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DIVERSIFICATION, RISK MITIGATION AND THE 30/30 RULE

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EXECUTIVE SUMMARY

The United Kingdom's legal sector is one of the most well-regarded in the world.

A May 2024 report published by the Legal Services Board, led by Professor Rachael Mulheron KC (Hon), Professor of Tort Law and Civil Justice at Queen Mary University of London and one of the country's leading legal academics, highlighted the vital role that litigation finance has to play in both facilitating access to justice but also helping the country's legal sector maintain its global standing and reputation.

While this report, and most of the UK's growing litigation finance sector, predominantly focuses on large-scale collective actions – known as class actions in the United States but, until recently, rarely seen in the UK – at Seven Stars, we operate at the opposite end of the sector, focusing on smaller, precedent-based case types with lower, fixed costs that allow us to achieve an attractive rate of returns for our investors while minimising the risk involved.

This paper examines our approach to litigation finance, how we diversify and mitigate risk, and a real-world example of the potential dangers of overcommitting to a specific case type.

THE ROLE OF LITIGATION FUNDING IN THE UK LEGAL SECTOR

The United Kingdom's legal sector is one of the most well-regarded in the world.

Due to the substantial costs associated with bringing legal action, the litigation funding sector provides opportunities for:

- Law firms to bring cases on behalf of their clients on a no-win, no-fee basis, often running claims they would otherwise not be able to due to cash flow concerns or claimants being unable to afford litigation.
- Law firms to pursue high-value collective actions against businesses guilty of malpractice, negligence, or other outrages or injustices against consumers, where the claimants would otherwise lack the means to take on large entities and their legal teams.
- Funders to facilitate access to justice for claimants via the financial support they provide to law firms.
- Investors to participate in an alternative investment with the potential for high returns and, in the case of Seven Stars, with minimal or highly mitigated risk.

Furthermore, a report¹ published by the Legal Services Board² in May 2024, led by Professor Rachael Mulheron KC (Hon), Professor of Tort Law and Civil Justice at Queen Mary University of London and one of the country's leading legal academics, found that:

- Litigation funding serves a clear public interest in facilitating access to justice.
- The UK's legal sector benefits from the ease with which law firms can engage with litigation funders, with funders not needing to be members of the Association of Litigation Funders or another body to operate in the market.
- Litigation funding plays a vital role in providing and improving access to justice.





HOW DO LITIGATION FUNDERS OPERATE?

Litigation funding is most commonly associated with high-value collective actions, such as that brought by 550 sub-postmasters for loss and damages following the Post Office/ Horizon IT scandal.

While collective actions are likely to become increasingly prevalent in the UK, primarily thanks to the backing of litigation funders and their investors, it is not the only opportunity in this space.

Rather than targeting collective actions, where costs can escalate and leave litigation funders feeling like a “walking wallet,”³ at Seven Stars we target smaller, precedent-based claims.

WHY TARGET SMALLER CASE TYPES?

We specifically target precedent-based legal claims or claims under Government compensation schemes or Acts for investment, which reduces the risks involved. This is because a precedent-based case has already won a court victory, and all cases involving the same facts fall under the same judgment.

Targeting smaller cases ensures that:

- We can better control costs – we typically establish fixed, specific funding levels for each case type we fund.
- Risk is minimised due to the cases we fund being predominantly precedent-based.
- We can project and deliver a steady flow of returns to our investors.
- We can select and work closely with regulated law firms to fund existing cases where we’ve established it is viable for the firm in question to repay the funding and satisfactorily deliver its services to its client, who in such cases is the claimant.

Given all these reasons and our experience in dealing with such claims to date, we believe that our approach is preferable to targeting the larger collective actions, which have come to be known as “casino cases” due to their high-risk, high-reward nature.



RISKS AND RISK MITIGATION

While our approach to targeting smaller case types is lower-risk than funding high-value collective actions, there are still some risks associated with litigation funding.

Our comprehensive due diligence processes and lending methodology minimise the risks to Seven Stars and its investors.

