Legal and Strategic Implications of Litigation Funding in IP Litigation

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Introduction

Demand for legal finance is growing—and that's particularly true in the intellectual property space, where patent owners face uniquely high cost and risk. Understanding the benefits of legal finance and how to obtain it can provide can be the key to unlocking the value of intellectual property, whether it is through achieving success in a licensing or patent enforcement campaign, accelerating a royalty stream, or acquiring or divesting patent assets to serve the corporate strategy.

Patent litigation is, as they say, high risk but high reward. A patent owner relies on costly experts and attorneys, and confronts the possibility that the entire case could be dismissed at any point during an inevitably lengthy litigation process (likely against a well-heeled, seasoned opponent). The patent legal landscape has continued to become more challenging, with patent owners now virtually guaranteed to be required to dual-track PTAB proceedings alongside litigation.

In the past, patent owners could share those costs and risks with any number of law firms that would take IP cases on full contingency. But in today's challenging legal environment, even the most successful of those firms are re-thinking their willingness to absorb pure contingency risk in patent matters. As patent holders seek new risk partners, that has driven an increase in demand for legal finance, which effectively offers the same ability to warehouse the cost and risk of litigation as a contingent fee arrangement.

In many ways, the patent space was the precursor to litigation finance: owners that otherwise would have been unable to afford the cost of litigation to protect their intellectual property rights could work with firms willing to take their cases on partial or full contingency. As IP firms become increasingly reluctant to share risk, it's natural that there is greater demand for outside capital in the space. Still, securing IP financing can be challenging for those unfamiliar with the process. Patent owners and their counsel can benefit from partnering with professional investors that understand the complexity of patent matters and have the longevity to support the long and costly IP litigation process.

Against this backdrop, it's more important than ever for patent owners to understand their financing options so they can secure the optimal solution. In that spirit, we offer an overview of what patent owners and their counsel need to know about securing financing for IP matters.

Recourse or Non-Recourse Financing?

The first question a patent owner should consider is whether to seek recourse or non-recourse financing. As its name suggests, recourse financing is secured by collateral with value that the financier deems sufficient to secure the loan, and could include some or all of the patent portfolio and/or other company or personal assets. The recipient of recourse financing puts such collateral at risk, as it may need to be surrendered in order to repay the financing partner.

Non-recourse financing, on the other hand, is akin to a law firm's contingency arrangement with a client, in that the financier recovers its invested capital and the related return only upon a successful resolution of the underlying legal claim. Thus, none of the recipient's other assets are affected if the relevant legal claim is unsuccessful. Another prime benefit is the recipient's ability to achieve more favorable accounting treatment of legal expenses, as will be discussed in more detail below.

While either type of financing might be a fit depending on the specific matter, this paper will focus on non-recourse financing. Most litigation finance providers fund commercial litigation and arbitration on a non-recourse basis.

Investment Criteria

As a precursor to seeking financing, claimants and their counsel should thoroughly develop the litigation strategy. Given the technical and jurisdictional complexities associated with IP litigation, developing such a strategy will take work, but it's an important prerequisite to obtaining funding. Most financiers conduct extensive due diligence before financing an IP matter, and that thorough review is not possible without a fully developed plan for monetization. An ancillary benefit to this approach is that the underwriting phase of the financing process then serves as a second, objective review of the monetization strategy—a valuable set of "fresh eyes" before the client, law firm and funder take on what can be considerable litigation risk.

The best candidates for IP finance meet the following criteria:

Choice of counsel. The patent holder has retained litigation counsel with patent trial experience, ideally in the same field as the patented technology. It shouldn't matter whether litigation counsel is from a large firm or boutique, as long as they have the expertise and capacity to handle the contemplated campaign. Financing providers often prefer that counsel be at least partially contingent, so as to align interests with the client and the funder. A commonly used "hybrid" contingency is where the law firm significantly discounts its usual hourly rates, and also receives a percentage of the proceeds from a successful resolution. A benefit of legal finance is that many, if not most, firms are open to such a hybrid contingent arrangement, thereby expanding the client's range of options beyond the dwindling number of firms willing to take patent cases on a full contingency.

