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THIRD PARTY LITIGATION FINANCE AND ITS IMPACT ON THE BANKRUPTCY INDUSTRY

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Third-party litigation funding is a multibillion-dollar U.S. industry in which investors help litigants and law firms pay legal fees and expenses in exchange for a return from a winning case or cases. It seems a natural fit in bankruptcy matters, with creditors vying for limited resources and liquidity-constrained debtors seeking a lifeline to preserve whatever value remains in their enterprises. So, what role does litigation finance play in today's bankruptcy world? And what role will litigation finance play in the future?

Litigation Finance's Historical Significance in Bankruptcy

To begin with, it helps to understand the size of the litigation finance market, which is small in comparison to the legal services market in the U.S. There are a few dozen commercial litigation funders globally, who together committed to invest an estimated $8.7 billion in commercial disputes over the last three calendar years.[1] It is now estimated that litigation finance companies, which include public companies, registered investment companies, and multi-strategy investment funds, control about $15.2 billion in investible domestic capital, with additional resources overseas.[2] While this number sounds impressive and has increased substantially in the past decade, it is a drop in the bucket when compared to the amounts litigants spent on legal fees and expenses every year in the U.S.

To date, most litigation finance money is put to work outside of the bankruptcy context. It is more commonly found in areas where litigation tends to be the most expensive, risky, long-lasting, and with the highest potential for damages. These factors make litigation finance an attractive option for individual and corporate plaintiffs and law firms seeking to externalize the cost and mitigate the unpredictability of their legal spend and are often attractive for patent, antitrust and non-bankruptcy commercial litigations with large-dollar stakes. These plaintiffs can preserve cash, lower their operating costs, and have greater pre-judgment profitability.

In comparison to the areas of litigation mentioned above, litigation finance in bankruptcy cases has been less prevalent over time. Although bankruptcies occur in all climates, historically low corporate default rates in recent years have limited the number of large-scale disputes and quality funding opportunities. Other challenging factors include the relatively rapid pacing of bankruptcy proceedings, which creates a mismatch with extensive diligence processes required by some litigation financing underwriters; a bankruptcy system that strongly encourages settlements and releases of causes of action; and vulnerabilities where resourceful existing creditors, including hedge funds, may use their leverage to direct value to themselves (and away from potential litigation finance-funded parties).

Litigation Finance's Growth with Distressed Companies and Bankruptcy

While litigation financing firms have not played a significant role with respect to bankruptcies and companies in financial distress to date, times <u>*are*</u> changing. Last year saw growth in high-profile cases, several of which are discussed below. Like rescue financing, litigation funding can be a critical lifeline for the preservation and creation of value. It continues to expand in the marketplace for entities in a variety of complicated circumstances.

Pre-Bankruptcy: Financially Distressed or Constrained Companies

Financial stresses related to litigation can have significant impacts on even the most well-capitalized companies, so the benefits of litigation financing for those in financial distress can be critical. Distressed companies that choose to use litigation financing may be faced with operationally material litigation costs, are typically unable to secure credit from traditional lenders, and often unable or unwilling to raise additional equity capital. Outsourcing legal expenses helps preserve liquidity and allows managers to reliably predict their cash flows, providing robust legal flexibility while smoothing out the inherent volatility of litigation. Without litigation funding, monthly legal bills can add up quickly and vary considerably depending on the stage of the case.

Recently, a financially distressed automotive business was able to obtain a commitment for litigation funding to pay the automotive business' legal fees and costs in a private transaction. The company's sales had been reduced to almost nothing due to the allegedly unlawful anti-competitive tactics of a larger competitor. The company had been unable to effectively seek redress and rebuild its business at the same time; however, it turned to litigation funding to preserve cash and help avoid having to file for bankruptcy, and it was successful.

