matter what the popular pejoratives, they often are very passionate about their client's cause. Choosing the right case to joint venture with the client requires the lawyer to be sceptical. Constantly ask 'what is wrong with this case' rather than 'what am I going to do to get round the problem'.If he is not sceptical, the lawyer can outsmart himself before even drafting the DBA, let alone the pleadings. How does the clever lawyer avoid his own worst enemy? By becoming an implacable adherent to process that does not permit too much affection for the case or the client before the investment commitment is made. Develop an efficient and economical order in which to conduct due diligence of the case, one that looks to reject an unprofitable case as soon as possible in the process. The sooner, the better. As with any investment project, the later in the process the show-stopper is discovered, the more difficult it is to face the cost and disappointment of 'broken-deal expenses' and broken hearts, believing the case was a sure winner. Scepticism in screening can be surprisingly value-additive: as one goes through the process of trouble-shooting the case, unique strategies for presentation and even resolution often emerge; in other words, the forensic examination of a case as an investment can intrinsically make it better and more valuable. These are among lessons learned from 'early case assessment' techniques that are now *de rigueur* for many large businesses.

Develop a methodology that works for your particular firm and apply it consistently across all cases being screened. Beware the case that is so alluring that one wants to exempt it from the normal due diligence processes, or put through the process in only a perfunctory way. Be logical in the methodology. For example, look at collectability of the award first, not last. And be consistent in the method. Simple consistency can permit comparisons among cases to select the best investment candidates across a field, and good and bad investments over time. Consistency permits comparison, and comparison permits relative scoring and ranking. Consider a scoring system for case intake 'triage' and to compare investment opportunities against each other; even a simple ranking system can permit useful comparison and foster constructive debate about the opportunity relative to another.

As elementary as it may sound, consider using checklists to cover basic items of investigation. Checklist processes also allow efficient delegation of underwriting processes to more junior staff or outsources, and yield a verifiable record of diligence that, in turn, can be cross-checked by others. Consistent methodology permits group decisions (for example, by a DBA committee) around a common understanding of findings (a case precis). Using precise underwriting stages, where benchmarks must be met before proceeding from one state to the next, engenders discipline, responsibility and accountability in the process. A set of consistently applied methodologies will allow the firm to build a

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DBA portfolio from the outset, rather than through hindsight.

The process should be rigorous and economic. The goal is to evaluate, and eventually to value, the case investment. This may require rethinking old beliefs, like 'the bigger the case budget, the more we will make' and 'the longer the case goes, the longer we can keep our team deployed'. Identifying, understanding, evaluating and weighing case risks is only the intermediate goal. The goal is to understand overall likely time-to-return on invested capital – the case's comparative value to the firm. Put simply, if the case budget (with fees valued somewhere between cost and market) can yield a risk-adjusted return of one-times invested capital per year, the project has the markings of a good investment.

Each firm will have their own preferred underwriting processes, defined by opportunities, experiences, resources, personnel, and even personalities of the project managers/case originators involved. The following will suggest some ideas for setting up a conveyer belt for evaluating contingent litigation risk and investment, and a sieve for sorting through risk factors and sorting out show stoppers. The goal, as banal as it might sound, is to determine if the case is 'bankable'.

It is difficult for most lawyers to imagine a rainmaking 'method', much less one that is directed at opportunities to take cases under a DBA. But consider this: most large business clients have claims they are not prosecuting because they have made a decision that 'it's not in the budget this year,' or 'we thought that case would be over by now,' or 'we're overrun with cases we are defending, leaving no time to think about claims we might prosecute'. DBAs present opportunities to generate new work from existing clients and new clients. Identifying what would seem to be 'quality claims' from 'quality clients' takes one a long way down the path to underwriting quality investments. Familiarity with the client and the reliability of its executives is obviously a major step in testing the evidence, and ultimately determining the terminal value of the claim under consideration. Dreaded counterparty risk dissipates.

INITIAL SCREENING

Conducting diligence on a case costs money. Developing a budget for initial case screening is always a good place to start. Damages, collection risk, external risks (market changes, defendant financial stature, potential for regulatory change) and cost/budget information will need to be harvested from a variety of sources, including independent research into the background facts and circumstances of the industry and the parties. This process has its own cost. One should focus on key variables that will affect the analysis. These will emerge (one would hope sooner rather than later) as the pivotal risk factors that will inform time-to-return, likely outcome, and expected value, whether by trial or through settlement. By identifying these key issues and systematically re-evaluating them through the underwriting process, one avoids things slipping between the cracks. It is useful to think of this process as one of expanding and refining the areas of examination rather than a series of rote steps. Just as a recipe in a cookbook for, say, pizza, requires the dough to be leavened ahead of time, one needs to begin developing the prosecution budget early in the underwriting process – while the sauce of case merits is simmering. Finding an optimal timing and order for diligence can become three-dimensional if third-party funding and or insurance appear to be a fundamental need in the case project. They will want to conduct their own due diligence. It helps if your process resembles theirs.