Case Analysis. Counsel has conducted a thorough case analysis sufficient to satisfy its ethical obligations, and has obtained any contingency fee committee approvals its firm may require. This analysis will typically include a review of the patent prosecution history, preparation of patent claim charts for the products at issue, and analysis of potential prior art. For patents which have been previously transferred, licensed or litigated, counsel will also review the related files to assess any impact to the contemplated litigation. Counsel and the client will also have determined where the litigation is to be filed, a decision which may be more complicated in view of the Supreme Court's 2017 decision in *TC Heartland LLC v. Kraft Foods Group Brands LLC*.

Capital requirement. The matter under consideration requires at least $1 million in financing. Some funders may be willing to finance lesser amounts (for example, just the litigation costs) but the extent of due diligence required for patent financing usually necessitates a threshold in this range. Many financiers (and law firm contingency fee committees) will also seek an estimated litigation budget through trial, broken down by fees and costs. The budget allows the funder to reserve capital for the full extent of the litigation, as well as to identify and plan for any complexity anticipated in the case. The budgeting process can also facilitate realistic discussions with the client, particularly when they have not previously (or recently) been involved in patent litigation. See mid-tier patent monetization financing section below for smaller cases.

Potential damages. Litigation counsel has an initial damages theory that supports at least $20 million in damages at trial. This is not to say that smaller cases aren't meritorious but rather that with a median cost of $3-5 million through trial, the economics of financing may not make sense for either the client or the funder in smaller cases. Further, damages is one of many areas of the patent law which has become more challenging in recent years, and thus it is important that litigation counsel provide this analysis, although the client can often provide valuable input and industry insight. For this reason, damages experts should often be engaged early in the decision-making process. These experts can help both the client and the funder develop damages theories and model a range of potential damages so both sides can make better decisions and outline productive strategies for maximizing returns.

Invention. The invention is in a field with high, established royalty rates, or where the value of the patented technology is easily quantifiable. This criterion is particularly relevant to university-generated IP, where the innovation may be so cutting edge that the related field has yet to be commercialized. This criterion also implicates patents which relate to computer-implemented technology, in light of the Supreme Court's 2014 decision in *Alice Corp. v. CLS Bank International.* Cases involving such patents are more difficult to finance, although a patent owner and their counsel might improve the odds by preparing a thorough analysis of why the relevant claims would survive an *Alice*/Section 101 challenge.

Once the above criteria are met, the matter should be well-positioned for a funder's consideration. Conversely, the inability to satisfy these criteria may mean the matter is not well suited for litigation finance or just needs further development.

Diligence process

Since non-recourse financing is entirely dependent on the successful resolution of the case, every matter typically undergoes a rigorous diligence process to determine the strength of the merits and damages claims and whether the economics of an investment are viable. Some financing firms conduct this underwriting analysis internally, which has the benefit of immersing them in the details of the case and thus facilitates knowledgeable feedback as the case proceeds. The underwriting of IP cases typically includes a thorough analysis of the infringement, validity and damages aspects of the case. To be efficient—important both to the funder and the patent owner—the process can be prioritized so as to address the issues in the order which the funder sees as most challenging for the particular case. The patent owner and litigation counsel should expect to be involved throughout the process, given their collective knowledge about the history and detail of the patents to be asserted.

Funders will often engage outside experts to conduct prior art searches, reverse engineering and financial analysis. Also, in light of recent developments in the U.S. patent law, many patent owners are increasing their patent filing and enforcement activity outside the U.S. For financing which will involve multi-jurisdictional proceedings, the funder may retain local counsel in each jurisdiction to conduct additional due diligence. Typically, the underwriting costs are borne by the funder as a cost of doing business, although outside costs may be recouped as part of any financing which is consummated (consistent with how VC and private equity firms handle such costs).

