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(From left) Michael A. Nicolas, managing director; William H. Strong, chairman; Timothy S. Farrell managing director and William P. Farrell, Jr. managing director of Longford Capital, litigation finance.
Photos by Michael R. Schmidt

Skin in the game

Longford Capital wants to pay you to litigate your client's best cases. All you need to do is convince your firm to take some of the risk.

By Roy Strom

Here's a business proposition for you, large-firm litigation partner: Leave your law firm today. Use your experience to judge the merits of multimillion-dollar corporate lawsuits. Then shop that skill to investors, asking for millions of dollars to do one thing: Invest in winning lawsuits.

Think you can crack it?

Bill Farrell Jr. and Mike Nicolas do.

They left the partnership at Neal Gerber & Eisenberg last year to form Longford Capital, a litigation funding firm that has so far bankrolled 10 corporate plaintiffs in exchange for a portion of their winnings and all the risk of losing.

Litigation funding may be a young and controversial practice, but the Longford founders see it as a can't-miss "asset class." Also known as third-party litigation financing, the founders believe their business will be one of the winners to emerge from the increased pressure on the traditional law firm model.

Here's why. Litigation finance could allow law firms to let out the heat built up by the friction of two competing interests: clients' increasing demands for alternatives to the billable hour and law firms' general inability or unwillingness to respond to those demands — largely due to a reluctance to take on the risk associated with alternative fees as well as internal conflicts with how they pay partners and an aversion to budgeting cases.

"We really present a neat opportunity for a law firm or a particular lawyer to bite off as much risk as they want," Farrell said.

Litigation funders allow corporate plaintiffs to file cases at essentially no cost — providing them the ultimate alternative fee and allowing them to use what they might pay for litigation on other aspects of their business. Funders like Longford only make a return on their investment if the case wins. If it's a loser, the funders cover all the costs.

For law firms, working with a litigation funder is not much different than having a forward-thinking general counsel as a client. The funders insist on paying firms some version of an alternative fee, and they pay more for better and faster results.

It's a young field yielding growing returns that attract investors.

Burford Capital, one of the largest publicly traded litigation finance companies, said in March it made a 52 percent return on the cases it had invested in that have seen a resolution since its 2009 inception. Bentham IMF, which says it invented litigation finance 13 years ago in Australia, has invested in 185 cases and won or settled 95 percent of them. Ralph Sutton, the company's U.S.-based chief investment officer, said the average return on a case is three times the amount of money it invests.

Longford had raised $56.5 million as of July. It is too early to report any results on its 10 cases, but the company was awaiting its first settlement in mid-July.

Early fat returns might do more than just lure investors: They could provide a model for law firms themselves to get into the business. By shouldering the risk and reaping the outsize rewards associated with contingency fees and other alternative forms of payment, litigation funders could be seen as eating conservative law firms' lunches.

The supposed promise of the litigation funding business model raises a question: Why don't law firms do this?

"In a fully efficient commercial litigation finance business, law firms would be a very significant competitor of ours," Nicolas said. "Particularly large law firms. They have the people. They have capital they're generating by way of collections. They could compete."

Farrell and Nicolas point this out because they're confident law firms won't take all the risk — at least not any time soon. That would require drastic changes to most large firm partnerships built upon the billable hour. Longford is more focused on convincing firms to put some skin in the game. After all, their business model depends on it: Longford will not pay lawyers using only the billable hour.

"Ultimately, I might be creating my own demise 10 years down the road," Farrell said. "Because I'm introducing these lawyers to the concept that you can take some risk and really benefit from it. Your clients will like it better, and you will make more money if you're successful."

Farrell and Nicolas are not the first lawyers to leave large firms for a litigation funding company, and they likely won't be the last. But an in-depth look at their business model offers insight into a growing field that's challenging the billable hour — yet comes with inherent risk for anyone looking to make a similar move.

Spotting an opportunity

Farrell and Nicolas first worked together at Gardner Carton & Douglas in 1998 before they moved to Neal Gerber & Eisenberg in 2006.

Mike Nicolas, managing director
Longford Capital

"In a fully efficient commercial litigation finance business, law firms would be a very significant competitor of ours."

