Expert Q&A on Bankruptcy Litigation Financing

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An Expert Q&A with Emily O. Slater of Burford Capital LLC discussing her views on bankruptcy litigation finance.

Legal claims held by bankruptcy estates often represent an unsecured creditor's best source of recovery. However, funding the litigation of those claims has been a long-standing issue. Bankruptcy stakeholders have generally relied on financing options, such as providing releases, obtaining contingency fee arrangements, fee deferrals, or further cash contributions from out of the money creditors. But, these solutions have their limitations, often resulting in bankruptcy stakeholders settling claims for less than they are worth or forgoing them altogether.

Legal finance allows estates to pursue valuable claims that otherwise may have to be abandoned or settled and increases recoveries for creditors. Practical Law asked Emily O. Slater of Burford Capital LLC to discuss her views on bankruptcy litigation finance. Ms. Slater is a Managing Director of Buford's underwriting and investment arm in New York. Before joining Burford, Ms. Slater was a litigator at Debevoise & Plimpton LLP, where she specialized in complex securities and other bet-the-company litigation and regulatory investigations involving billions in damages. Ms. Slater regularly represented financial institutions and public companies before the SEC and DOJ.

WHAT IS LITIGATION FINANCING AND HOW CAN THIS FUNDING BENEFIT CREDITORS AND STAKEHOLDERS IN A BANKRUPTCY CASE?

Litigation finance, also called legal finance and third-party funding, refers to a transaction in which litigation risk is valued and used to secure financing from a capital provider that is not a litigation party in exchange for a share of the future proceeds generated by the litigation risk. Funds are often provided on a non-recourse basis. If the litigation does not meet the agreed definition of success, the capital provider does not receive back its capital or a return on its investment. Non-recourse litigation finance is used to manage risk and improve creditor recoveries in bankruptcies that have significant litigation assets or litigation between creditor groups.

For more information on third-party litigation financing generally, see Practice Note, Third-Party Litigation Financing in the US (5-518-1314).

HOW DID THE USE OF LEGAL FINANCE IN BANKRUPTCY CASES GAIN TRACTION?

Litigation finance first emerged in Australia as a necessary solution to the challenges of insolvent claimants and their representative. Over the course of the last decade, the use of finance in commercial litigation and arbitration has become common practice in the US and UK. In a bankruptcy scenario, there generally is little available cash for an office holder (like a bankruptcy trustee or liquidator) to pay lawyers to recover assets, particularly to recover damages for harm that may have been perpetrated against a company during its descent into bankruptcy. There are often claims against:

- Officers and directors for severe mismanagement or fraud.
- Advisors that may have aided and abetted malfeasance.
- Equity holders that may have improperly diverted assets from the company.

In today's sophisticated corporate finance environment, where small and medium sized debtors can have a complex capital structure with a mix of secured and subordinated creditors, the successful resolution of claims may be the only avenue of recovery for out of the money creditors. However, trustees and lawyers require resources to pursue these claims and in many jurisdictions, lawyers are prohibited from taking matters on a contingency fee agreement. Even in cases where lawyers may be willing and able to finance the cost of legal fees, there are still cash costs for experts and other discovery, as well as administrative costs of the estate.

Legal finance emerged as a natural solution to obtain the necessary capital to pursue these contingent assets for the benefit of creditors.

WHAT THIRD-PARTY FUNDING OPTIONS ARE AVAILABLE TO PARTIES IN BANKRUPTCY?

Historically, bankruptcy stakeholders have relied on limited financing options, including:

- Releases by management, advisors, former equity holders, and other third parties that provide capital in return for the releases.

- Contributions of capital from senior creditors as part of plan negotiations.
- Contingency fee arrangements, fee deferrals, or further cash contributions from out of the money creditors.

But these solutions have their limitations and can result in bankruptcy stakeholders releasing claims for less than they are worth or forgoing them altogether.

