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Expert Analysis

Litigation Funding: An Essential Tool for Maximizing the Value of the Debtor's Estate

By **Kenneth Epstein**

And **Eric B. Fisher**

Perhaps now more than ever unsecured creditors face an uphill battle to obtain a meaningful recovery in most corporate bankruptcy cases. The debtor's assets are typically "liened up" well in advance of a bankruptcy filing, leaving little value unencumbered for anyone other than senior lenders. The trend in many commercial bankruptcy cases is towards a quick auction of the debtor's assets,[1] meaning that, after secured lenders are paid from the asset-sale proceeds, the likelihood of unsecured creditors receiving meaningful value under a plan of reorganization or liquidation may be remote.

When there is no available cash to pay them under a plan, unsecured creditors may be assigned the rights of a debtor to bring avoidance actions and other litigation claims against third parties. These litigation assets possess real value only when there are resources available to prosecute the claims aggressively to yield meaningful settlements or judgments for the benefit of unsecured creditors. Without these resources, a debtor may be unable to bring a claim or may be forced to settle a claim for less than full value. It can be a challenge to finance bankruptcy estate litigation when the debtor's remaining resources, after payment of senior creditors, are needed for the bankruptcy estate's wind-down and claims-administration expenses.

Third-party litigation funding promises to become a more regular feature in bankruptcy litigation, just as it has become more prevalent in general civil litigation.

Litigation funding is a tool for unlocking the value of a bankruptcy estate's litigation claims when the estate itself lacks the resources to pursue the claims and traditional sources of financing are not available. It can be used by any party pursuing a claim for the benefit of the estate: the debtor, creditors' committee or trustee—and at any stage in the case, both before and after confirmation of a plan of reorganization or liquidation. This article offers an overview of commercial litigation funding in the bankruptcy context.

Overview of Commercial Litigation Funding

As most litigators now know, litigation funding is an investment in the outcome of a litigation made by a third party. Through a litigation funding transaction, a party to a litigation secures capital from a funder based on the anticipated future value of the litigation. When litigation counsel is hired on a contingent fee basis, litigation funding can be used to pay for disbursements, like expert witness and e-discovery costs; and when litigation counsel's fee arrangement is not a pure contingent fee, then litigation funding may be used for counsel's fees as well. Simply put, litigation funding may afford the bankruptcy estate representative greater flexibility in hiring the lawyers and advisors of their choice.

Litigation funding can be used in the bankruptcy context to fund any type of action that creates an opportunity for significant recoveries for the estate. In addition to the more typical preference and fraudulent transfer claims, litigation funding may also be used to support the

KENNETH EPSTEIN *is an investment manager and legal counsel at Bentham IMF, a leading global litigation funder.* ERIC B. FISHER *is a partner with Binder & Schwartz, a litigation boutique with a diverse practice that includes complex bankruptcy litigation matters.*

prosecution of breach of fiduciary duty claims, malpractice claims, tax claims, commercial tort litigation, insurance claims and any other claim that could yield value for the estate.

If a case financed by a litigation funder is resolved successfully through settlement, award or judgment, the funder is repaid its initial investment and an agreed-upon return. Should the outcome be unfavorable for the litigant, the litigation funder is owed nothing. In the United States, litigation funders do not take control of the cases that they fund. For example, a litigation funder will not control its client's choice of counsel, mandate settlement or direct case strategy. While a litigation funder may have an opinion on each of these matters, ultimately it is left up to the client to decide.

Litigation funding can help level the playing field when an estate representative is up against well-heeled defendants seeking to use their greater resources to drive a settlement unfavorable to the estate. In this circumstance, with money in its coffers, the estate representative can litigate and negotiate from a position of strength.

If the litigation asset is valuable enough, it may be possible for an estate representative to obtain and use funding in ways unrelated to a particular case. For example, excess funds from a litigation funder can be used to pay the administrative costs of the trust, to investigate additional potential sources of recovery to creditors, to pay financial advisors and other professionals who are unwilling or unable to share risk in the case, or to find assets and enforce judgments against judgment debtors.

It may also be possible to guarantee a minimum recovery to the estate from a particular litigation asset. For example, in *In re Complete Retreats*, No. 06-50245, 2011 WL 1424579 (Bankr. D. Conn. 2011), the liquidating trustee entered into an option agreement with its litigation funder whereby, subject to court approval, the litigation funder paid the trustee an option premium for the right to fund the trustee's fraudulent conveyance action. The option premium ensured a minimum recovery to the estate and also secured funding to prosecute the litigation. The defendants to the fraudulent conveyance action filed an objection to the trustee's motion for approval of the agreement on the grounds the funding agreement was champertous and against public policy. In overruling the defendants' objection, and approving the funding agreement, the court held that securing a minimum recovery to the estate was clearly in the estate's best interest, and that the agreement was not champertous or against public policy. Id. at *3.

> Bankruptcy estate professionals, including lawyers, trustees and receivers, should remain alert to issues concerning litigation funding, to ensure that they deploy this tool when it can best be used to maximize the value of the debtor's estate.

Established, reputable litigation funders have broad experience and expertise in evaluating the merits of a litigation claim. Because funders conduct rigorous due diligence in evaluating a claim as a possible investment, they may be more objective in evaluating its value to the estate. In a trust scenario, this independent analysis can help justify the pursuit of claims, and help trustees, receivers and other estate representatives make more informed decisions about the claims they are considering.

The Bankruptcy Context Provides Rigorous Oversight of Funding Arrangements

A recent survey conducted by Law360 found that, while lawyers in general have mixed feelings about litigation financing, lawyers who have actual experience using this type of financing view it favorably.[2] Those reporting negative views gave no specific reasons, but an oft-cited concern is that funders may have motivations that are not fully disclosed and that may incline them towards resolutions that are not necessarily in the best interest of the litigant. While this concern is based on misconceptions about litigation funding, it is particularly the case that the concern is alleviated in the bankruptcy context.

