Funding the Post-Confirmation Trust When the Well Runs Dry

By Ken Epstein, Investment Manager/Legal Counsel, Bentham IMF

The average duration of large, public company bankruptcies has fallen sharply since the financial crisis. Remarkably, it took just over seven months in 2017 to administer a case.[1] While this trend lowers costs and provides other benefits to the bankruptcy estate, it means that unsecured creditors must act quickly to protect their interests. The rapid pace affords little time for the investigation, development, and prosecution of avoidance and other causes of action, or the negotiation and settlement of claims against the bankruptcy estate. Yet it's these very efforts that often form the basis for unsecured creditors' recoveries.

Post-confirmation liquidation and litigation trusts, established under a plan of reorganization pursuant to Section 1123(b)(3)(B) of the U.S. Bankruptcy Code, are used with increasing frequency to help provide value to unsecured creditors. Governed by state laws, a trust can handle the entire winddown process, as is the case with liquidating trusts, or just the prosecution and/or defense of claims, as is the case in litigation trusts. In a complex bankruptcy case requiring extensive post-confirmation work, multiple trusts may be created.

No matter the scope, it's crucial that a trust be well-funded so the trustee and its professionals can carry out their duties effectively. Seed funding from a debtor may provide sufficient funds to investigate and commence litigation but provide little for the remaining life of the case. Additional funding is often unavailable or difficult to obtain. In this context, litigation funding may be an option, either in conjunction with or in lieu of contingency counsel.

Filling the Void

When there is little money in the bankruptcy estate to prosecute causes of action, trustees frequently turn to contingency counsel to provide legal representation in exchange for a portion of settlement or judgment proceeds. Until recently, this was the primary option available when the trust estate's liquidity was tight and traditional sources of capital were inaccessible. Now, a robust market for litigation funding exists in the U.S., providing an alternative for financing recovery efforts.

Litigation funding can be a cost-effective way to finance an individual case. For a trust administering multiple litigation assets, it may be possible to bundle litigation claims together to obtain more favorable rates. As with contingency fee arrangements, litigation funding is nonrecourse to the client. If the case is unsuccessful, the debtor or trustee owes nothing to the litigation funder. In addition to financing estate litigation, litigation funding can offer the trust estate:

- **Protection against defendants who can outspend the estate representative.** A well-financed plaintiff can litigate and negotiate from a position of strength. It can wait for the best time to settle a case or proceed with confidence if it believes the other side is being unreasonable. A defendant may be less likely to

engage in dilatory tactics when it knows a plaintiff is under no financial pressure to settle. When optics are important, having flush coffers can send a very strong message to opposing parties.

- **The use of litigation funding for other purposes.** In some circumstances, a debtor-plaintiff may be able to use funding proceeds to help finance its bankruptcy case. In addition, if the litigation asset is valuable enough, litigation funds may be used to pay the administrative costs of the litigation or liquidating trust, to investigate additional potential sources of recovery for unsecured creditors, to pay financial advisors and other professionals, or to find other assets and enforce judgments against unrelated judgment debtors.

- **The ability to retain the estate representative's chosen law firm or expert.** A debtor or trustee may want to use a law firm with whom it has an existing relationship, or retain a law firm or a consulting or testifying expert that does not work on contingency. Litigation funding may provide a trustee with more choices and flexibility, both upon initial engagement and during the pendency of the case.

- **The option to cash out and shed risk from an existing litigation or appeal.** A trust estate may be able to prosecute a claim without putting its own money at risk by hiring contingency counsel or by obtaining litigation funding. However, only a litigation funder will help a claimant monetize an existing litigation or cash out a portion of a recent judgment to reduce stress and the risk that the ruling may be reversed or reduced. In addition, it may be possible to obtain an upfront cash payment from a litigation funder in exchange for the right to fund a meritorious litigation. *In re Complete Retreats, LLC*, No. 06-50245, 2011 WL 1424579 (Bankr. D. Conn. 2011).

- **A fresh, experienced point of view.** Funders bring more than capital to the table. Reputable litigation funders have extensive experience in evaluating the merits of a litigation claim. Because funders conduct rigorous due diligence in evaluating a claim as a possible investment, they provide a fresh analysis and perspective. In a trust scenario, this independent analysis can help justify the pursuit of claims and help trustees make more informed decisions about the claims they are considering.

While the body of law is still developing, Bankruptcy Courts have found litigation funding to be beneficial to the bankruptcy estate in a number of cases. See *In re Land Resource*, 505 B.R. 571 (Bankr. M.D. Fla. 2014), *In re Complete Retreats, LLC,* No. 06-50245, 2011 WL 1424579 (Bankr. D. Conn. 2011).

Not surprisingly, challenges to these agreements often arise in the post-confirmation context when a debtor or trustee is seeking funding to prosecute avoidance and other actions. See *In re Motors Liquidation Co.*, 555 B.R. 355 (Bankr. S.D.N.Y August 2016), *In re Complete Retreats, LLC*, No. 06-50245, 2011 WL 1424579 (Bankr. D. Conn. 2011), *In re Transcapital Financial Corporation*, 433 B.R. 900 (Bankr. S.D. Fla. 2010).