LOSING A CLAIM

The entire basis of litigation finance is that a legal case is an asset that can drive a return. As such, a legal case can only deliver a return if it is won and the law firm repays us per the terms of their funding agreement.

Our primary means of mitigation against the risk of losing a claim is our comprehensive due diligence processes, which analyse our existing and prospective borrowing law firms and specific case types.

At a case level, our due diligence processes review numerous factors, including existing precedents from Superior Courts or with reference to Government schemes, to understand and ascertain the likelihood of success and for a particular case type to be a profitable funding opportunity.

In respect of the law firms themselves, in addition to the due diligence we conduct when accepting them for borrowing, we further assess each funding request, including a review of the case files for the claims to be funded. As we only fund existing claims, this enables us to ensure that we only fund cases that we believe to be meritorious and are likely to succeed.

Underpinning our due diligence processes, we also place

several conditions on our borrowing law firms, including an insistence on them having After-the-Event (ATE) insurance, if required.

LAW FIRM RISK

We lend to regulated law firms or regulated marketing companies, helping such firms acquire cases while ensuring there is a strict mechanism of controls in place for borrowers. Our Advisory Panel of Legal, Corporate Finance, and Business experts carry out significant due diligence on the financial stability of the law firm and the viability of the cases seeking funding. If approved by our advisory panel, we complete a deed of assignment over the cases and, where possible, take a debenture over the law firm's assets.

In the event of fraud by a legal firm, we could make a claim under the Solicitors Regulation Authority (SRA) Indemnity Fund or the mandated Professional Indemnity (PI) insurance of each Solicitor, which they are obliged to hold.

CASE TYPE RISK

Seven Stars targets small individual precedent-based claims against large liquid entities. By diversifying across a range of small claims, we can spread the risk of unsuccessful claims and reduce the impact of settlement delays.

ATE insurance must be in place for all cases funded by Seven Stars. ATE insurance policies cover the cost of 'own disbursements' (the funds spent on that case) on funded cases in the event that a case is lost; in this scenario, it also covers the other party's costs.



It is not a capital insurance for the investment, and Seven Stars is not a beneficiary; however, it does provide some assurance that the borrowing law firm will receive funds that they can use to cover indebtedness.

All borrowing law firms and cases are actively monitored to provide details of the progress of funded cases. Borrowing law firms must repay the funding provided or replace any cases with the agreement of Seven Stars.

DEBT SECURITY RISK

Where possible, Seven Stars Legal takes a charge over the assets of all borrowing law firms and the cases being funded. The borrowing law firms are charged an interest rate, arrangement fee and a contractual share of their success fees for winning the cases. The potential gains from winning a case can be several times the amount spent pursuing the case. Losing a case results in usually losing only the sums invested in pursuing the case, some of which can be covered by ATE insurance. This difference between the potential gains and the potential losses (covered by ATE insurance) provides an element of security and capital protection.

The borrowing law firm enters into either a Deed of Assignment of funded Assets or a general Debenture with Seven Stars. The assignment covers all no-win, no-fee (i.e. not profit costs) income due to the borrowing law firm, both disbursements and the contingency fee, so it will generally be of greater value than borrowings.

Seven Stars aims to provide a minimum level of debt cover of 1.2 times the borrowed amount. In practice, it is closer to 2 times the borrowed amount on most cases funded but can go as high

as four times on Financial Ombudsman Service or Financial Services Compensation Scheme claims.

In the event of solicitor default, Seven Stars holds the right to reassign the cases to another firm.

RISKS BEYOND OUR CONTROL & UNFORESEEN CIRCUMSTANCES

Outside of the risks described above, all litigation funders, law firms, and other companies working in the legal sector and the sectors in which we may operate resulting from the types of claims we choose to fund are, to varying degrees, vulnerable to regulatory judgments and notices, developing legal positions due to Court of Appeal or Superior Court decisions, and adverse decisions that may impact our ability to fund specific case types.

