# Portfolio Litigation Funding and its Use by Insolvent Estates

A Lexis Practice Advisor® Practice Note by
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This practice note discusses the benefits of portfolio litigation funding where the debtor's estate may lack the resources to fully pursue litigation, needs working capital, or wishes to de-risk litigation outcomes.

Litigation is one of the primary tools of the bankruptcy practitioner and serves a key role in driving settlements and recovering assets into the estate. Litigation is also extremely costly, which is a problem for debtors and others with limited financial resources, since adequate resources are crucial to maximizing claim value. A disparity in economic resources can be lethal, and lead to sub-optimal results like the abandonment of claims or settlements for pennies on the dollar, but this need not be the case. How, then, can a cash-strapped estate optimize its returns on outstanding claims?

One now-common practice of estate trustees and their counsel is to seek to mitigate such financial disparities by hiring legal counsel on a contingency basis. However, in many cases, this arrangement offers an imperfect solution. While a contingency fee arrangement may allow the trustee to bring claims he or she might otherwise be unable to afford, it can also limit the upside to the bankrupt estate.

Litigation funding offers an alternative: an insolvent estate can obtain capital from a third party to pursue its claims in exchange for a contracted rate-of-return. Funding is quickly becoming commonplace in the U.S. legal industry and is particularly well suited for debtors and trustees with multiple claims. As this article will demonstrate, in the right circumstance, it has certain clear economic and non-economic advantages over alternative financing options. While a number of important features about litigation finance are beyond the scope of this article, it is worth mentioning that litigation funders in the U.S. do not take control of the litigation. In other words, litigation funders do not control the client's choice of attorney, case strategy, or whether and when to settle a case. While a funder may have an opinion on each of these matters, ultimately it is left up to the client to decide.

This practice note addresses portfolio litigation funding as follows:

- How Portfolio Funding Works
- How Portfolio Funding Can Boost Estate Returns – A Comparison
- Who Can Benefit Most from Portfolio Funding
- Portfolio Funding and Contingency Counsel – A Hybrid Solution
- Conclusion

For related information on retaining counsel in a Chapter 11 bankruptcy proceeding, see Retaining the Debtor's Chapter 11 Professionals and Approval of the Debtor's Chapter 11 Professionals. For information on litigation in bankruptcy, see Adversary Proceedings.

## HOW PORTFOLIO FUNDING WORKS

Portfolio litigation funding operates a lot like single-case funding. A claimant can obtain capital from a third party to prosecute claims in exchange for a contracted return. Like with single-case funding, portfolio-case funding is non-recourse, allowing the claimant to bring substantial resources to bear against well-heeled defendants without putting any of its other assets at risk. Litigation funding can be used by a debtor, or any other party involved in an insolvency-related dispute. It is available for virtually any type of commercial litigation.

By bundling a diverse set of individual cases into a portfolio, funders see a lower risk investment opportunity. They may obtain their return from multiple sources, as opposed to just one. As a result, a funder will often charge a multiple on its deployed capital as opposed to a percentage of the litigation proceeds, an important distinction. If the litigation proceeds are expected to be large, this could enable the debtor or trust estate to keep significantly more money in its pocket.

The process for obtaining funding on a portfolio basis is also very similar to an individual case. The funder will seek to understand the nature of the claims, the potential defenses, and recoverable damages. With this information, and subject to further diligence and definitive documentation, the funder can provide the basic economic terms to the client. Upon agreement on the terms, the funder embarks on its diligence process. It is still commonplace for a funder to request a period of exclusivity—usually 30 or 45 days—during which the client agrees not to shop the deal to another funder. This gives the funder some comfort as it invests in due diligence that the prospective client is serious about exploring funding as an option.