While the body of law is still developing, Bankruptcy Courts have found litigation funding to be beneficial to the bankruptcy estate in a number of cases.

Though it may depend on the circumstances of the bankruptcy case, post-petition litigation funding is typically reviewed by the Bankruptcy Court under a broad standard of reasonableness. *In re Superior National Ins. GR*, 2014 WL 51128 (U.S. Bankr. Ct. C.D. Cal. Jan. 7, 2014), *Davidson Kempner Capital Mgmt. LP v. Official Committee of Unsecured Creditors of Motors Liquidation Co.* (*In re Motors Liquidation Co.*), 2017 WL 3491970, at *8 (S.D.N.Y. Aug. 14, 2017).

Practice Tips

Whether pre- or post-confirmation, claimants and practitioners should be familiar with the key issues that are likely to arise when litigation funding agreements are used in bankruptcy. Here are a few things to keep in mind:

- **Securing witnesses and records.** One of the biggest challenges a post-confirmation trustee may face in prosecuting a prepetition claim is the disappearance of critical fact witnesses and missing books and records necessary to support prosecution of a case. This may be more or less of an issue depending on the nature of the claim being pursued. It may also be an area of inquiry for funders trying to assess the risk of a particular investment opportunity. Bankruptcy court jurisdiction over post-confirmation matters may also be more limited than preconfirmation. A liquidating trustee may exercise some, but not all, of the powers of a bankruptcy trustee or debtor in possession. See Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6-7 (2000) (only a trustee or debtor in possession, which is cloaked with the powers of a trustee, may invoke the right to surcharge collateral under 11 U.S.C. 506(c)). Thus, time is of the essence.

- **Synchronization of the trust agreement and plan documents.** The trust agreement should work in concert with the confirmation order. The trustee must be vested with the discretion to investigate and pursue all potential causes of action, subject to proper trust governance. The more detail provided in the trust and plan documents, the better it is from a claims preservation and standing perspective. To set appropriate expectations about the potential use of alternative financing arrangements and to prevent headaches down road, the plan and trust documents should provide a clear road map for the use of financing. Specifically, the documents should authorize the use of alternative financing arrangements, spell out in detail the approval process, and clarify the trust's ability to pledge litigation proceeds as collateral. See *In re Superior National Insurance*, 2014 WL 51128 (2014) (holding that the estate representative must obtain bankruptcy court approval for each individual funding request).

- **Getting the funding agreement approved.** In many circumstances it is necessary or appropriate to get Bankruptcy Court approval before entering into a litigation funding agreement. Most funding agreements have standard confidentiality provisions that may need to be modified in the bankruptcy context. It's a good idea to inquire whether a potential funder has experience in Bankruptcy Court. In a post-confirmation context, where a trust estate is established and operating with oversight from a committee or governing board, the need for court approval should be evaluated on a case-by-case basis. A lawyer should work with the litigation funder to determine the best course of action. Consideration should also be given to the choice of law provision in the litigation funding agreement, as champerty and maintenance laws remain on the books in several states.

- **Extending the work product privilege to litigation funders.** Most litigation funders will want to enter into a nondisclosure agreement before nonpublic information is shared with them so the confidential nature of the attorney's work product can be maintained. A body of law supports the extension of attorney-work product protections to litigation funders. *Miller v. Caterpillar,* 17 F. Supp. 3d 711, 735 (N.D. Ill. 2014). As a separate matter, the confidentiality of attorney-client communications shared with litigation funders requires special consideration. Many funders prefer not to receive confidential information of this type and believe it is not necessary to make an informed investment decision.

- **Assuaging concerns about relinquishing control of the litigation.** The practitioner or client may worry about losing control of a litigation once a litigation funder gets involved in a case. In the U.S., however, it is not the practice of litigation funders to take control of the cases they finance. A litigation funder will not dictate the client's choice of counsel, mandate settlement, or otherwise direct case strategy. Every litigation funding agreement should be structured to ensure control is maintained by the client and that the interests of the client and the litigation funder are properly aligned.

- **Learning about the bankruptcy estate's prospective litigation funder.** A lawyer recommending that a client consider litigation finance should check out the *bona fides* of the litigation finance company before making a recommendation. A trustee may be obligated to seek bids from multiple funders. Given that some cases take years to resolve, an estate representative should be reasonably sure that the litigation funder will be able to meet its financial commitments for the duration of the case.

Growing Source of Financing

Commercial litigation finance is expanding and is likely to continue to gain ground as bankruptcy professionals become more comfortable with this form of financing. Proper planning and awareness of key issues relating to funding will help practitioners use this tool wisely to help maximize recoveries to their clients.

---

1. UCLA-LoPucki Bankruptcy Research Database, Average Duration of Large, Public Company Bankruptcies Concluded 2007-2017.

About the Author

Ken Epstein is an investment manager and legal counsel at Bentham IMF, a global commercial litigation funder. He leads the company's investments in bankruptcy and insolvency-related matters and serves as a resource for debtors; creditors, including hedge funds, private equity funds, and alternative asset managers; bankruptcy estate representatives; and other stakeholders seeking to pursue litigation claims.