HOW SEVEN STARS MANAGES THESE RISKS

In addition to the risk mitigation steps identified above, we follow a self-imposed diversification model, known as the 30/30 rule, to enable us to proactively and effectively deal with risks beyond our control.



THE 30/30 RULE

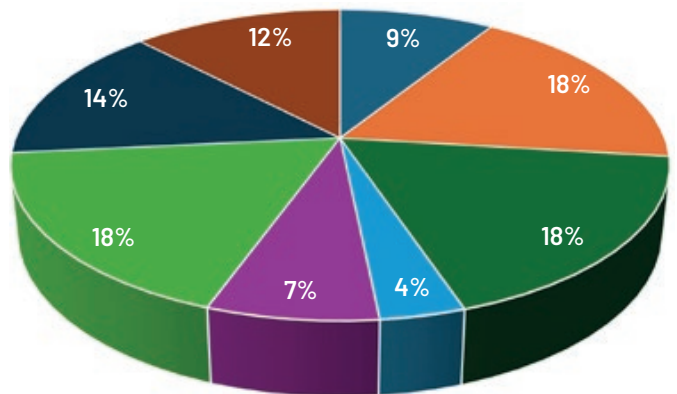
The 30/30 rule is a straightforward diversification methodology stating that at any given time, we will have a maximum of 30% of all deployed funds committed to a single law firm or a specific case type.

Given our projected growth trajectory, in practice, it is unlikely that we will have close to 30% of our funds committed to any single law firm in future.

The following charts highlight our current and projected firm spread at the end of 2024.

CURRENT FIRM SPREAD: APPROVED LENDING

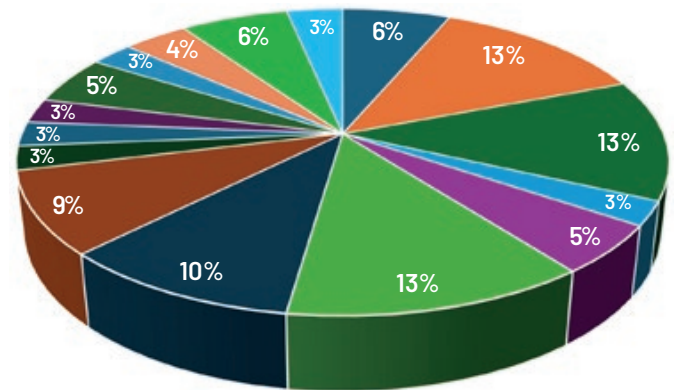
At the end of 2024, we were working with **eight regulated law firms** with approved funding agreements, with the maximum deployment to a single firm of 18% of all approved lending.



PROJECTED FIRM SPREAD: APPROVED LENDING + DUE DILIGENCE PIPELINE

This table highlights how our lending spread will look should funding agreements be approved for all law firms within our due diligence pipeline as of the end of Q4 2024, which will mean we are working with **16 regulated law firms**, with a maximum exposure of 13% to three firms.

The spread detailed on this chart will further split and diversify as we continue to sign funding agreements with more law firms.





EXCEPTIONS TO THE 30/30 RULE

While we are committed to the 30/30 rule as a long-term foundation for good practice and sound governance, there are occasions when it may be in the best commercial interests of Seven Stars and its investors for our deployed funds in a specific law firm or case type to exceed 30%.

SOLICITORS REGULATION AUTHORITY FEE CAP IMPACT

In July 2024, the Solicitors Regulation Authority introduced a fee cap for law firms working on financial mis-selling cases in line with the Financial Conduct Authority fee cap for claims management companies.

This fee cap changed how we fund certain case types and could significantly impact the profitability of law firms and their capability to use litigation financing to run specific case types.