Distressed companies can also use decisions about disclosure of litigation financing relationships to their strategic advantage. Having a litigation funder with an objective and knowledgeable viewpoint "in your corner" can be a powerful tool to drive meaningful settlements on the merits, often on an expedited timetable. While litigation is a distraction for any company, the time saved can be particularly valuable for a cash-constrained entity that needs to allocate maximum capital and management focus on satisfying investors and manufacturing, marketing, and selling its product. Some companies have even chosen to announce the presence of litigation financing to send a message to opposing parties. It *means* something to have a sophisticated litigation funder backing your claims with unknown millions in non-recourse financing -- and defendants recognize this.

Even those cases with strong merits but facing a prohibitively large imbalance of resources may take on a new character with the participation of litigation financing. For example, a litigation funding agreement was approved for a class action brought against Google and Meta for their alleged misconduct in on-line

[1] *2023 Litigation Finance Market Report*, Westfleet Advisors, April 1, 2024, https://www.westfleetadvisors.com/publications/2023-litigation-finance-market-report/.

[2] Ibid.

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advertising.[3] The claim was brought by Crowsnest Pass Herald, a struggling Alberta newspaper with a limited circulation, on behalf of all similarly situated web-publishers. One can hardly imagine this small plaintiff taking on two of the most formidable legal opponents without assistance.

For those who opt *not* to disclose the presence of funding, the overwhelming majority of U.S. jurisprudence dictates that the arrangement is likely to be shielded from discovery and not provide public distraction (at least outside of a chapter 11 proceeding). The subject of disclosure of litigation finance agreements is nuanced and beyond the scope of this article.

Post-Bankruptcy: Litigation or Liquidating Trust Funding

Within the ecosystem of distress and bankruptcy, litigation funding is often used today by liquidating or litigation trustees who lack sufficient cash to fund administrative costs or pay for litigation. It is frequently the unsecured creditors that stand to benefit from litigation here. In some situations, affirmative litigation—where debtors or their successors are the plaintiff—may be the sole source of recovery. But turning litigation into cash requires an investment of capital to fund investigations and pay lawyers and litigation expenses. Absent funding, trustees are forced to find lawyers to work on full contingency (which is often difficult considering the type of litigation being pursued) or settle quickly at a material discount because the defendants will expect that the plaintiffs do not have sufficient funding to "go the distance" through trial and appeals. Litigation funding reduces the relative leverage of overpowered participants and evens the playing field for all parties.

Many (if not most) litigation trusts are governed by trust agreements negotiated as part of the plan process. They provide that litigation trustees—under the direction of a governing body—may commence and settle claims without the need for a court order. However, some litigation trustees seek the assurance of court approval. CAH Acquisition Company and certain of its affiliates—companies in bankruptcy in the Eastern District of North Carolina—provide an example.[4] The bankruptcy involves a rural hospital system that became insolvent as a result of fraudulent billing practices. The trustee (serving as a chapter 7 trustee and a litigation trustee, depending on the debtor) alleges that participants in the fraudulent scheme—including several executives of the debtors—used the debtors' critical access hospital designations to bill insurance companies for medical services performed at other facilities to receive higher reimbursement rates and distribute earnings to scheme participants as illegal kickbacks. The debtors have viable causes of action but did not have sufficient funds to pursue the litigation. After an extensive marketing process to secure litigation funding, the Bankruptcy Court presiding over the cases authorized the CAH entities to enter into a comprehensive litigation funding agreement. The funding provided is being used by the trustee to pursue claims against the debtors' former principals, as well as several laboratories and marketers, for their respective roles in the allegedly fraudulent billing schemes. Without litigation funding, the debtors' claims would likely have been undervalued or simply abandoned.

[3] *Pass Herald Ltd. v. Google LLC*, T-589-22, CanLii 2024 FC 305 (Federal Court of Canada Feb.26, 2024).

[4] *In re: CAH Acquisition Company # 1, LLC*, d/b/a Washington County Hospital et al, No. 19-00730-5-JNC, LexMachina 5:19-bk-730 (Bankr. E.D.N.C. Feb. 19, 2019).