Portfolio funding can provide several advantages to the estate over individual case funding, and/or hiring one or more lawyers on a straight contingency fee basis. These benefits include:

- The ability to choose the legal team(s), financial advisor(s), and expert(s) of its choice
- The flexibility to pay some advisors on an hourly basis and others on a contingency basis
- The ability to obtain substantial working capital
- The ability to use the funding proceeds to pay creditors early, finance defense-side costs and claims resolutions, and/or investigate the feasibility of bringing additional actions
- The alignment of interest between the litigant, the lawyer, and the financier

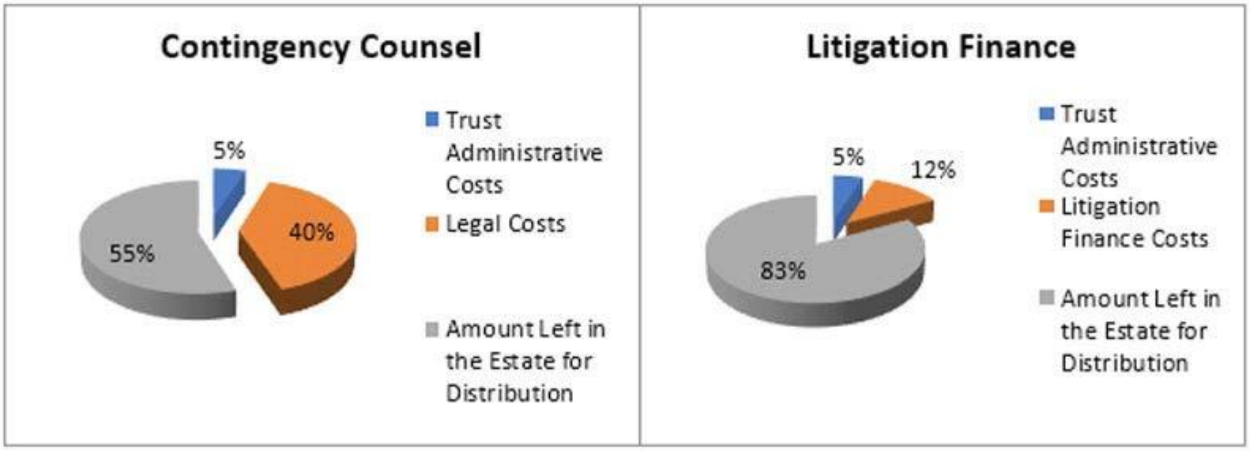
## HOW PORTFOLIO FUNDING CAN BOOST ESTATE RETURNS – A COMPARISON

Estate professionals may be presented with a number of financing options to prosecute claims and defray the economic risks associated with a litigation. The following hypothetical example highlights the importance of making wise financing choices when pursuing estate litigation.

Imagine a scenario where an estate could realize a total recovery of $50 million, but in order to do so it must bring multiple recovery actions. Assume that the estate will incur $2.5 million in administrative costs regardless of how it funds its claims, which it has, and that the estate will incur $2.0 million in hourly legal fees and associated litigation expenses to bring all necessary actions, which it does not have.

In this hypothetical, the estate might opt to pursue full recovery despite its financial limitations through one of two options. Under Option A, the estate could hire counsel on a contingency basis and pay them 40% of any recovery instead of hourly fees (saving $2.0 million in upfront costs). Under Option B, the estate could hire counsel on an hourly basis and also contract with a litigation funder so that the funder pays 100% of the total litigation fees and expenses (i.e., the $2.0 million) in return for 3x of the funder's deployed capital. Of course, the impact of the financing terms on estate and creditor recoveries is highly variable and will depend on the unique terms of the law firm engagement or third-party investment. But, as the table below shows, in this example, the estate keeps a greater portion of the litigation recoveries (Litigation Proceeds Recovery Rate) when portfolio litigation financing is used as compared to contingency counsel.