Litigators their entire careers, the pair had an ongoing case in 2009 that was becoming difficult for their client, a public company pursuing a trade-regulation case against a foreign competitor, to continue funding. Taking the case on a contingency fee was out of the question.

Farrell had heard about litigation finance in London and spoke with his younger brother, Tim, who is CEO of the American Hardware Manufacturers Association in Chicago, about how he might incorporate it into his practice.

Farrell saw it as a great way to win business by satisfying client demands for more aggressive alternatives to the billable hour. His brother saw it as something else.

"He said, 'What about instead of just using it for your practice and maybe your firm's practice, what about running a company like that? There's not enough current supply of capital dedicated toward this sort of financing,'" Farrell said.

"To some degree and, perhaps to a large degree, litigation is a sideshow," his brother said. "It's a distraction. It's a diversion of resources. … The option of transferring most if not all of the financial risk to a funder like Longford makes an awful lot of sense to an awful lot of people. In my mind and in the mind of a lot of others, it comes down to being a better business decision."

The trio first thought to open Longford in 2010.

Like good lawyers, it took them three years to do their due diligence on the businesses involved in the concept and to lay a strong foundation for their company, which they said is reflected by the advisers they employ: Schulte Roth & Zabel as legal counsel, PricewaterhouseCoopers as auditor and Northern Trust as financial administrator.

What convinced them more than anything to launch Longford was their belief that the demand for litigation funding in the United States far exceeded the supply of capital. As a result, they believe their investments will reap great returns.

The financial performance of companies like Bentham and Burford may be evidence of that. So, too, might the ability of Gerchen Keller Capital, the largest litigation funding shop in Chicago, to raise $250 million for its second fund, announced in January.

The Longford group relied on its own statistical analysis to determine how large the market might be.

They looked at the aggregate amount of the three broad types of litigation that Farrell and Nicolas had handled in their careers, and which Longford invests in: commercial disputes, antitrust and intellectual property.

From 2000 to 2010, they found that 98 percent of cases in federal court either settled or were resolved before the first day of trial — good odds for getting some kind of return on a lawsuit without the dice roll of a jury trial.

They found roughly 150,000 of those cases were going on at any given time in the federal court system and another 150,000 in the 50 state courts. The Federal cases last 2.9 years on average.

Even if 10 percent of those cases would be candidates for funding, that's 30,000 cases. At 1 percent, there would be 3,000 viable cases.

Farrell estimated that only 200 cases are being funded on an annual basis by the dozen or so financing companies in the field.

"That's how small it is," Farrell said. "So we saw incredible opportunity in terms of scalability and size."

The asset class is so new that at least one competitor welcomes Longford to the market. Bentham IMF's Sutton said Longford will help educate the bench and bar about the proper role of third-party litigation funding.

"Would I like to have the whole field to myself? Sure," Sutton said. "But if I'm not going to have the whole field to myself, they're exactly the kind of people I would welcome to the business."

Bill Strong, the co-CEO of Morgan Stanley's Asia Pacific business from 2011 until early this year, also saw a significant opportunity. After performing his own market research, the only question for Strong became whether or not Longford can pick the "cases that are most meritorious that can best utilize our capital." He's confident Farrell and Nicolas can do that. Strong was an early investor in Longford and joined as chairman in May.

Bill Farrell Jr., managing director
Longford Capital

"I'm introducing these lawyers to the concept that you can take some risk and really benefit from it. Your clients will like it better and you will make more money if you're successful."

Farrell "must have — maybe like I do — kind of an entrepreneurial streak in there somewhere, and he was willing to take the leap of faith," Strong said.

"Another thing that was very important to me as an investor (was) the fact that Bill and Michael and Tim and Jason (Searfoss, chief financial officer) are effectively betting their careers on the success of Longford. They didn't have to do this."

Strong's decision to join Longford was viewed as another shot in the arm for litigation funding. News of his hire was covered by the New York Times, the Wall Street Journal, Chicago Tribune, Bloomberg Businessweek and other media outlets.

Taking the risk

The Longford group is confident today, but that doesn't mean there was no risk involved in their decisions.

Both Farrells and Nicolas had children under the age of 5 when they decided to launch Longford. There were nerves, especially for people whom Tim Farrell described as "very conservative."

