

# THE NATIONAL LAW REVIEW

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## 2018 Annual Review and 2019 Outlook Highlights Private Equity Fund Litigation Risk Areas

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In our [recently released 2018 Annual Review and 2019 Outlook for Hedge Funds, Private Equity Funds and Other Private Funds](#), we note that innovative market disruptors, a maturing credit cycle, and a philosophical change in how the industry views and utilizes litigation are likely to lead to increased litigation risk for advisers (and their funds) in 2019. Below we have excerpted the areas that should be on the top of every adviser's list as we look toward 2019.

### **The Unicorn Ripple Effect**

While the number of IPOs has increased, rich valuations for private companies may constrain opportunities for liquidity and future funding rounds. Ultimately, an uneven IPO outlook for unicorns could lead to disputes. Overly optimistic valuations can lead to inflated expectations, especially among employee shareholders expecting a payout and investors expecting gains. A company with rich valuations may have greater difficulty creating liquidity for shareholders. As more unicorns linger and fall into distress, some may fail, leading to litigation. And as the Theranos case has taught us, the failure of a unicorn is likely to attract not only regulatory scrutiny, but also potential private litigation claims.

### **Litigation Funding Alters the Landscape**

Historically, limited partners have shied away from initiating litigation – in part because their primary objective is to maximize the value of their investment and litigation is viewed as having high costs with an uncertain return. In addition, advisers have an asymmetric advantage in that they often can draw on the fund to cover legal expenses, whereas limited partners must cover their own expenses. Enter litigation funders, who are raising funds and capital at an unprecedented pace and whose business strategy is to invest in claims by covering the expenses of litigation in exchange for a share in the recovery. Litigation funding has the potential to fuel a new wave of LP-driven litigation that, up until recently, had been viewed as a risk that was hard to quantify and seemed unlikely to materialize.

### **Private Credit Defaults and Workouts**

The market for private credit lending (sometimes called alternative finance or private capital) continues to boom, with some experts estimating that it will exceed \$1 trillion by 2020. The influx of capital into the private credit industry is altering the landscape for deal types and deal terms. Rising competition, intense deal activity, and the reach for yield have led to more complicated capital structures. This complexity coupled with higher interest rates are signs of a maturing credit cycle – which in turn signals an increased risk of defaults. End of cycle defaults often lead to contentious workouts. Given that disputes tend to follow market trends, the continued growth of the private credit market today could lead to disputes tomorrow.

### **Portfolio Company Litigation**

There are seemingly countless ways that ownership and sale of a portfolio company can expose advisers and their funds to litigation. There is a growing trend by plaintiffs' lawyers to name advisers, funds and their board-designees as defendants in traditional portfolio company litigation. Advisers (their principals) and their funds also are common targets when a portfolio company fails post-sale and a creditors' committee comes knocking to



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pursue recoveries. And there has also been a steady uptick in something that was once viewed as taboo in the industry - advisers and their funds suing other advisers and their funds related to sales of portfolio companies. Each of these trends is likely to continue in 2019 and beyond.

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