During the pendency of a Chapter 11 case, there is a high degree of transparency required of the debtor, and the debtor's actions are overseen by multiple parties, including the bankruptcy court, the U.S. Trustee's office, creditors (secured and unsecured) and other stakeholders. Non-ordinary course agreements, like litigation funding agreements, entered into by the debtor post-petition, must be disclosed and are subject to approval by the bankruptcy court. The approval process typically involves an opportunity for parties in interest to object to the funding agreement and for the court to rule on that objection.[3] The likelihood that an estate or its professionals would enter into an imprudent agreement are lessened because of this oversight. The bankruptcy process protects not only the estate but also the funders. Funders take comfort in entering into an agreement that has been thoroughly vetted and approved by a court.

Most of the bankruptcy decisions involving litigation funding have arisen post-petition when a party in interest objected to a trustee's motion to approve a litigation funding agreement between the trust and a commercial funder. Though it may depend on the circumstances in the particular bankruptcy case, post-petition litigation funding will typically be reviewed by the bankruptcy court under a broad standard of reasonableness. *In re Superior National Ins. GR*, 2014 WL 51128, at *3 (U.S. Bankr. Ct. C.D. Cal. Jan. 7, 2014) (business judgment standard applied to review post-confirmation third-party funding of litigation trust). For example, in *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),[4] the district court approved litigation funding provided by U.S. Treasury and Export Development Canada over the objection of a hedge fund that claimed that the financing it had offered to the plaintiff was less expensive than the government funding. Applying a reasonableness standard under Rule 9019 of the Bankruptcy Code, the district court rejected this challenge and affirmed the bankruptcy court's approval of the litigation funding supplied to the estate by the government. See also *In re Tropicana Entertainment*, Case No. 08-10856 (KJC) (U.S. Bankr. Ct. D. Del. Jan. 20, 2017) (approving post-confirmation funding for the litigation trust).

Section 364(c) of the Bankruptcy Code, which concerns court approval of liens granted against the debtor's property, may apply if the funding is secured by estate property. Most third-party funders seek a security interest in the proceeds of the litigation they are funding. Accordingly, it also may be important to insist on a subordination or other inter-creditor agreement between the third-party funder and other secured creditors of the estate to ensure clarity and avoid possible disagreements down the road. Funders will typically require this to protect their investment.

As litigation funding becomes more prevalent, it may be supplied by third parties through structures that are different from a typical loan, if an alternative structure will help to meet the needs of the case. Other sections of the Bankruptcy Code will thus also likely come into play. For example, §363(b)(1) may be applicable if the funding is essentially a sale of the estate's claim to a third party. As a recent illustration, Gerchen Keller, now part of Burford, purchased an interest in a fraudulent transfer judgment against defendants in the Renco bankruptcy, in a transaction that was approved as a §363 sale under the Bankruptcy Code. This sale structure helped the bankruptcy trustee to ensure a minimum recovery to the estate's creditors while also funding the trustee's continuing litigation of the case on appeal.

In addition to the oversight and court approval process, the interests of the estate in litigation are also protected in bankruptcy court by the legal duties imposed on the debtor's estate and its representatives. Bankruptcy trustees and receivers have duties set forth under the bankruptcy code and are obliged to act in the estate's best interest. As a fiduciary, the estate representative must maintain control over the litigation and cannot cede control to the funder. Thus, while some litigation funding arrangements may give greater input and monitoring rights to the funder than other arrangements, in the bankruptcy context, acceptable arrangements will likely be strict about ensuring the estate's complete control over the litigation. See, e.g., *In re Land Resource, LLC v. Meininger*, 505 B.R. 571, 576 (M.D. Fla. 2014) (approving litigation funding agreement and noting that "Trustee would maintain ultimate control over the prosecution").

Conclusion

Third-party litigation funding promises to become a more regular feature in bankruptcy litigation, just as it has become more prevalent in general civil litigation. To this point, the Bankruptcy Code has proven flexible enough to address this phenomenon. Bankruptcy estate professionals, including lawyers, trustees and receivers, should remain alert to issues concerning litigation funding to ensure that they deploy this tool when it can best be used to maximize the value of the debtor's estate.

1. For one of the earliest quantitative studies and discussions of this trend, see Lynn M. LoPucki & Joseph W. Doherty, "Bankruptcy Fire Sales," 106 Mich. L. Rev. 1 (2007).
2. Cristina Violante, "What Your Colleagues Think of Litigation Finance," Law 360 (Dec. 11, 2017).
3. Because defendants in certain bankruptcy estate litigation are often also parties in interest in the Chapter 11 case, defendants also have standing to object to litigation funding. In those circumstances, courts will need to balance the need for transparency against the right of the estate representative to not have to disclose potentially sensitive information to defendants in active litigation. For example, in *In re Superior National Ins. GR*, 2014 WL 51128, at *4 (U.S. Bankr. Ct. C.D. Cal. Jan. 7, 2014), the bankruptcy court required that the estate representative review and approve all requests for litigation funding, but allowed the filing of portions of motions to approve funding under seal, so as to facilitate court review, while not providing the information to the defendants to the fraudulent transfer action.
4. Binder & Schwartz serves as counsel to the Motors Liquidation Company Avoidance Action Trust in the underlying litigation of *Motors Liquidation Company Avoidance Action Trust v. JPMorgan Chase Bank, N.A., et al.*, Case No. 09-00504 (MG) (Bankr. S.D.N.Y.).