"We are not outsized risk-takers at all," Tim Farrell said.

Before he told Marshall E. Eisenberg of his plans in March 2012, Bill Farrell warned his wife that he might be working from the kitchen table the next morning (Eisenberg was fully supportive of the plan, said Farrell, who was allowed to remain a partner until he left about a year later. He remains of counsel at the firm). Nicolas had similar conversations with his wife, who assured him, saying he should never pass up an opportunity he'd later regret.

"We'll be fine no matter what," his wife told him. "Let's take a shot."

All third-party litigation funders work a bit differently — either by what types of claims they invest in, how they select cases or how much participation they have in the case.

For Longford, a law firm brings a case that has at least $25 million in documentable damages. Farrell and Nicolas review all the documents and put it through a 50-point test on a 1 through 10 grading scale. The intent of what they call the "underwriting process" is to ensure they are investing in the most likely winners — only the most meritorious cases.

If the case scores a 5 or lower on any of those 50 criteria — which include factors such as grading the law firm that will handle the case, the defendant they are up against, jurisdiction, the case's merits, the defendant's ability to pay and even the client's rationale for seeking funding — they pass on the case.

As of mid-July, Longford had reviewed about 120 cases — most referred to them by law firms, where they often give presentations to introduce their business. At least 95 cases were rejected after scoring a 5 or lower on any one or more of the 50 criteria.

"When we find a case we like, we spend days and days on it," Farrell said. "So we have to be able to decline cases quickly."

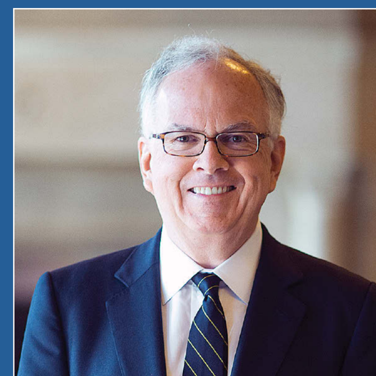
If a case passes Longford's internal review, it hires a law firm to conduct a second, independent review with the imperative to find a reason not to invest in the case.

"You're not going to hurt our feelings if you say it's a bad case," Farrell said. "That's what you're hired to do."

This rigorous review of cases is Longford's first defense to the charge that has been lobbed at litigation funders by detractors, including the U.S. Chamber of Commerce: Funneling more money to help litigants file cases will spur frivolous lawsuits.

Longford stresses it is interested only in the most meritorious cases. Picking losers is the fastest way to drain its capital, they said.

Frivolous may be the wrong word, but it may be true that litigation funding will result in cases being filed that otherwise may not have been and that also will lose. If one winning lawsuit can result in a large payday, can't Longford and others take a shot on a bunch of cases and plan that only a few will pan out?



Bill Strong, chairman
Longford Capital

"Bill and Michael and Tim and Jason (Searfoss, chief financial officer) are effectively betting their careers on the success of Longford. They didn't have to do this."

Bill Farrell said Longford does expect to lose some cases, but it would not be a sustainable business to swing only for home runs — what he called the "venture capital" approach.

"Ours is anything but that. It would be impossible for Longford Capital or any of the existing funds to do it that way," Farrell said.

"Our models are based upon intensive due diligence. Part of it is supply of capital. The other part is the underwriting time. We take 30 to 45 days before we make an investment. You just can't get that many out."

IMF Bentham's Sutton also rejected the notion that litigation funders could gamble on risky cases with the hope that one big return will make up for a host of losers. He said the risk involved in betting on lawsuits is largely quantifiable for litigators who have been in the courtroom for decades.

"When I gamble, it's on cards," Sutton said. "Gambling is taking risk without being able to truly control for most of the risk. This is trying to control for the risk (of litigation) with expertise, understanding and insight about the particular cases."

Once Longford decides to invest in a case, it will get to work writing a contract with the client and law firm to fund the case.

That process requires the law firm that will handle the case to draft a detailed budget.

"This is a challenge for a firm," Nicolas said of the budgeting process. "It's not billable work. You have to do it in order to work with us. But we do think it is the best practice for law firms and sometimes we find ourselves bringing firms into best practices."