Financing can be sought at any stage of litigation—pre-filing, mid-case, pre-trial, post-trial and even post-settlement. The length of the diligence process varies depending on the case stage. For patents which haven't previously been litigated and cases which are yet-to-be-filed, the full diligence process generally takes 60 days. For cases which have made it past the PTAB or survived dispositive motion practice, the due diligence process is usually shorter—closer to 30 days. After a trial verdict, pending appeal, the process can be as short as 10 days.

Once diligence has been completed, the financier will work with the patent owner and counsel to develop a term sheet that reflects the economic terms of the transaction. Some funders provide preliminary terms in advance of (and subject to) conducting their due diligence. If the client and law firm have a desired approach, it is to their benefit to raise that early in the process so the funder can have it in mind during its underwriting.

Investment pricing

Patent financing economic terms can take a variety of forms, ranging from equity-style (a percentage of the proceeds from the litigation) to debt-style (a return of the financed amount, plus some multiple and/or running rate) or a combination thereof. Each financing arrangement can be customized to ensure counsel and their client have the resources they need throughout the full duration of the case.

Equity-style financing essentially replicates the contingency-fee economics which have developed over many years of patent litigation. In their simplest form, they are expressed as a set percentage of proceeds from the related case or assets. Clients and their counsel often prefer this straight-forward approach, since the respective percentages are set from the beginning of the case and everyone shares at their agreed amount, whether the ultimate proceeds are large or small. Variations on this approach include percentages which step up over the course of the litigation, as more time and expense are incurred.

Debt-style financing is also common in the legal financing world. In this approach, the committed budget is reserved at the outset and then capital is deployed as the case progresses and fees and costs are incurred. At any given time, the total amount of deployed capital is known (or know-able). If a resolution opportunity presents itself, the patent owner knows how much the funder and counsel, collectively, are to be paid and the remaining amount is entirely the patent owner's. This approach may be preferred by the patent owner where the potential damages are high relative to the amount of financing required.

These two approaches can also be combined, so as to offer the best of both. No matter which approach, from the client's perspective, the payments due to the funder and litigation counsel collectively should approximate the contingency fee arrangement. In other words, the goal is for the economics to be neutral to the patent owner—whether they are financing the case solely through contingency counsel or through a combination of a funder and counsel, the collective economics should be about the same.

Impact on a Company's Shareholders and Credit Rating

One of the benefits of litigation financing is that it typically does not have a negative impact on a company's shareholders or credit rating. In fact, litigation financing is usually viewed as an improvement of a company's credit since the contingent nature of repayment preserves liquidity. While litigation financing providers bear equity-like risks, existing shareholders are unaffected.

Mid-tier patent monetization financing

While all attractive patent litigation financing opportunities revolve around a strong patent portfolio, not all patent cases are the same. Some patent portfolios are infringed by numerous companies, but the potential damages may not be significant for each licensing target. There are financing companies that focus more on the mid-tier patent monetization financing market. The opportunity can be similar to large scale legal financing, but has potentially less risk and thus less reward. For example, due to the potential damages being lower on a per target basis, settlement discussions / settlements with each target typically occur earlier in the litigation process, thus reducing the risk associated with lengthy litigation. The financing is typically non-recourse, but the financing company usually plays an active role on the patent monetization team. The choice of counsel is a team decision (typically contingent) and the overall case analysis / due diligence is typically less exhaustive. The mid-tier opportunities are oftentimes patent licensing programs with at least ten or more licensing targets. The capital requirement is under $1 million in financing and can be set up as an expense pool funded partially via early licensing deals. The capital is used for technical analysis, teardown, claim charts, experts, and other out of pocket expenses. The potential damages do not have to be significant for each licensing target, but rather need to be at least $5 million collectively for all the licensing targets.

