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Investors courting litigation finance for profit potential

Advocates like fact that strategy isn't correlated to other markets

By Rick Baert

The verdict is in from a few endowments and pension funds: Take a chance on corporate litigation finance investments. But for other asset owners, the jury is still out.

Litigation finance investments target corporation-vs.-corporation lawsuits, providing money to plaintiffs for legal costs in lawsuits in exchange for a portion of any finalized settlement, shared between the money manager and the law firm providing legal representation. The investment managers vet requests from corporate plaintiffs for funding and reap sometimes double-digit returns by selecting cases in which their portion of the expected settlement will be larger than the financing they provide.

Managers — and some asset owner executives who've signed on with them — say the strategy provides uncorrelated returns regardless of market volatility or economic conditions.

"It's uncorrelated to economic activity," said David Holmgren, chief investment officer at Hartford HealthCare, Hartford, Conn. "So in a sense, it's like the traditional inflation-protection investment. This fits in with that diversification bucket, but we also do want income-producing and asset-backed assets in this allocation."

Hartford HealthCare on March 31 committed $20 million to a litigation finance strategy managed by Halcyon Capital Management LLC, New York. It was Hartford HealthCare's first commitment to the strategy. Hartford HealthCare has $3 billion in pension, endowment and other assets.

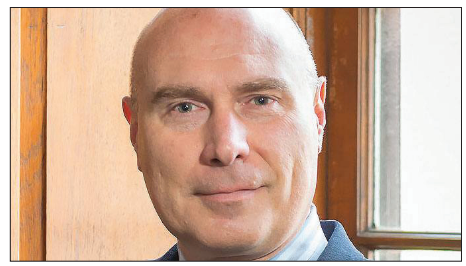
Also, the University of Michigan, Ann Arbor, in February committed $50 million to Lake Whillans Fund I, managed by litigation fund specialist Lake Whillans Capital Partners, a new manager for the $10.5 billion long-term portfolio of UM's endowment. In a report to university regents, Kevin P. Hegarty, executive vice president and chief financial officer, said Lake Whillans provides "funding for commercial litigation involving breach of contract or trade-secret misappropriation." Officials at the university could not be reached for further details.

Public pension funds also are taking notice. The $460 million Aurora (Colo.) General Employees Retirement Plan, which is conducting an asset/liability review expected to be completed by the end of the year, is considering an allocation of at least 5% of assets in corporate litigation finance, said David McConico, chairman of the pension fund's board of trustees.

Growing interest

Managers of litigation finance strategies have seen growing interest, although pension funds are just starting to explore the asset class, said John Greene, New York-based managing principal and portfolio manager at Halcyon Capital Management, which managed $250 million in the strategy as of Aug. 28.

Mr. Greene said that litigation finance investments are more liquid than other alternative asset classes, with an average of 2.9 years for litigation finance vs. the typical five-year lockup of private equity.



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David Holmgren expects his investment to eventually earn returns in the low double digits.

"We've seen more interest out of the endowment world, but pension funds are starting to take a look now, too," Mr. Greene said. He would not identify the other pension funds that have expressed interest.

Added William H. Strong, Chicago-based chairman, partner and managing director at another litigation finance manager, Longford Capital Management LP: "We view this as an asset class driven by corporate plaintiffs, but it's also intriguing to investors because it's uncorrelated to anything on the market."

Mr. Strong said that, along with endowments, investors in Longford's litigation strategy funds include state and municipal pension plans and European funds of funds, although "a significant portion" of investors are high-net-worth and family office investors.

Mr. Strong would not identify investors.

Longford has invested in 100 cases through its two investment funds. The first fund, with $57 million in assets under management, had its last closing in 2013, Mr. Strong said. Its second fund had a final closing at $500 million announced Sept. 18.

"We sort through the cases we're offered, do the due diligence, then sign an agreement with the corporate plaintiff," Mr. Strong said. "We then put up the money for ... the life of the case, no matter its length. We diversify our investments based on the type of case, location, any detail we can control."

