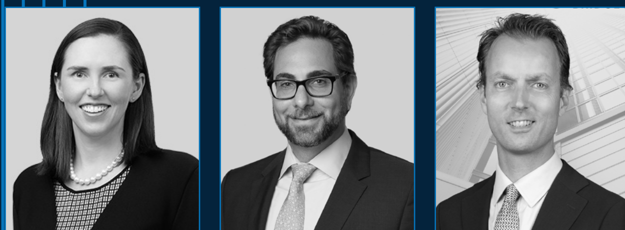
LITIGATION FUNDING FOR INSOLVENT COMPANIES



Eloise Matsui, Ken Epstein and Marijn Flinterman
Omni Bridgeway
Hong Kong, USA and The Netherlands *respectively*

> "The development of litigation funding over the past decade and the increased availability of capital… provides distressed businesses with financing options not available during previous economic downturns"

Setting the scene

Companies in financial distress and insolvency practitioners ("**IPs**") across the globe face a common problem: limited financial resources to effect a turnaround or, in case of a liquidation, to deliver a meaningful return to creditors.

The development of litigation funding[1] over the past decade and the increased availability of capital in the sector provides distressed businesses with financing options not available during previous economic downturns. Similarly, litigation funding can be a welcome lifeline for IPs seeking to maximise returns to creditors.

Whilst litigation funding structures vary by jurisdiction, funders can provide a variety of options dependant on the needs of the IPs or the company tailored to the local regulatory regime.[2] This article sets out some of the ways litigation funding can help address the common challenges or themes faced by distressed companies and IPs.

What do insolvency practitioners typically require funding for?

A. Finance for the running costs of the administration

IPs are often appointed over companies with limited or no liquid estate assets. They may believe the estate has viable claims but often find themselves in a "chicken-and-egg" scenario: they need cash to run the administration and investigate available claims, but they need to make successful claims in order to realize cash. Without the financial resources to fund day-to-day operations and gather additional information to pay for legal advice regarding the viability of claims, whatever value remains may disappear. While this may be welcome news to existing and potential defendants, it's a serious problem for the financially-distressed or insolvent company and its stakeholders.

Quickly unlock value captured in straightforward claims

IPs will of course look to the existing creditor pool to see whether any of the creditors has the appetite to fund these costs. This may be the most efficient and cost-effective way to raise money. Alternatively, IPs may choose to liquidate any available assets to cover those legal costs. But these options may not be readily available in every case.

Despite the company having no liquid assets, a funder may be able to finance the pursuit of a company's more straightforward claims, or use these claims as collateral to fund other, more complex claims that require further investigation and development. A qualified funder should be able to quickly assess the situation and advise a distressed company or IP on its funding options.

Monetising claims

For immediate capital, many funders can purchase (or pay cash advances on) the estate's claims, judgments and arbitration awards. This may be a quick way to return cash to a business or estate so the IPs or management can focus on the business operations, business continuity or carrying out a financial restructuring.

Some jurisdictions restrict the ability to trade claims, so a thorough review of local laws must be conducted in order to assess the availability of this option. Since price is a function of risk, early-stage cases may not be worth what a financially distressed business or IP hopes they might be. Cases that are likely to yield a higher price (or advance rate) are those which are further along the litigation timeline, have survived dispositive motions, are less fact-intensive and/or require less cooperation on the part of the claimant.

DIP or super-priority finance

In some jurisdictions, like the United States, it is permissible for funders to provide debtor-in-possession finance ("**DIP**

1 Also commonly referred to as third-party funding, litigation finance or legal finance
2 See *A Cross-Jurisdictional Comparison of the Use of Commercial Litigation Funding in Insolvency in Selected Jurisdictions*, INSOL International, November 2022 for a survey of commercial litigation funding in various jurisdictions across the globe.

Finance") finance to a bankrupt company.[3] DIP Finance provided by a litigation funder can be in lieu of, or in addition to, more traditional DIP Finance, which is often advanced by a company's pre-petition lender. In the US, DIP Finance is typically sought by a debtor at the beginning of a Chapter 11 bankruptcy process and must be approved by the Bankruptcy Court.

The DIP financier is often granted a priority on all the company's assets in the event of a subsequent liquidation. However, when a funder provides DIP Finance, the pledged assets may be more limited – for example, perhaps limited to a particular claim and its proceeds. This should be less concerning to secured lenders anxious about protecting their senior position in the waterfall for the primary business assets.

For IPs dealing with cross-border insolvencies with a US connection, Chapter 15 of the Bankruptcy Code (which is based on the UNCITRAL Model Law on Cross-Border Insolvency) may provide a basis for obtaining credit.[4]

Other jurisdictions around the world have emulated some of the US-style DIP Finance provisions. Since 2018 "super-priority" rescue finance is now part of the Singapore corporate insolvency regime as prescribed in *the Insolvency, Restructuring and Dissolution Act* ("**IRDA**"). In 2021, the Singapore Court ordered that Omni Bridgeway's financing of a private international arbitration be given super-priority status in the context of a corporate restructuring. This ruling should provide comfort to IPs (and funders) that funding agreements will be treated like other forms of rescue finance.