Available Throughout: DIP Funding, Working Capital and Claims Monetization

As the use of litigation funding continues to grow with distressed companies and bankruptcy participants, litigation finance companies (and, frankly, other lenders, shareholders and creditors) are now beginning to successfully experiment with law firms and debtors in more bespoke and creative ways.

Litigation finance has been used in several cases for debtor-in-possession (DIP) financing, working capital, and claims monetization. A recent example of DIP financing is the NS8 case involving a company that filed for chapter 11 after claimed "deception and fraud" of its co-founder and former CEO threw the operations into turmoil.[5] The debtor sought up to $10 million in DIP financing, with a portion specifically allocated to pursue claims related to malfeasance. The Chief Restructuring Officer, in its application to the court, stressed that "the Debtor's most valuable assets do not consist of inventory, accounts receivable, intellectual property or other assets associated with the operation of their business, but instead, are comprised of unliquidated litigation claims." One differentiating factor in this case is that the lender's collateral consisted of not just the future litigation recoveries, but recoveries from the estate more generally. In addition to situations where legal claims support DIP financing by lenders, there are several instances where legal claims support the funding of legal proceedings and working capital.[6]

The bankruptcy of *In re MLCJR LLC* (the Cox Oil case) in the Southern District of Texas, which occurred in late 2023, is another important example of the participation of litigation funders in the bankruptcy market.[7] The debtor, an oil and gas company, suffered damages before its bankruptcy when a cargo ship owned by another company veered off course and collided with one of Cox Oil's offshore drilling rigs. Here, an investment banker representing Cox Oil was able to separate and successfully market the company's valuable litigation assets to a universe of sophisticated litigation funding acquirers. Unlike the past, today's companies in bankruptcy have access to a mature marketplace of highly capitalized buyers who can calculate the market value of litigation assets, finance and acquire them in full, and provide immediate capital to the debtor. In this case, a well-resourced affiliate of Burford Capital was the leading bidder, which changed the tenor of negotiations between the original litigants and ultimately led to an advantageous settlement at an amount informed by the market-driven value of the asset.

[5] *In re: Cyber Litigation Inc.*, No. 20-12702-CTG, LexMachina 1:20-bk-12702 (Bankr.D.Del. Oct. 27, 2020).

[6] *In re: Burtonsville Crossing LLC*, No. 21-10491-MCR, and *ElderHome Land, LLC*, No. 21-10492-MCR, LexMachina 0:21-bk-10492 (Bankr.D.Md. Jan. 5, 2021); *In re: Odyssey Contracting Corp.*, No. 17-35898, LexMachina 2:15-bk-22330 (Bankr.W.D.Pa.) (where a portion of the financing was made available to the debtor as working capital).

[7] *In re: MLCJR LLC*, No. 23-90324, LexMachina 4-23-bk-90324 (Bankr.S.D.Tex. May 14, 2023).

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Claim monetization is the fastest growing use of proceeds for litigation finance clients.[8] There are examples of funders purchasing claims from litigation trusts with ongoing litigation, or litigation they have won, but is being appealed.[9] Some circuits have explicitly authorized the sale to third parties and others have been less clear. A recent decision from the United States Court of Appeals for the Fifth Circuit *In re South Coast Supply Co.* supports this trend. Here, the Fifth Circuit held that preference claims arising under section 547 of the Bankruptcy Code may be sold. The Fifth Circuit issued a thoroughly reasoned opinion that joined other circuits in authorizing the sale of preference claims.[10]

The Future Role of Litigation Funders in Bankruptcy

There is reason to believe that litigation finance will play an increasingly important role in the bankruptcy process, especially during the next economic downturn and tighter lending environment. For one, litigation funders are managing more investment capital than ever before and looking for places to invest, including the distressed market. Secondly, plaintiffs and law firms are better educated and have become more comfortable with litigation funding. Concerns that previously clouded the marketplace, like standardizing processes for confidential client communications when a funder is involved, or misplaced fears that a funder would look to exert control over the litigation, have largely been resolved.