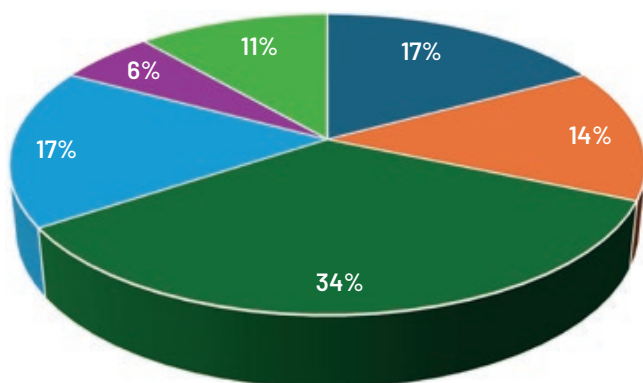
With this in mind, we decided to extend our lending in the pensions mis-selling space before the introduction of the Solicitors Regulation Authority fee cap so that we could

maximise returns before making adjustments to our lending methodology for funding requests received after 26th July 2024, when the fee cap came into force.

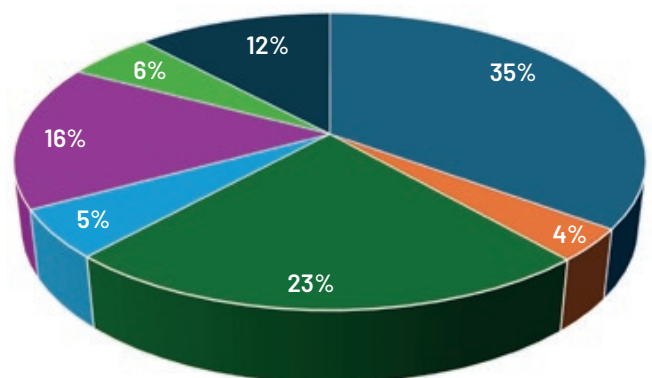
This resulted in our case type distribution at the end of Q2 2024 appearing as in the chart below, which saw us have 34% of our agreed lending committed to pensions mis-selling claims, which our borrowing law firms pursue via the Financial Ombudsman Service and/or the Financial Services Compensation Scheme.

2024 PORTFOLIO REBALANCING EXERCISE

Subsequent signing of new funding agreements and rebalancing activity throughout the second half of 2024 saw our agreed lending split develop as per the below chart. While conducting our rebalancing activities and assessing funding proposals and drawdown requests from lenders, we took a strategic decision to allow our committed funds for housing disrepair claims to exceed 30% given the scale of opportunity in this sector.



- Housing Disrepair
- Pensions Mis-selling
- Bank Fraud
- Business Energy Claims
- Contested Probate
- PCP Claims



- Housing Disrepair
- Pension Mis-selling
- Car Finance Claims (PCP)
- Business Energy Claims
- Bank Fraud
- Irresponsible Lending Claims



CHALLENGES IN ADHERING TO THE 30/30 RULE

As the 30/30 methodology is a self-imposed rule, while there are some challenges and potential scenarios we must be mindful of within our operations, most of these require us to make decisions in the best interests of our business and investors rather than providing any threat to our viability, and we retain the ability to remain flexible in our approach so we can achieve our objectives.

REGULATORY UPDATES

On occasions and as outlined in the previous example, regulatory updates from the organisations that oversee the sectors in which our Funding Partners work – or even the legal sector as a whole – may necessitate temporarily committing more than 30% of our deployed funds to a specific case type or law firm.

As we work closely with our Funding Partners and have real-time “boots on the ground” via members of our Advisory Panel, we’re always well placed to plan ahead of any regulatory changes, which often go through several rounds of proposals and consultations before coming into force and thus should never really be unexpected or surprising.

FUNDING DEMAND FOR SPECIFIC CASE TYPES

As new consumer outrages and the chance to help those affected achieve financial justice become apparent, it is only natural that ambitious and dynamic law firms will quickly pick up on such commercial opportunities.

Where it is clear that such opportunities may be hugely scalable and profitable, there is likely to be a fast-growing demand for litigation finance to support anticipated claims volumes.

