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Podcast:
Tax Aspects of Litigation Finance

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Tax Aspects of Litigation Finance

- **Guest:** Phil Balzafiore, Head Of Tax at Tetragon Financial Group
  - Tetragon is a publicly traded diversified fund with a NAV of USD 2.9 billion in assets under management, and, together with it's affiliates, of nearly USD 35 billion
  - Tetragon invests in public equity markets, certain private equity holdings, convertible bonds, CLOs, among other asset classes
  - Tetragon also invests in other early-stage or pre-launch asset management businesses, often with a focus on uncorrelated businesses, and has partnered with aspiring asset managers in industry-specific equity categories, mining and natural resource development issuers, and more recently, litigation finance

Litigation Finance: What is it?

- Generally involves funding plaintiffs or law firms that are pursuing legal claims for the plaintiffs on a contingent fee basis (or sometimes funding plaintiffs pursuing legal claims with law firms charging non-contingent fees)
- Investor (usually a fund with underlying investors) provides funding to plaintiffs or law firms; funding is secured by contingent claims
- Simply, another secured asset class: generally high yield, potentially high risk

One Form of Financing – Documented and Underwritten as Loan to Law Firm

- Term loan secured by contingent claims
  - Typically 5-7 year term (often limited to 5 years to avoid AHYDO interest expense disallowance)
  - Initial draw period typically of 2-3 years
  - Stated principal and interest
    - Most often interest deferrable or optionally deferrable (PIK)
    - Interest rate often mid to high teens
  - Technically loan can be non-recourse
    - Can be functionally recourse if loan is secured by broad pool of contingent claims that comprise essentially all of primary assets of law firm borrower, which is typically an LP, LLP or similar

One Form of Financing – Documented and Underwritten as Loan to Law Firm (cont'd)

- Loan secured by pool of contingent claims
  - Underwriting typically **a percentage** of potential recoveries
- First years cash out through advances
  - Typically, interest is deferred
  - Repayment of interest and principal occurs as underlying contingent claims are successfully recovered, remainder at maturity (if this didn't occur, collateralization would suffer).

Forms of Finance

- Loan Form: Funding Agreement documented as a loan with draw downs, stated "principal", fixed "maturity", fixed "interest", secured by pool of contingent claims
- Other Forms: Other "Litigation Funding Agreements" ("LFA") do not identify "principal" or "interest", may identify percentage participation in identified contingent claims and/or preferred returns to Funder

Potential Tax Characterizations

- Debt
- Assignment / sale of contingent claims
- Funder and Law Firm deemed partnership
  - This can be a re-characterization concern, or can be an affirmative structuring goal, each depending on circumstances
- Derivative financial instrument – “prepaid forward contract”
  - Neither a loan, nor a sale, nor a partnership

Tax Consequences of Loan Structure

- Investor – tax consequences generally non-optimal for U.S. investors
  - Financing, despite high yield, likely debt for tax
    - Financing debt analysis turns on form and underwriting standard
    - Generally, there is a reasonable expectation of being repaid both principal and interest as financing is secured by a pool of contingent claims, and underwriting results in economic expectation of repayment.
      - High yields driven not just by credit risk, but also limited financing sources because big banks often lack expertise to evaluate collateral and properly price, so often stay on the sidelines.
  - Phantom interest income
    - Current inclusion as original issue discount ("OID")
      - Highly likely that OID, regardless of how speculative, accrues concurrently
    - Ordinary income
    - Short-term capital loss ("STCL") for accrued OID (and principal) not collected
      - STCL does not offset prior inclusion (increased basis from OID inclusion just increases the ultimate loss on the uncollected loan)
      - But, potential arguments for ordinary treatment as a business bad debt deduction or under Arrowsmith principles
      - (See generally, Garlock, Federal Income Taxation of Debt Instruments, Section 1602 and 1603)

Tax Consequences of Loan Structure (cont'd)

- Non-U.S. investors subject to net U.S. income tax on originated litigation finance loans, as negotiation and execution is "origination" and probably a "U.S. trade or business" (not so for secondary market acquisitions of existing loans)