B. Development of claims

Seed finance or staged funding

As noted, funders can provide seed capital or staged funding to allow an initial phase of investigations to be completed or a prospects advice from counsel to be obtained. There seems to be a significant demand for this type of early-stage funding amongst IPs. As funding at this stage can be quite risky, a financially distressed company or IP should expect funding to be expensive relative to that which is available for more developed claims. When providing seed capital or staged funding to allow an initial phase of investigations to be completed, a funder will usually require the exclusive right to fund the substantive claim if it turns out to be viable. If the funder later decides not to exercise this option, and the IP nevertheless successfully prosecutes the claim, the funder will usually be entitled to reimbursement of their sunk costs.

In some circumstances, the amount of seed funding being sought by an IP may be beyond the risk appetite of a single funder. Helpfully, many funders are open to co-funding claims with other third-party funders or a creditor (or group of creditors). Where the IPs and/or lawyers are prepared to go "on-risk" for part or all of their fees, this makes seed funding a more attractive option for funders.[5] In turn, a funder willing to fund a case is probably a positive factor for the professionals involved, as they will then know the risk is not being totally borne by themselves if they take the matter on a partial contingency-fee basis.

How can insolvency practitioners monetise dispute assets?

Litigation and arbitration claims, judgments and awards are all valuable assets that can be leveraged or sold to generate and increase returns to creditors. Several types of claims tend to arise in the insolvency context and may be suitable for funding. These include:

- Contractual disputes (including claims against trade debtors);
- Claims against directors and officers for breaches of duties leading to a corporate collapse;
- Negligence claims against auditors or other professionals related to a company's insolvency;
- Insolvent trading-type claims; and
- Claims relating to uncommercial transactions, such as claw-back actions, preference payments or unwinding undervalue transactions to return funds to the insolvent estate.

Traditional litigation funding models

Like litigating without funding, the IP (as claimant of record) brings the claim, commences legal proceedings (or arbitration) on behalf of the company, and engages lawyers. The funder will typically agree to pay all (or a portion) of costs as they are incurred (this can cover legal fees and disbursements, as well as the IP's own fees). In exchange, the parties agree, typically by way of a bespoke funding agreement, for the funder to receive a portion of any successful recovery. Often that portion will increase on a staged basis depending on how much time has passed between entering the funding agreement and obtaining a recovery. If there is no recovery, then the funder would typically not receive anything (hence, the funding is considered "non-recourse"). Whether the funding agreement needs to be approved by the relevant court varies by case and between jurisdictions.

Purchase of claims, in whole or part

As mentioned above, if an IP has a need for immediate capital and/or has no desire to pursue the claim until conclusion, a funder can purchase (or pay cash advances on) claims, judgments and arbitration awards. This can include single claims or portfolios of multiple claims.

The structure of the claim sale will depend on what is permitted in the relevant jurisdiction, though often claims are transferred by way of assignment. An assignment can be for all or part of the economic or legal interests in the claim. If a funder purchases the claim, it will want to make sure it can access and obtain the relevant information from the IP and have the co-operation of necessary lay witnesses.

The consideration paid by the funder will depend, among other things, on how far the claim has progressed, what remains to be done, and the prospects of enforcement against the respondent. The cash consideration may only be a small portion of the total claim, though earn-outs are

3 See 11 U.S.C § 364 ("Bankruptcy Code"); *In re NS8*, Case No. 20-12702 (CSS) [Dkt. No. 165] (Bankr. D. Del. 2020) and *In re Welded Construction, L.P, et al.*, Case No. 18-12378 (KG) (Bankr. D. Del. 2018) [Dkts. 704, 745].

4 See Bankruptcy Code §1521(a)(7).

5 Whether lawyers are permitted to go on-risk or agree to any contingency or success fee arrangement differs between jurisdictions and is usually governed by local laws and regulations applicable to legal practitioners.

not uncommon. This could be attractive to an IP otherwise unable to access funds in the short term. Also, it may allow IPs to provide distributions to creditors, and even complete a winding-up process, more quickly. A higher price can be obtained by a seller for a final judgment or award (as compared to a claim which has not yet been initiated).

Funding enforcement

If an estate already holds favourable judgments or arbitral awards but has limited funds or other resources necessary to collect against unwilling or evasive judgment debtors, several funders offer financing, strategic know-how and project management skills for hire. This can be extremely handy if the judgment debtor's assets are, or are suspected to be, in a jurisdiction where the IP has limited or no expertise. Some funders have in-house asset-tracing capabilities to assist the IP in its assessment of the collection prospects. This can be valuable in securing buy-in from key stakeholders seeking assurance on the prospects of success.