Assessing potential financing partners

Commercial litigation finance has seen explosive growth in the past few years. As new players and new funding models emerge, it's important for patent owners and their counsel to carefully consider prospective funders on several points:

Expertise. Partnering with an experienced finance provider with specialized in-house IP expertise provides access to an additional resource to help answer questions, add insight and serve as a second set of eyes, all of which can aid in fine-tuning the strategy before the litigation begins. Post-investment, an experienced funder's involvement is similar to that of a consultant: they receive periodic reporting on progress but do not control the case. That said, when desired, their experience and perspective across years of IP investments can allow them to continue to add strategic value to the litigation team.

Experience. IP litigation is complicated. It pays to work with a finance provider that knows the space and has considerable appetite for risk. With the prevalence of IPR petitions in high-value patent cases and increased motion practice (venue transfer, patentable subject matter challenges, motions to stay pending AIA proceedings, etc.), patent cases are taking longer to resolve and budgets are increasing. It is not unusual for case budgets to exceed $10 million. Partnering with a financier with a track record in the IP space and a long-term investment perspective allows the client and the litigation team to focus on winning the case, no matter how complex and lengthy it may turn out to be. In mid-tier financing scenarios, experience in funding / managing IP litigation is critical since, as noted above, the funder will typically have an active role in managing and working to develop the licensing / litigation strategy.

Longevity. Because most patent matters eventually continue through to appeal, it's important to select an established partner that will have the capital to see the matter through to its conclusion. Among other reasons, this prevent parties from being pressured into an early settlement due to a lack of resources. Similarly, patent owners should be cautious of legal funders which don't have meaningful committed capital, or which need to raise the necessary funds once they've decided to finance a case, as their investors may not be willing to continue to fund the case in its latter stages.

Economics. While some finance providers offer capital on a non-recourse basis, others require owners to give up an equity stake in their patent as collateral, and the patent owner can decide which approach makes sense for their situation. Separately, some law firms and funders seek to charge a patent owner upfront to perform due diligence on an opportunity, without any guarantee that the matter will be financed. Reputable finance providers and experienced law firms understand that such investment is a cost of doing business and will absorb those costs if a matter is not financed. Finally, while a patent owner should be realistic about the current level of risk (and related pricing) in the patent space, financing providers should be open to structuring terms that balance risk and reward with the patent owner.

The evolution of legal finance

Given that patent contingency firms somewhat pioneered the field of legal finance, people may think of funders as only able to cover a portion of attorneys' fees and costs. Many patent owners aren't aware that financing can be used in a much wider range of ways. This is particularly true in the current patent environment, with heightened risk and increased enforcement cost causing a broad devaluation of patent portfolios. While patent owners and their counsel may and will continue to seek funding for fees and costs, there are additional ways to leverage a financing and risk-sharing partner to unlock the value of a company's intellectual property.

Patent portfolio finance. The America Invents Act (AIA) and changes in patent caselaw over the past few years have created substantial uncertainty, and that uncertainty has in turn dramatically devalued U.S. patents. The USPTO has reported decreased fees from patent renewals as owners rationally winnow their patent portfolios. Patent sale transactions, even those involving large portfolios from recognized innovators, are being concluded for relatively small payments and perhaps a share of future licensing revenues. Legal finance can be a better solution for patent owners wishing to divest patent assets, as well as for interested acquirors. Some financiers might be willing to acquire patent assets and monetize them directly, with the seller being paid entirely upfront or with a share of future proceeds. Other financiers prefer to work with the acquiror to provide funding for the acquisition and/or the monetization costs, with the acquiror then developing and executing on the monetization strategy. Depending on the seller's capital needs and appetite for risk, partnering with a financing provider can be a far better alternative than abandoning the assets entirely.

Judgment de-risk. After surviving the litigation and PTAB process, many patent matters then go on to appeal—at which point the patent owner may well have exhausted all financial resources. Also, depending on the issues in the case, a patent owner may be concerned about the Federal Circuit reversing or altering a judgment and wish to hedge against that risk. Legal finance can provide partial funding secured by the judgment, which allows patent owners to generate capital and reduce the risk of a negative appellate outcome, as well as to defend the judgment on appeal.