Legal finance allows estates to pursue valuable claims that otherwise may have been abandoned or settled, which increases creditor recoveries. Legal finance comes in a variety of forms:

- **Companies reorganizing in Chapter 11 can finance or monetize claims.** Companies reorganizing in Chapter 11 often have an outstanding high-value claim or basket of claims. Although these Chapter 11 companies may obtain DIP financing, they typically prefer to use DIP capital for funding operations and not for pursuing litigation that is non-core to the business and has substantial risks to a return on investment. Instead, companies may choose to partner with a legal finance provider to obtain non-recourse legal financing or to preserve DIP cash. This may limit risk or generate additional operating cash through the outright monetization of a claim.
- **Funding liquidations or litigation trusts.** A funder can provide non-recourse capital to cash-strapped estates and trusts that have litigation assets, potentially allowing for a faster and larger recovery to the estate and creditors. Creditors may also prefer to seek funding for a litigation trust so that any existing cash can be reserved to guarantee creditor recoveries. With increased resources, an estate can decide to launch a broad litigation strategy that can accelerate the timing of creditor recovery. If a trustee has a basket of claims that include claims or counterclaims against the estate, litigation finance can also help finance the legal fees on both affirmative and defensive claims. This option is particularly well suited for an estate or trust that has a portfolio of cases with varying levels of risk and expected duration.
- **Providing capital to law firms to pursue matters taken on risk.** Litigation finance can provide non-recourse capital to law firms that litigate bankruptcy matters on contingency. The direct injection of capital helps smooth cash flow for the firm and lower its risk exposure. This funding enables the firm to capitalize the expansion of its contingency business or take on litigation expense risk when a cash-poor estate cannot pay litigation expenses. The litigation financier can provide capital to firms for a substantial single case or across a portfolio of multiple cases.
- **Financing inter-creditor disputes.** If a bankruptcy estate involves senior and subordinated creditors, disagreements may arise over their respective priority. Creditor groups can use an injection of non-recourse capital to challenge a lien or seek to remove priority, without assuming additional risk. For example, the Motors Liquidation Company Avoidance Action Trust obtained litigation funding (with court approval) to fund litigation challenging the priority of secured creditors of old GM (see *In re Motors Liquidation Company*, Case No. 09-50026, Dkt. No. 13980 (Bankr. S.D.N.Y. June 29, 2017)).

WHAT'S THE BIGGEST MISCONCEPTION ABOUT USING LEGAL FINANCE IN THE BANKRUPTCY CONTEXT?

Bankruptcy practitioners frequently have significant concerns about a litigation finance provider controlling the litigation or settlement. Given that most bankruptcy professionals owe fiduciary duties to stakeholders, decision making authority cannot be ceded to a third-party. It is important for bankruptcy practitioners to know that most legal finance providers are passive investors and eschew control of litigation strategy in their funding agreements. If a practitioner receives a funding proposal that requires settlement approval, that is a red flag and the practitioner should seek other options in the market. Concerns about giving up control should not stop a bankruptcy professional from seeking litigation finance.

For more on ethical concerns of litigation financing, see Practice Note, Third-Party Litigation Financing: Ethical Issues for Attorneys (W-011-9173)

HOW WOULD YOU DISTILL THE VALUE THAT LEGAL FINANCE OFFERS TO STAKEHOLDERS?

Legal finance ensures the efficient administration and recovery of assets for bankruptcy estates or litigation trusts for the benefit of creditors. It enables an estate to pursue claims and achieve recoveries that otherwise may not have been possible. A bankruptcy professional is also able to ensure the best recovery for creditors by negotiating the best fee agreement for each case. For example, to reduce the overall cost and risk of proceeding with litigation in large cases, stakeholders may benefit from litigators working principally on an hourly basis instead of on a full or partial contingency.

Stakeholders also benefit from market testing of both the case and funding terms because it:

- Ensures the best possible pricing for the litigation.
- Provides impartial assessment of the strengths, weaknesses, and potential value of a case as a measure against the bankruptcy professionals' risk assessment when considering bringing an action.

IS BANKRUPTCY COURT APPROVAL REQUIRED FOR THIRD-PARTY LITIGATION FINANCING?

Litigation finance arrangements in bankruptcy may require court approval under the Bankruptcy Code and Federal Rules of Bankruptcy Procedure. Parties must evaluate the need for approval based on the facts and circumstances in which a stakeholder is seeking capital. The general guidelines for seeking court approval include:

- Financing an estate during the pendency of a bankruptcy case, a debtor-in-possession, trustee, or creditors' committee generally needs to obtain court approval for financing under section 364 of the Bankruptcy Code.
- Financing a professional during the pendency of a bankruptcy case is potentially subject to disclosure requirements under Bankruptcy Rules 2014 and 2016.
- Post-plan confirmation financing requires court approval subject to the terms of the plan or litigation trust agreement and is also dependent on when funding is being sought or by which party.
- Sale of claims or litigation assets requires court approval under section 363 of the Bankruptcy Code.