In such situations, Seven Stars may face a scenario where

several law firms submit funding proposals for the same case or claim type. Were this to happen, and if agreeing to lend to all the requesting law firms would take our commitments to a single claim type beyond 30%, we would decide how to proceed based on the case type analysis completed by our Advisory Panel and in the best interests of our business and investors.

But even when a lucrative opportunity comes along, we’ll recognise the likely risks and potential for unforeseen circumstances and look at the bigger picture rather than going “all in” on a particular claim type or the next big thing to be called “the new PPI.”

CASE COMPLETION FLOW

When we sign a funding agreement with a law firm, and they draw down the agreed funds, we do so anticipating the timeline in which we will see funds returned, which we can use to forward plan cash flow, investor returns, and our exposure in respect of both law firms and case types in the long-term.

Should this be disrupted due to regulatory changes or other factors, this may lead to us needing to decide how appropriate further lending may be in specific sectors, should we feel we need to withhold funding or otherwise adhere to the 30/30 rule. As with all decisions, we will always act in our business’s and investors’ best interests when assessing such situations.



CASE STUDY: PCP MIS-SELLING IN THE UK

In January 2024, the Financial Conduct Authority (FCA) launched an investigation into the potential mis-selling of car finance⁴, specifically Hire Purchase and Personal Contract Purchase deals, amid concerns that consumers have been charged billions of pounds in overcharged interest via the use of discretionary commission arrangements; estimates suggested consumers could be due an average of £1,100 in compensation.

By March 2024, the FCA had paused its investigation to allow car dealers and manufacturers to “self-investigate.” Within this pause, the regulator also extended the time lenders had to respond to complaints, effectively bringing all car finance mis-selling claims to a halt.

At this time, claims were due to recommence by the end of September 2024.

Subsequently, in July 2024, the regulator announced a further extension to this pause⁵, and later extended it to cover non-discretionary commissions⁶ following a Court of Appeal ruling in October 2024⁷. As of January 2025, the FCA proposes to provide a further update and next steps in May 2025, with claims due to recommence in December 2025. These dates may change subject to the outcome of an appeal against the Court of Appeal’s ruling at the Supreme Court, due to be heard in the first quarter of 2025⁸.

This pause likely caused many funders to review and reconsider their activities and how affordable or otherwise providing litigation financing may be in situations where unexpected circumstances could arise.

In this case, there was always the chance - and perhaps an expectation in some quarters - that dates would be pushed back, but it’s unlikely that many litigation funders, law firms, or consumers were expecting everything to be pushed back quite so far.

WHERE DOES THE FCA’S PAUSE LEAVE LITIGATION FUNDERS?

Litigation funders’ position will depend on their exposure.

For example, Seven Stars has learned of at least one litigation funder with around 80% of its total committed funds tied up in motor finance claims. Given this funder advertises its funding as a short-term, 12-month solution, this extension will likely significantly impact its cash flow, ability to fulfil its obligations to investors, and possibly even its viability as a business.

What looked like a significant opportunity just a few months ago is now a real risk to the entire business and its ability to generate returns for its investors.

HOW EXPOSED IS SEVEN STARS IN THE PCP MIS-SELLING SPACE?

We believe this case is a robust endorsement of our broad adherence to the 30/30 rule and demonstrates the benefits of our approach to due diligence and governance.

While PCP mis-selling claims may remain a profitable litigation funding opportunity, we took a decision to not yet commit significant funds to this claim type given the likelihood that the FCA would extend the pause, especially given the regulatory and legal developments in the sector.

As such, our current exposure in this space is limited to 14% of our total agreed lending. As none of these monies have yet been drawn down, we have no exposure in this space in practice and have paused further funding while we assess if the cost of funding is viable to generate our desired returns given the current landscape, although we continue to actively analyse and assess this sector.



CORPORATE GOVERNANCE

Further information about how we assess requests for litigation funding and work to fulfil our responsibilities to our investors, borrowing firms, and the legal and legal funding industries is outlined in our Corporate Governance Statement.

To receive a copy of this document, please email hello@7stars.legal.

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