Portfolio approach

Portfolio funding is a useful tool for IPs because they often look at pursuing more than one claim. It allows the IP to leverage up some claims that may not appear as strong as others or that do not meet the minimum claim sizes required by some funders. The benefit to the estate is often evident in the pricing funders can offer for a portfolio deal. Because a diversified portfolio should be less subject to a binary outcome, funders should be able to provide more attractive terms.

Risk-sharing and potential share in uplift

If risk-sharing between the funder and the lawyers is permitted in the relevant jurisdictions, it often serves to enhance the claim's funding prospects. For example, a funder may agree to pay 50% or 75% of the legal fees as the cases progress, with the lawyers deferring the remainder of their fees – i.e., going "on-risk" – for the remaining amount. If the matter resolves successfully then the funder can pay the balance to the lawyers once the resolution sum is obtained. The same structure can be applied to the IP's fees.

In some jurisdictions, lawyers are prohibited from contingency fee arrangements, but generally IPs are not similarly restricted. Funders can also offer an uplift in the fee upon successful recovery, or upon successful recovery within a prescribed time or set amount. This can motivate all the professional advisors to work towards early resolution, wherever possible.

Is court approval required?

The local statutory regime and jurisprudence will dictate whether court approval (or approval from the creditor body or, in the case of a litigation trust, a governing committee) is required for an IP to enter into a funding agreement. For example, in Hong Kong (since it has been clear from the jurisprudence that litigation funding is a permitted exception to the tort against maintenance and champerty) liquidators regularly sought the approval of the High Court of Hong Kong SAR prior to entering into a funding agreement with a funder. In the 2020 case *Re Patrick Cowley and Lui Yee Man, Joint and Several Liquidators of the Company* Harris J held that for compulsory liquidations, the liquidator has the power to cause a company to enter a funding agreement and the Court's sanction is not required to enter into such an arrangement with a funder.

In the US, the need for court approval will depend on who is pursuing the claims and when. Prior to filing for federal bankruptcy protection, court approval is not required. If the claims are being pursued by a company (or an official committee granted standing by the court) *during* a Chapter 7 or 11 process, then court approval is required. A motion on notice to all interested parties will be necessary, and, unless the court permits otherwise, disclosure of the terms of the funding agreement may be required. In the post-confirmation context, where claims are often assigned to a litigation trust pursuant to a plan of reorganization or liquidation, court approval is unlikely to be required, in most instances. However, a risk-averse trustee unclear of his authority may seek an order from the court, as a precautionary measure.

Distribution of recovered proceeds

When a funder purchases the legal interests in one or more claims from a company or estate, the funder effectively becomes the claimant of record, and any recoveries will be distributed directly to the funder as owner of the claim(s). Bespoke arrangements such as earn-out mechanisms (through which sellers retain contractual rights to future recoveries) will be dealt with in the sale and purchase agreement.

In the "traditional" litigation funding model, the company remains claimant of record and as such the inclusion of the funder in the distribution of recoveries (the so-called "waterfall" of payments) must be negotiated. Given the risk profile of non-recourse litigation funding, payments to litigation funders typically rank (super) senior. Often the applicable laws will provide for statutory protection and priority ranking of costs incurred in the process of liquidation (IP fees being a notable example); whether such statutory ranking extends to payments to funders depends on each individual jurisdiction. Notwithstanding applicability of statutory frameworks, funding agreements typically contain bespoke provisions prescribing the priority of distribution of recovery proceeds.

Coverage of adverse costs and security for costs orders

IPs are often concerned about exposure to *adverse costs* orders they might face if an action is ultimately unsuccessful – orders which, depending on the jurisdiction, can involve dazzling amounts. In the US, this is typically not a concern as each party to the lawsuit pays their own attorneys. Elsewhere, IPs can mitigate this risk by having the company purchase specific *after the event* ("**ATE**") insurance to cover the possibility of an adverse costs order (and some funders may even require IPs to arrange such insurance). Other funders, as part of their offering, may have a global ATE policy in place that they can automatically extend to the claims that they fund, obviating any need for the company itself to arrange insurance. Whatever the scenario, given

the substantial impact that ATE insurance can have on the company when pursuing claims, IPs are advised to research available insurance options and funding terms regarding such coverage.

Similarly, it is common for *security for costs* orders to be made against insolvent claimant parties. These types of orders require a party (often the claimant) to pay money into court, or provide a bond or guarantee, as security for their opponent's costs of litigation. Costs associated with such orders are typically part of the funding arrangement but IPs should take particular care to ensure that these are explicitly included in the funding terms.

Conclusion

Financially distressed companies and IPs face unique challenges. Cash is often in short supply and IPs may find themselves unable to raise finance from the existing creditors or traditional financiers. When this occurs, and a company or IP believes it has legal claims to pursue, or claims that could benefit from further development, litigation funding may be an avenue worth considering. There is a growing number of funders equipped to deal with insolvent companies and fund financially distressed companies to help facilitate a rescue of the company or a recovery to creditors.

This article first appeared in the Q2 2023 edition of INSOL World.