UNDERWRITING AND DUE DILIGENCE

The underwriting process, which begins in earnest once an initial screening of the case suggests it is potentially a good investment and there are no obvious show-stoppers, is a blend of art and science, instinct matched with good old fashioned sleuth work. Process and methodology, and a logical series of steps that can engender discipline and permit cross-checking of conclusions, are not a substitute for instinct, but do allow instinct to be rationally applied. It may be necessary to obtain counsel's opinion about a key point of a law, and/or a primary or second opinion about the expected measure of damages, the market and financial conditions of the defendant (or claimant), or trends in the law or marketplace that could influence recovery, settlement or the level of award. To get an opinion that makes sense and is useful, there is no substitute for clear and focused instructions that everyone involved in the process agree. There is also no substitute for cross-checks at key stages by others in the firm, letting someone else put a set of eyes on the proposed investment, whether inside the firm or outside.

DETERMINING CAPITAL REQUIREMENTS

The overall budget for the case is the investment to be made. If it is high or low, the expected rate of return will be off, and a realistic investment decision cannot be made. The importance of disciplined, realistic budgeting should be underscored. The budget can also serve as a benchmark in the DBA itself for changes in the percentage of fees to be paid to the lawyers. For example, if unforeseen circumstances arise in the course of the engagement that were not contemplated by the budget, the lawyers might receive some incremental uplift in their percentage interest in the case.

VALUATION

Before the financial features of the DBA can be structured, expected returns need to be modelled against the capital to be invested – as determined by the budget. A rule of thumb in the US is three or four times invested capital over an average case life of three years, or about a 100% uplift on investment per year, viewed on a compounding basis. This must be adjusted where case elements or market forces suggest an early settlement; where the legal theory promises a likely guaranteed return (as with a shareholders' derivative suit); or where damages are somehow liquidated or subject to an identifiable floor. In other words, the expected return should be risk-adjusted to be fair – and competitive.

There are various methods and tools available to help model and estimate expected return. These range from the simple, like a detailed 'case map' showing how and where key developments and information exchanges take place in the case, to the more complex, like decisional and probability analysis (through use of tools like decision trees), or software modelling through Monte Carlo simulations and game theory analysis. Many of these basic tools are available online, and there are vendors who develop bespoke modelling software for lawyers and claim managers. It is useful to remember that no software model or predictive system will ever be able to peg the true value of the case, but they can be invaluable in bringing intellectual discipline and honesty to the valuation process, providing a framework for thinking about value, communication with others inside and outside the firm about expected values, and articulating risk factors that can be modulated. Decision analysis is a technique to manage the complexity and uncertainty inherent in decision-making. By estimating a probability that each key event will occur or not (with a monetary amount representing each potential outcome), decision analysis permits one to compute the 'expected value' of a case. That value is a probability weighted average of all possible outcomes.

This is rarely a wasted effort: the information and models can be used on an ongoing basis through the claim prosecution, such as to examine and evaluate settlement options. Think of these processes and tools as decisional paradigms that can assist in identifying and highlighting risks and when they are likely to materialise; diagnose problems and design solutions to them; assess evidence and witnesses; and generally inform and focus the overall trial strategy to be employed. Using them can provide a powerful learning experience at least.

Obviously, valuing a case is a multi-dimensional and multi-disciplinary exercise. Decision analysis can help define the expected outcome at trial. Use of game-theory modelling techniques examine party behaviour in the settlement process over the life of the case, where information is constantly increasing for the parties and their advisers. The use of both techniques – trial outcome analysis and party settlement analysis – is often the best way to measure the range of value in a case. After all, the vast majority of cases settle.

PRICING AND STRUCTURING

After a claim has been valued in some fashion, the pricing structure for the DBA can be established. The proposal will always be made in a unique environment – one where the client has superior information about the facts, but the lawyers have superior information about the law and legal process. A host of factors must be folded into this process: ethics obligations (potential for conflicts of interest; rights to resignation from the representation; duties to prosecute appeals; representation in parallel or subsidiary proceedings); and venture capital principles (the right to protect the investment; lien rights; devices to protect against abandonment of the claim; interests in collateral; protections against non-monetary settlements). Eventually, a percentage or series of percentages, a minimum return with multiplier, a cost-reimbursement component, or some combination of these can be proposed to the client. Although, under the current regulations, it remains unclear whether a 'partial DBA' can be agreed with the client, there will be instances where risks in the case suggest seeking a blend of third-party capital to meet or backstop the budget, even if it is only for out-of-pocket costs.

CONCLUSION

The great American jurist Oliver Wendell Holmes, in *The Path of the Law* (1897), wrote: 'For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and master of economics.'

These words weren't necessarily heeded by his brethren lawyers in America as they began the world of contingent fees. But they can inform how British lawyers go about creating the new world of damages-based investments in cases in the UK.

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