Every case in which Longford has invested to date has won, Mr. Strong said.

Stand-alone strategy

Mr. Greene at Halcyon said its litigation finance business grew from a sleeve in its multistrategy portfolios to a stand-alone strategy."We've always found lots of litigation-focused opportunities over the past decades in our multistrategy portfolios," Mr. Greene said. "There's been a desire over time to go into more bespoke investments, a collaboration process both internally and with our limited partners. It's uncorrelated; we like that opportunity set. We melded all that together ... with differentiated risk and exposure. A lot of people do want uncorrelated risk."

Halcyon manages a total of $9 billion in assets.

Neither Longford nor Halcyon would release performance figures, again citing client confidentiality. However, Mr. Holmgren of Hartford HealthCare said that while it's too soon to get returns on his fund's investment with Halcyon, "we modeled this at making the low double digits, and there's been no reason so far to think that we don't hit our goals."

The Halcyon investment is part of Hartford HealthCare's 13% economic hedge target allocation, which returned 11.5% vs. the custom benchmark's -0.6% return for the 12 months ended June 30, Mr. Holmgren said.

Mr. Strong said Longford's investors usually place their litigation finance investment in a private equity, absolute-return or "other bucket."

Although the attraction to such an uncorrelated investment has been compelling, sources said there have been headwinds over what's perceived by many as the strategy's headline or reputational risk.

At Aurora General Employees, Mr. McConico said the system's other trustees were concerned about how it would look for the system to invest in lawsuits.

"Their main reaction was concern about political risk," Mr. McConico said. "Our plan is a well-performing plan. We look at timber and other unusual strategies for a pension fund our size. We're used to looking outside the box. But with this asset class, there's still some headline concern." Aurora returned a net 11.38% for 12 months and an annualized 7.32% for 20 years, both as of July 31.

Mr. Holmgren said Hartford HealthCare officials "totally researched" the cases in which Halcyon invests "and are sensitive to any headline risk exposure. When considering this asset strategy, we will not consider any fund or strategy that's involved in patient or health-related lawsuits. "That potential conflict is why we won't look at certain strategies like life settlements (as an investment)," he said. "

The Halcyon strategy is really based around small niche plays like software patents. It's a David-vs.-Goliath type of story. It nicely aligns with our view of helping the little guy to fight the big software providers. It's culturally compatible with our mission … The first strategy we picked is really centered around small mom-and-pop firms being taken over by a giant, that don't have capital as they seek justice, or it's something small like trade-patent claims. (Halcyon) has zero in medical malpractice."

Three years ago, said Longford's Mr. Strong, "there was some of that (headline risk) concern. But not now. ... These are plain-vanilla corporate litigation cases."

Consultants divided

Investment consultants are divided on recommending investments in litigation finance, said Mr. Greene of Halcyon. "Some care, some aren't as focused on this," he said.

"Our experience is that some consultants have a focus on this and will put resources on it. Others aren't so focused. We've had some where it's been an investor decision to task the consultant to get their view on the asset class and managers. But of the large consultants, only a minority focus on this. A lot of our competitors are not institutional managers. They're mostly startups, not institutional grade. Consultants have their own clients, and they'll do what the clients want them to do."

Various consultants reached for this story would not comment.

The fact that many of these managers are not seen as institutional grade was an issue during board discussions at Aurora General Employees about the strategy.

"At our last meeting in September, in discussing sectors for consideration in the asset/liability study, I brought up commercial litigation financing," Mr. McConico said. "Our consultant (Callan Associates) has an opinion that the asset class is not institutionally ready; now the next step is to educate them. I said it was an emerging sector that we might want to have an investment in."

Mr. Greene said there's plenty of room for growth in corporate litigation finance, given that "the penetration right now of litigation finance is at or below 1% of cases. The vast majority of plaintiffs still use hourly billing invoices" to pay their legal counsel. "And that's a lot when you consider that $200 billion is spent in the U.S. on litigation annually."

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