Practical Guidance

A Trustee's Choice: Hire Contingency Counsel or Use Litigation Funding

A Practical Guidance® Article by
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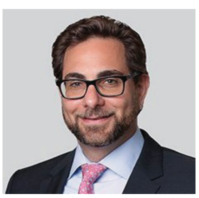

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This article discusses a Chapter 7 trustee's choice between hiring litigation counsel on contingency fee versus pursuing a plan to use litigation funding to pursue bankruptcy claims. This is quickly becoming one of the busiest years for Chapter 11 filings since the Great Recession. And with so many companies filing for bankruptcy without much time to prepare, litigation is an inevitable result. Many of these disputes will be handled by Chapter 7 Trustees and post-confirmation estate representatives, charged with wrapping up insolvent estates and maximizing recoveries to creditors. These representatives have important duties and face difficult choices, including whether to bring litigation and how to finance it.

Litigation is extremely costly, which presents an obvious difficulty for parties with limited financial resources. At the same time, no trustee wants to abandon valuable claims or accept a lowball settlement. To solve this problem, trustees typically turn to contingency counsel to litigate cases in exchange for a percentage of the recoveries. Contingency fees vary widely, but they are often 30%–55% of recoveries. While contingency arrangements do allow claims to proceed, they have certain limitations that fiduciaries must consider. Litigation funding—and, in particular, portfolio litigation funding—offers an alternative to a traditional contingency fee arrangement under certain conditions.

For more information on litigation funding in general, see Portfolio Litigation Funding and its Use by Insolvent Estates. For information on litigation in bankruptcy proceedings, see Adversary Proceeding.

How Litigation Funding Works

Litigation funding enables claimants to obtain capital from a third party to prosecute claims in exchange for a contracted return, typically a multiple on the deployed capital or a percentage of the litigation recovery. It is nonrecourse, allowing the claimant to bring substantial resources to bear against well-heeled defendants without putting any other assets at risk. Litigation funding is available for virtually any type of commercial litigation. It can be used by debtors, or any other parties involved in insolvency-related disputes. Deployed funds can be used not only to pay attorney's fees and litigation costs but also for working capital or other uses, for example, paying creditors early. This unique aspect of litigation funding thus enables the trustee to simultaneously fulfill the trustee's duty to creditors that wish to play the "long game" and to creditors who want to take early money, forgoing all or a piece of the upside down the line.

Another key benefit of litigation funding is that it enables claimants to use their first-choice counsel. In the insolvency setting, this can be particularly important because not every law firm that represents a creditor group pre-confirmation is able to take matters on contingency. Counsel to the unsecured creditors committee or a group of bondholders are usually very familiar with the issues involved in litigation and may want to remain involved. When the trustee has to engage new counsel to handle litigation on a contingency basis, they may have to start from scratch. While important legal and ethical considerations are beyond the scope of this article, it is worth mentioning that litigation funders are not able to control the client's choice of attorney, case strategy, or whether and when to settle a case. Thus, a trustee need not worry about abdicating its fiduciary duties or professional responsibilities in these respects by entering into a litigation funding arrangement.

How Portfolio Litigation Funding Works

Portfolio litigation funding has much in common with single-case funding. Portfolio funding enables claimants to obtain capital from a third party to prosecute multiple claims against multiple defendants in exchange for a contracted return across a set of cases. Just like single-case funding, portfolio funding is nonrecourse, applicable to commercial litigation, available for insolvency-related disputes, and funds can be used for litigation costs or other purposes. Like single-case funding, portfolio funding likewise permits claimants to engage their first-choice counsel.

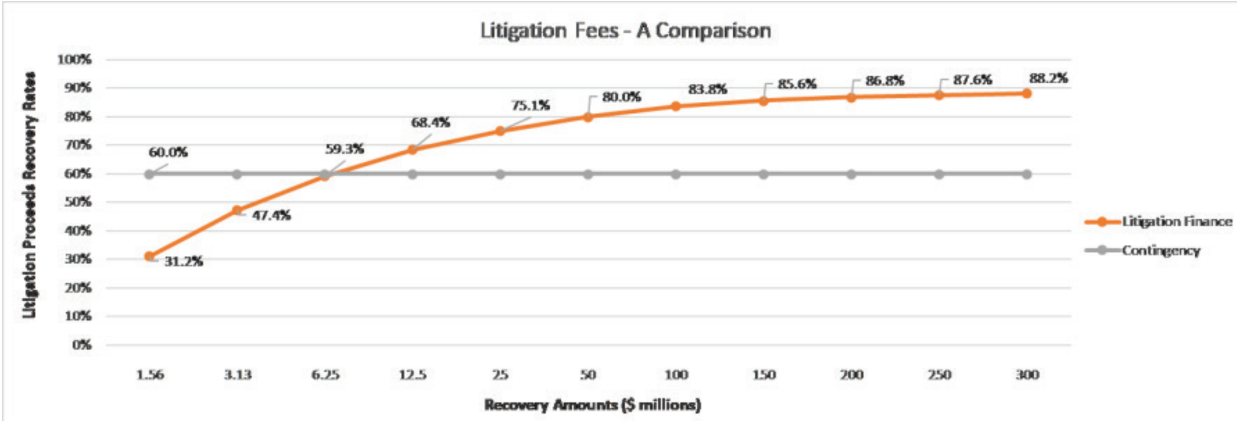
The key difference between single-case funding and portfolio funding is that by bundling a diverse set of individual cases into a single portfolio, the total risk to the funder's investment is lower. They may obtain their return from multiple sources, instead of just one. This typically results in more favorable terms for the claimant. Specifically, a funder will often charge a multiple on its deployed capital rather than a percentage of the litigation proceeds (which often applies in single-case funding and is standard for contingency fee arrangements). This is an important distinction. If the litigation proceeds are expected to be substantial, a portfolio funding arrangement can result in the debtor or trust estate keeping significantly more money than it would under a percentage-based arrangement.