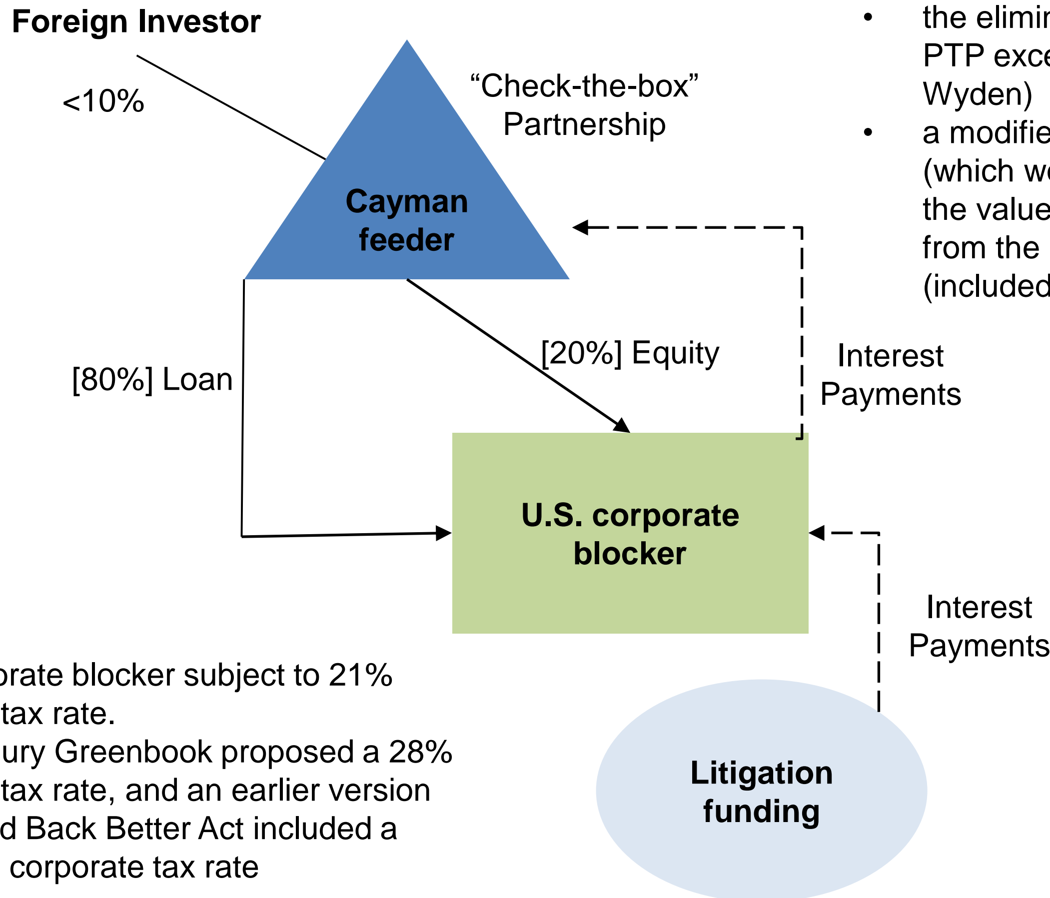
- Non-U.S. investors invest in a U.S. corporation (U.S. corporate blocker) which participates in the funding

  – US corporate blocker concedes net U.S. tax on otherwise "effectively connected income"

  – US corporate blocker often partially debt-funded to mitigate U.S. tax burden

  – US corporate blocker tax burden "phantom" in early years given interest on law firm loan is PIK OID

Mitigation Structures for Non-U.S. Investors



- Cayman feeder would be subject to proposed tax reform provisions, including:
  - the elimination of the "passive income" PTP exception (proposed by Senator Wyden)
  - a modified portfolio interest exemption (which would exclude a holder of 10% of the value of a debtor corporation's stock from the portfolio interest exemption (included in the Build Back Better Act))

- U.S. corporate blocker subject to 21% corporate tax rate.
- The Treasury Greenbook proposed a 28% corporate tax rate, and an earlier version of the Build Back Better Act included a graduated corporate tax rate

Mitigation Structures for Non-U.S. Investors (cont'd)