Longford's contract with law firms and clients is based both on the budget and on a negotiation with the firm over how much risk it is willing to accept — in other words, how far it will stray from the billable hour.

Longford will invest between $1 million and $10 million on a case. It will work with law firms under a variety of payment options, ranging from a full contingency fee to a slight discount on rates, which is offset by the law firm earning a slight reward based on a positive outcome. The larger the discount the law firm accepts, the larger the potential bonus.

"The only arrangement we're not comfortable with is a full 100 percent hourly fee," Farrell said.

For example, if a law firm tells Longford a case will cost $4 million, Farrell might agree to pay the firm $3 million upfront. He will ask the firm to forego collecting the final $1 million in exchange for a $3 million bonus if the case is successful. In that scenario, the law firm is risking $1 million with the potential to triple it. All the lawyers have to do is what they are telling Longford they are confident they can do — win the case.

"Why don't firms more often think creatively on their own? I think that's something that we'll see happening more and more," Farrell said. "But it won't change things. It will be good for law firms. It will be good for Longford. And it will be good for clients."

Aligning interests

The group at Longford talks often about "aligning interests."

Whereas the billable hour puts a law firm's interests at odds with its client (at least theoretically), a contingency fee or some other success-based billing model makes law firms and clients root for the same outcome: A positive resolution reached as fast as possible.

General counsels have been clamoring for alternatives to the billable hour for years — and especially so following the 2008 financial crisis. But they do not appear hopeful that large law firms will fulfill that need.

Tim Farrell, managing director
Longford Capital

"We are not outsized risk-takers at all."

In a survey conducted by legal consultants Altman Weil last year, general counsels were asked to rate how serious they believed law firms were at changing their business model to be more receptive to things such as alternative fees. With a 1 meaning "not at all serious" and 10, "doing everything the law firms can," the general counsels answered with an average rating of 3.

What's standing in the way?

Nicolas sees law firm compensation — often tied to billable hours — and a profession generally uncomfortable with risk as being the two biggest reasons why law firms have struggled to meet their clients' demands.

And there is the constant pressure large firms face to increase profits per partner — which creates stress to collect fees continuously rather than wait for payoffs years down the road when a piece of litigation concludes.

"There is certainly a resistance or a reluctance in firms to change fundamentally the way they think about billing and the way they think about risk," Nicolas said.

"We bill our time. We collect our fees. That's the way it works. And post-crash in 2008, the whole world changed. But we still, as a community, had a hard time with the acceptance of the risk associated with contingency fee relationships."

One large firm that bucks the mold and hails itself as a leader in alternative-fee litigation is Chicago's largest and arguably most profitable firm — Kirkland & Ellis.

While the vast majority of the work it does continues to be based on hourly billing, Reed Oslan, a litigation partner, said Kirkland works often with litigation funding shops like Gerchen Keller Capital. It has not handled any cases for Longford.

"It is a real and growing space, for sure," Oslan said.

More broadly, Oslan said the alternative-fee program at Kirkland has been a success for the firm and its clients.

The firm began handling a few contingent fee matters roughly 20 years ago. When those were successful, Oslan said, "That made it somewhat easier for us to sell the notion of contingent fees and risk-sharing to our partners."

"We are, generally speaking, a risk-tolerant group," he said. "We do a lot of private equity work. We do a lot of restructuring work. We understand risk. And our culture of our firm is probably more accepting of risk than a traditional law firm."

Farrell said litigation funding is moving more firms toward that stance. So, too, are the continued demands for change from clients.

Longford, for instance, has agreed to an alternative billing model with two of the country's largest 50 firms that had previously never deviated from the billable hour. They declined to name those firms.

That's welcome news to Farrell and other litigation funders. Farrell is less concerned that large law firms will grow such an appetite for risk that they someday render his business redundant.

He just wants more law firms comfortable with the idea that, by putting some money on the line, litigation funding can garner big returns.

"It wouldn't surprise me if one day the partner's capital accounts are used more aggressively to offer contingent fees," Farrell said. "That would be a good use of that money. But I don't see it happening in the near future."

What's the near future? Ten years, he said.

That might even be enough time for more litigators to make the jump. ■

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