In cases where court approval is necessary, a party seeking outside capital should:

- Be prepared to:
  - disclose the funding agreement;
  - demonstrate that the funding terms were market-tested by seeking multiple bids; and
  - articulate the reasons why the funding is in the best interest of stakeholders.
- Conduct due diligence on the finance provider to ensure that they have selected a stable, experienced partner with demonstrable capital availability. A party should partner with highly regarded providers of litigation finance, which typically are specialist firms that:
  - offer a high degree of legal and financial knowledge;
  - have experience in bankruptcy matters; and
  - focus exclusively on financing complex commercial cases.

CAN YOU PROVIDE AN EXAMPLE OF HOW LITIGATION FINANCING HAS SUCCESSFULLY BEEN USED IN A BANKRUPTCY CASE?

For more than a decade, the bankruptcy trustee in *Magnesium Corporation of America* (MagCorp) and the trustee's counsel pursued claims against MagCorp's former holding company for placing MagCorp into bankruptcy. In 2016, having won a $213 million judgment for the benefit of MagCorp's creditors, the trustee felt confident that MagCorp was likely to successfully defend the judgment on appeal and collect the judgment. However, after litigating the matter for 13 years, the trustee:

- Did not have sufficient funds to litigate the matter if there were to be a re-trial.
- Was concerned with the risk of a negative appellate outcome on creditor recoveries.

To address this risk and ensure that it had adequate funds to litigate, the trustee obtained litigation financing by arranging for the public sale of an interest in the right to receive proceeds from the judgment on appeal. The court approved a $26.2 million sale or a portion of the case proceeds to a litigation funder (later acquired by Burford), which enabled the estate to:

- Monetize a portion of a contingent asset.
- Hedge against appellate risk.
- Guarantee a minimum recovery to creditors.

This unprecedented financing arrangement was recognized at the Financial Times Innovative Lawyers Awards for North America for having provided a novel solution to a common problem faced by bankruptcy estates.

DO YOU FORESEE INCREASED USE OF LEGAL FINANCE BY BANKRUPTCY PRACTITIONERS?

There is an increased role for legal finance in the bankruptcy context as rising interest rates, trade tariffs, fluctuating commodity prices, and continuing fundamental changes in the US economy spur new bankruptcy filings and bankruptcy professionals become more familiar with the benefits of legal finance. We also expect creative and entrepreneurial bankruptcy professionals to propose new ways to use legal finance as the next generation of bankruptcies pose more complex, multi-jurisdictional issues with multifaceted risk assessments, negotiations, and sets of stakeholders. Highly sophisticated global legal finance providers, like Burford, are ideal partners in creative problem-solving and commercial deal structuring as more complicated bankruptcy scenarios arise.

WHAT ADVICE CAN YOU PROVIDE TO BANKRUPTCY PARTIES SEEKING TO RECEIVE LITIGATION FINANCING?

Parties should involve legal finance providers in the early stages of plan negotiations. Parties ideally should approach litigation finance providers when it becomes apparent there are significant potential litigation claims. Instead of releasing claims against management, advisors, former owners, and other third-parties at a significant discount to generate cash to pursue litigation, litigation finance can provide capital for litigation and bankruptcy administration to pursue the full value of those claims (and others). This benefits creditors by:

- Preserving as many claims as possible.
- Potentially obtaining more advantageous pricing for non-recourse finance.

If litigation finance is provided to an estate or a litigation trust's full book of low and high-risk claims, it can reduce the cost of litigation finance compared to financing a single, high-risk case. That benefit can inure to creditors in multiple ways, including lowering the cost of capital and potentially shortening the duration of recovery for creditors.

It is also crucial to emphasize that litigation funders are not interchangeable. A bankruptcy practitioner should engage finance providers with both litigation and bankruptcy expertise to properly structure and document transactions to align with the interests of creditors. Particularly in the bankruptcy context, parties should have confidence that the funder has:

- Available, perpetual capital provided by institutional investors.
- The ability to fund over time.
- The staying power to continue funding through potentially long-duration matters.

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