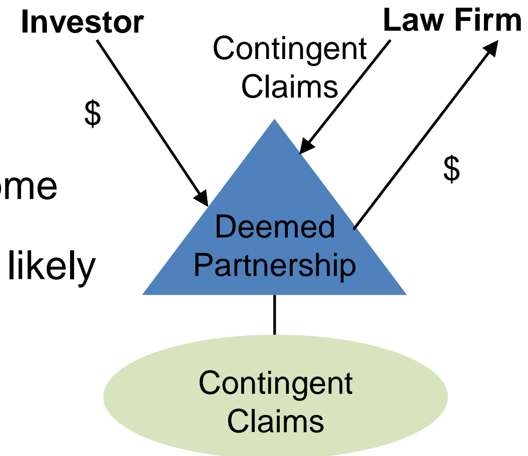
- Generally, a return mismatch between U.S. and non-U.S. investors equal to conceded US tax in US blocker
- Secondary market purchases of previously executed litigation funding facilities
  - Not ECI
    - Guidelines to be followed
  - No U.S. WHT on interest as long as less-than-10% investor
    - Portfolio interest exception

Tax Consequences to Law Firm Borrower

- If loan – receipt of advances not income
- PIK interest currently deductible, even though not current paid, limitations on deductibility apply
  - Primary: 163(j) limitation on deductibility of business interest expense (generally, limit to 30% of Adjusted Taxable Income)
    - Unlimited carryover
  - AHYDO limitation
    - If YTM exceeds AFR plus 500 bps, no interest deductible until paid
    - Any YTM above AFR plus 600 bps permanently disallowed
    - Avoided altogether if loan term limited to 5 years or less or no “significant OID” (generally, accrued OID after 5 years never exceeds current accrual period’s interest accrual; harder to manage)

Alternative Tax Characterizations: Partnership, Sale, Financial Contract

- IRS might assert other characterizations, depending on commercial aspects of funding
- Deemed partnership between Investor and Law Firm
- Potentially adverse to Law Firm:
  - Treatment as disguised sale – potential current income
  - Even if not disguised sale, distributions to Law Firm likely in excess of basis in partnership interest so immediate income either way

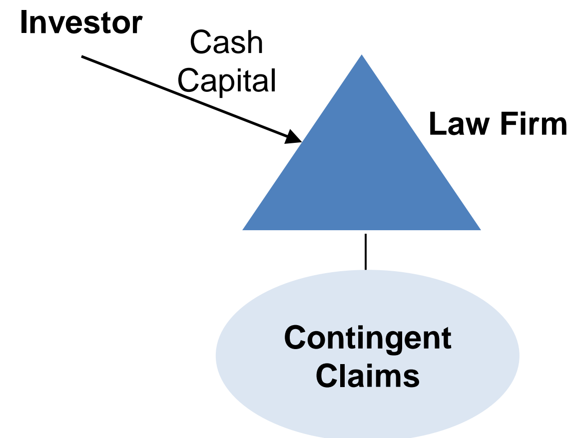


- Potential deferral benefit to investor relative to loan treatment because taxed only when contingent claims paid to the deemed partnership
  - Contingent claims likely yield ordinary income as unrealized receivables contributed by Law Firm (Sections 724(a) and 1221(4))
  - So, ordinary character of income in either loan and/or partnership characterization is less favorable to Investor than structuring as a sale or financial contract (discussed later) which should beget capital gain treatment

Alternative Tax Characterizations: Partnership, Sale, Financial Contract (cont'd)

- Most states' laws and ethics rules regarding non lawyers sharing profits currently prohibit Investor from becoming special class partner directly in Law Firm (See *e.g.*, Model Rules of Professional Conduct 5.4)

- However, potential trend toward allowing capital investments in law firms in certain states[1]



- No current income to Law Firm as cash is capital contribution

- Investor still achieves deferral until contingent claims paid as under the "deemed partnership" (but income is still ordinary when received)

[1] Sam Skolnik, *Litigation Finance Companies Eye Law Firm Ownership in Arizona*, BLOOMBERG LAW (Nov. 29, 2021), https://news.bloomberglaw.com/us-law-week/litigation-finance-companies-eye-law-firm-ownership-in-arizona

Sale of Participation in Contingent Claims

- Law Firm treated, for tax, as selling participation in contingent claims to Investor
  - Still sub-optimal to Law Firm as cash proceeds taxed currently
- Most beneficial treatment for Investor
  - "Wait and See" payments from participation not income or gain until purchase price recovered
    - Potential imputation of interest or allocation of basis to payments as received
  - Capital Gain, presumably at favorable long term rates

Prepaid Derivative

- Potentially same beneficial treatment for Investor as under Current Sale
  - "Wait and See" until basis recovered
  - All income is capital gain (1234A)
- Law Firm
  - Arguably deferral (cash arguably not current income)
  - No deduction for implied interest as is the case in a basic loan