Working capital. Beyond attorneys' fees and costs, patent owners often need additional working capital. This may come up for a variety of reasons, such as when the client has been self-funding the litigation, where there were substantial pre-suit costs (tear-down analysis, etc.), or where the company just needs capital to reinvest back into the business. A key consideration will be the funder's assessment of whether the potential monetization proceeds can support this additional financing. From a pricing perspective, working capital is usually additive to the case funding economics. Pricing will vary depending on how much collective financing is sought and the timing the working capital is to be paid (i.e., all upfront, or spread over the course of the litigation).

Litigation portfolio finance**.** Law firms and clients with portfolios of litigation can also take advantage of legal finance. Such financing is collateralized by a portfolio of existing matters and/or future matters, and can encompass both plaintiff and defense matters. The portfolio financing can be used to pay for all or partial legal fees and costs, for costs only, or to monetize litigation asset value. Because the financing is cross-collateralized across a portfolio of matters, the risk is diversified and the cost of capital is typically lower than for a single case financing. Law firms can use portfolio financing to reduce their overall contingency risk, enabling them to take on additional matters without increasing overall contingency exposure. It is also a way to offer alternative fee arrangements to the firm's clients, thereby enhancing competitiveness. For clients, portfolio finance can mitigate the impact of litigation on balance sheets—a particularly compelling benefit for publicly traded companies.

***Accelerating payments*.** Legal finance can also be used to structure large settlements and accelerate settlement and royalty payments. Non-legal funders and even legal funders without IP expertise may be hesitant to provide financing for settlement or royalty-bearing agreements where there is an ongoing legal risk due to the related intellectual property. Relative to financing secured by litigation or monetization proceeds, accelerating settlement or royalty payments can be far less risky and thus the cost of capital can be very attractive for the patent owner.

***Defense-side financing*.** While the more intuitive use is on the plaintiff side of the equation, legal finance can provide benefits for defense matters as well. Since legal fees and costs are treated as an accounting expense, financing them avoids that monthly drag on the company's P&L. A financing provider will typically work with the company to identify success milestones (e.g., resolution of the case at an early stage, settlement below a certain amount, etc.) and the related success fees. If the milestones are achieved, the financing firm is paid but if not, there is no obligation to repay the financing. Thus, defense-side financing can also serve as a risk-management solution.

***Fee-shifting protection*.** A somewhat unique application of legal finance is to protect against the risk of legal fee-shifting under Section 285 of the patent statute. The Supreme

Court's 2014 decision in *Octane Fitness, LLC v. ICON Health & Fitness, Inc.* significantly lowered the threshold for fee shifting in patent cases. In the two years that followed, motions seeking fee shifting spiked while the grant rate for such motions has remained steady at about 30%. With some of those awards rising well into the seven figures, a patent owner might want to mitigate that risk with legal finance.

<u>Key Takeaways</u>:

● **IP diligence takes time—but the process is worth it.** The benefits of the underwriting process outweigh any delay, and the better prepared the case is going into the process, the more likely it can move smoothly to a positive financing decision.

● **Consult damages experts early in the review process.** Since damages analysis is the focus of litigation funding, damages experts should be consulted early on in the assessment process to help both funders and clients maximize damages strategies and understand potential returns.

● **It's not "expensive".** The cost of capital for litigation finance is in line with the economics offered by contingent-fee law firms—economics that have been the standard for 40 years. In return for that economics, the patent owner also gets the benefit of non-recourse capital: If you lose, you don't pay.

● **Not all patent cases are equal.** There are financing options for patent cases that do not have significant patent damages. The capital requirement does not always have to be in the millions to find a financing partner.

● **Separating finance from litigation just makes sense.** Obtaining capital from an external source lets lawyers focus on doing what they do best, while offering a better alignment of incentives among counsel, client, and capital provider.