| **Litigation Costs for an Estate: A Comparison** | | | | |
|---|---|---|---|---|
| | OPTION A – Contingency Counsel | OPTION B – Litigation Finance | DIFFERENCE IN RECOVERY | Assumptions |
| Litigation Recoveries | $50,000,000 | $50,000,000 | | Creditor Body = 100 Creditors |
| Trust Administrative Costs | $2,500,000 | $2,500,000 | | 2% of recoveries |
| Costs of Contingency Counsel | $20,000,000 | $0 | | 40% of recoveries |
| Costs of Litigation Finance | $0 | $6,000,000 | | 3x Cost of Litigation, assumed to be $2.0 million |
| Amount Left for Distribution | $27,500,000 | $41,500,000 | $14,000,000 | Lit. Fin Recovery – Cont. Counsel Recovery |
| Amount Distributed to Each Creditor | $275,000 | $415,000 | $140,000 | Difference of Distribution Amount for Each Creditor |
| Litigation Proceeds Recovery Rate | 55% | 83% | 28% | Difference of Percentage Recovery to Creditor Body |




As the above calculations demonstrate, litigation financing is the more attractive financing option in this example. Both options allow the estate to pursue all its relevant claims without spending any money up front, and yet when the estate uses litigation funding, it retains some $14 million more (or an extra 28%) of the recovered assets as compared to the contingency counsel arrangement.

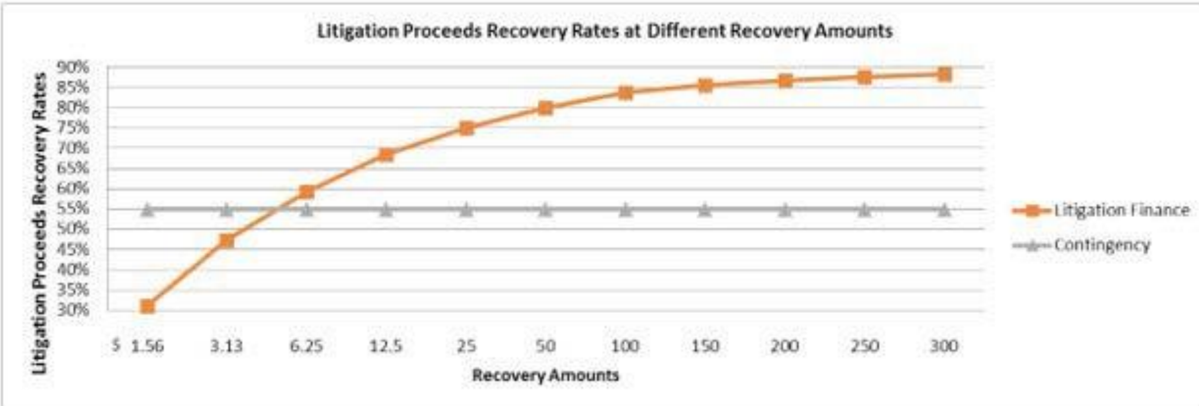
## WHO CAN BENEFIT MOST FROM PORTFOLIO FUNDING

A portfolio funding is likely to be most successful if it meets the following criteria:

- Multiple cases—usually three or more—are included in the portfolio
- Each of the cases has a strong probability of succeeding on the merits
- The portfolio contains diverse and unrelated claims and/or causes of action
- The defendants in the cases are unrelated and have low collectability risk
- The plaintiff, if successful, will be entitled to significant monetary relief
- The legal fees and costs will be significant—in excess of $3.0 million
- Legal counsel is sophisticated and has experience litigating similar matters

Put simply, portfolio funding tends to offer greater improvement on returns for an estate as potential recovery amounts rise—even assuming that such recoveries will require more legal fees and costs to pursue.

Let's revisit the above hypothetical but tweak it so that the estate's proposed litigation recovery ranges from $1.6 million up to $300 million. For these purposes, we can also assume that the total costs of litigating the cases are higher when the economic stakes are higher, so instead of the $2.0 million in costs discussed above, we adjust the total costs of the litigations at a rate of ½ the percentage of the change in recoveries. As the below table demonstrates, the greater the recovery, the more the estate keeps on a percentage basis when litigation financing is used, but the estate gets a better recovery under a contingency fee arrangement when the assumed recoveries fall below a certain threshold.