Most users of litigation finance report a positive experience and would use it again.[11] And as the industry has built scale and a healthy track record of success, those lawyers who were once reluctant to recommend litigation finance to their clients are now embracing this financing tool to help win new business. When individuals and corporate clients are in financial distress and stop paying their lawyers on a timely basis, litigation funders are best suited to step in to provide a workable solution—the best alternative to pausing an important claim (or even abandoning it) while preserving much needed liquidity. Lastly, creditor-on-creditor violence through liability management transactions and otherwise is not a new phenomenon, but it seems more prevalent and fiercer than ever before.[12]

Perhaps most importantly, vendors, employees, and other unsecured creditors should have the means to assert their legal rights in court regardless of their financial resources. The existing dynamic gives the power to the prepetition lenders, or the DIP lenders, regardless of the value of the claims to be pursued. It remains rare that a bankruptcy court will grant standing to an unsecured creditor committee even when there is a conflict and appearance of potentially viable claims. Historically, there have been few options to solve for that asymmetry, particularly since these groups are relying on limited and competitive estate resources to conduct their investigation and prosecute claims. Under the existing dynamic, junior creditors trade away potentially valuable claims at the outset of the case without having an opportunity to vet them, much less prosecute them. Litigation finance has the potential to reposition that power dynamic.

Conclusion

Litigation finance has the potential to change the balance of power between creditors and debtors. Unsecured creditors are typically under water: their litigation claims may be the only potential source of recovery, litigation is expensive to monetize, and without cash, the value of litigation claims is significantly impaired. These factors combine to make it difficult for unsecured creditors to maximize value from a distribution of litigation assets without litigation funding.

Litigation finance's presence in the bankruptcy industry is in its early stages. However, given the overall size of capital that litigation funders control and how this capital is deployed across case types, its presence in the marketplace will continue to expand -- particularly as the market becomes more familiar with the process, funders grow comfortable with investing in the distressed debt market, and the pace of corporate filings increase in the next economic downturn. Forward-thinking firms are preparing for these changes as we speak, developing smart internal processes, updating guidance to clients, and establishing strong litigation financing relationships to meet coming opportunities without delay.

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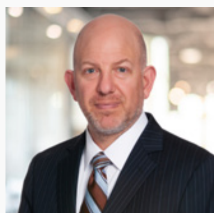
Ken is a Senior Investment Manager and Legal Counsel at Omni Bridgeway, responsible for leading the company's US initiatives in bankruptcy and insolvency-related matters. For over 20 years, he has successfully combined legal and finance expertise to help solve problems and add value for companies, lenders, and investors. Ken works closely with individuals, corporations, and law firms to provide funding and risk management strategies for distinct claims or claim portfolios. He has extensive experience advising chapter 11 debtors, creditors and estate representatives in complex debt restructurings and insolvency disputes. Many of Ken's current matters involve cross-border judgment enforcement and monetization for creditors.



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[8] 2023 Litigation Finance Market Report, Westfleet Advisors, April 1, 2024.

[9] *In re: Magnesium Corp. et al*, No. 01-14312-MKV, LexMachina 1:16-cv-06844-AJN (S.D.N.Y. Oct. 7, 2016).

[10] *Capital Working Fund Capital, LLC as assignee of South* Coast Supply Company v. Remmert, No. 22-20536, LexMachina 4:18-CV-02867 (U.S.D.C. 5th Cir. Jan. 22, 2024).

[11] 2023 Annual Report, Burford Capital LLC, March 28, 2024, https://investors.burfordcapital.com/financials/annual-reports/default.aspx.

[12] Dan Roe, "Help, the Lenders Are Fighting Again: Creditor Violence Driving Demand in Bankruptcy, Litigation Practices," The American Lawyer, April 22, 2024, https://www.law.com/americanlawyer/2024/04/22/help-the-lenders-are-fighting-again-creditor-violence-driving-demand-in-bankruptcy-litigation-practices/.