The Economic Benefits of Portfolio Funding

The best way to demonstrate the economic benefits of portfolio funding is by example. Estate A has five legal claims worth a total of $100 million. Litigating all five claims will cost $8 million in attorney's fees and costs. Estate A has $2.5 million in assets available and $2.5 million in administrative costs, leaving no money to spend on litigation. Estate A can either enter into a contingency fee arrangement, in which it will pay counsel 40% of total recoveries, or a portfolio funding arrangement, in which it will pay the funder three times (3x) the deployed funds. What makes more sense: paying a multiple of litigation costs or a percentage of the proceeds recovered? The answer depends on the circumstances, but particularly when the estate has substantial damages, the former option often allows creditors to keep more of the upside:

	Contingency Counsel	**Portfolio Funding**
Litigation Recoveries	$100,000,000	$100,000,000
Payment upon Successful Resolution	$40,000,000 (40% contingency fee)	$24,000,000 (3x deployed capital)
Amount Left for Distribution to Creditors	**$60,000,000**	**$76,000,000**

In the example above, portfolio funding results in a better return for the estate by making an additional $16 million available to creditors, funds that would have otherwise gone to pay counsel's contingency fee. There is, however, a point at which a straight contingency fee arrangement (percentage-based cost) is less expensive than portfolio funding (multiple-based cost). The inflection point will vary depending on several factors.



If the expected litigation costs are outsized in comparison with the potential damages, a percentage-based arrangement will likely be more economical. When damages across multiple claims are sufficiently great, a multiple-based arrangement could be advantageous. Further, when the estate has multiple claims, better rates are likely to be available from the funder because more cases are available to collateralize the investment. As an example, trustees should not hesitate to propose a grouping of preference claims and D&O claims. Doing so may enable the estate to access capital more cheaply, maximizing recovery to creditors. Different underlying claims, varying legal theories, and unrelated defendants reduce the risk of a zero recovery and are therefore attractive to the funder. Diversity among portfolio cases thus typically allows the funder to provide more favorable terms.

Advantages of Portfolio Funding

As described above, under appropriate circumstances, portfolio funding has advantages for the estate that contingency fee arrangements often lack, including:

- The ability to choose the legal team(s), financial advisor(s), and expert(s) of the trustee's choice
- The flexibility to pay some advisors on an hourly basis and others on a contingency basis
- The ability to obtain substantial working capital—funders, unlike outside counsel, can lend to their clients
- 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

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 both allow claimants in insolvency-related disputes to finance litigation when hourly fee arrangements are not available or are undesirable. The specifics of the claims will determine whether litigation portfolio funding or a contingency fee arrangement is more economical, but it is important for trustees to understand the options available. Litigation funding permits trustees to use counsel of choice, regardless of whether counsel can take cases on contingency. Beyond this qualitative (but critical) benefit, for estates with multiple claims and substantial potential recoveries, portfolio funding can have advantages for maximizing estate assets and returns for creditors. Without the trustee taking pause and conducting an empirical analysis, the estate could suffer by an uninformed choice of how best to maximize the value of the claims at stake.

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

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Joel E. 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 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.

Ken Epstein, Investment Manager and Legal Counsel, Omni Bridgeway

Ken Epstein is an investment manager and legal counsel at Omni Bridgeway, responsible for leading the company's investments in bankruptcy and insolvency-related matters.

He 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 maximize the value of litigation claims.

Ken has extensive experience advising and managing debtors-in-possession, individual creditors and creditor groups (ad hoc and official committees) and financial institutions in insolvency and bankruptcy-related litigation matters nationally and internationally. He began his career as a lawyer in the financial restructuring group of Cadwalader, Wickersham & Taft. Prior to joining Omni Bridgeway, he was managing director in the restructuring and remediation group at MBIA, a publicly listed financial institution.

Ken has taught bankruptcy law as an adjunct professor at Cardozo Law School and has served as a panelist and author on bankruptcy-related topics. He earned his J.D. from Brooklyn Law School in 2000, where he graduated cum laude after serving on the Journal of Law and Public Policy. Ken has extensive experience serving on for-profit and non-profit boards of directors.

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Megan Easley is Legal Counsel in Omni Bridgeway's New York office.

She conducts due diligence on potential investments and provides legal advice to Omni Bridgeway on matters of US law.

Prior to joining Omni Bridgeway, Megan practiced law at Susman Godfrey LLP, focusing on representing plaintiffs and defendants in commercial litigation matters in federal and state courts. During her time with the firm, Megan was seconded to GE Capital where she spent four years in the role of Special Counsel and managed domestic and international litigation, directing outside counsel handling government and internal investigations and litigation with exposure of more than $1 billion.

Megan also previously served as a law clerk for the Honorable Richard C. Wesley on the US Court of Appeals for the Second Circuit. Additionally, she worked as a Trial Preparation Assistant with the New York County District Attorney's Office Rackets Bureau before pursuing her law degree.

Megan received her J.D. from Cornell Law School, graduating magna cum laude and acting as a Notes Editor for the Cornell Law Review. She received her B.A. from Georgetown University, graduating magna cum laude. During her studies, Megan interned with the New York City Law Department, the US House of Representatives and the US Securities and Exchange Commission and completed a study abroad program with the University of Auckland in Auckland, New Zealand and at the Villa le Balze in Florence, Italy.