The inflection point will vary depending on cases involved and the terms of the engagements. Ideally, the set of cases pledged to the funder will be diverse. Different underlying claims, varying legal theories, and unrelated defendants are welcome factors and should reduce the risk of a zero recovery to the funder. Diversity among portfolio cases should allow the funder to provide more favorable terms.

## PORTFOLIO FUNDING AND CONTINGENCY COUNSEL – A HYBRID SOLUTION

Litigation funders and contingency counsel can and often do work together to finance cases. While potentially lucrative for outside counsel, representing a litigation trust on a contingency basis may involve putting significant funds at risk to pay for outside experts, discovery and court costs, and other expenses, with no guarantee that the firm will be repaid. If costs grow too onerous and litigation drags on, contingency counsel may feel pressure to spend less time and money on a case, potentially sacrificing on the quality of experts, to reduce their firm's financial exposure. With an injection of litigation funding, a debtor or trustee can shoulder its share of out-of-pocket costs, relieving the pressure on contingency counsel.

In addition, if a client needs working capital to operate its business while a litigation is pending, working with a litigation funder can help relieve a client of the pressure to take a lowball settlement offer. Contingency counsel that has already invested in several cases can also use litigation funding to monetize all or a portion of the fees it expects to receive to stopgap lumpy cash flows.

## CONCLUSION

The decision about whether to pursue a cause of action, and how vigorously to pursue it, should turn on the merits of the case and not the parties' financial resources. Litigation funding and contingency fee arrangements allow claimants in bankruptcy to finance a case when hourly fee arrangements are either not available or undesirable. In some circumstances, these two financing options can be used together to help maximize potential recoveries to creditors.

*The views expressed in this article are those of the authors alone.*

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Joel Cohen is a Managing Director in the Dispute Consulting group. Mr. Cohen comes to the firm with over 17 years of experience in the dispute, forensic, and insolvency practice areas, most specifically focused in the financial services and asset management industries. His experience encompasses a number of significant cross-border insolvency and litigation matters, where he has served as financial advisor and consulting expert to fiduciaries, offshore liquidators, bankruptcy, and litigation trustees. He has assisted these clients in a variety of litigation consulting services, including asset tracing, fraud, Ponzi schemes, industry custom and practice for investment managers, and forensic analysis. Mr. Cohen has also led several internal investigations within the context of family office, investment advisors, and various corporate structures.

Before joining Stout, Mr. Cohen was a Managing Director at a boutique financial advisory and consulting firm. Prior to that, he spent a number of years with a global financial advisory firm in its Dispute & Investigations group where he helped manage a team of CPAs, economists, attorneys, and finance professionals in executing a diverse array of complex engagements related to the various hedge fund/private equity fraud, insolvencies, and litigations that characterized the global financial crisis of 2008-09.

He was a leader in the disputes practice at a Big 4 accounting firm and senior vice president at a prominent investment bank in charge of internal investigations. Mr. Cohen has worked with premier law firms on accounting malpractice, business insurance disputes, fraud detection, and economic investigations.

Mr. Cohen has expertise in managing the expectations of various stakeholders involved in insolvency proceedings, liquidations, litigation settlements, and receiverships, namely in his capacity of assisting a board, trustee, receiver, or official liquidator with their duties, including U.S. and cross border considerations. He has extensive experience within the offshore world, regularly handling cases out of the Caribbean.

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Ken has experience advising debtors, creditors and other stakeholders in insolvency and bankruptcy-related matters nationally and internationally. He is certified as an insolvency and restructuring advisor and holds the CDBV designation from the AIRA. Ken has taught bankruptcy law as an adjunct professor at Cardozo Law School, authored numerous articles on bankruptcy-related topics and testified on several occasions before the Michigan House of Representatives, Financial Liability Reform Committee. Ken earned his J.D. from Brooklyn Law School in 2000, where he graduated cum laude.