Bankruptcy and litigation finance

Travis Lenkner | July 25, 2017

Legal claims held by bankruptcy estates often are the only basis for recovery for unsecured creditors. And yet—for obvious reasons—estates may be hard-pressed to maximize the value of these assets. Enter litigation finance, which is increasingly used in the bankruptcy arena to help generate meaningful recoveries.

When capital is scarce and risk appetite is low, bankruptcy trustees may elect not to pursue potentially valuable claims, or they may be forced to settle at a low amount due to a lack of resources. Trustees may lack money to pay lawyers (who themselves may be unable or unwilling to work on a full- or partial-contingency basis) or to take on the added burden of out-of-pocket expenses. Even when trustees muster the resources to pursue a claim, the high cost and uncertain duration of litigation can require a creative approach.

A recent case study illustrates this point. For more than a decade, MagCorp bankruptcy trustee Lee Buchwald and attorney Nicholas Kajon of Stevens & Lee have pursued claims against MagCorp's former holding company for driving MagCorp into bankruptcy. In 2016, having won a $213 million judgment, Buchwald and Kajon were confident MagCorp ultimately would overcome an appeal and collect. But they were running low on funds to see the matter through to its conclusion, and they sought to reduce the risk that a negative appellate outcome would erase years of hard work on behalf of creditors.

As Buchwald describes it, "I only had about $670,000 in the bank and had been litigating with a billionaire for 13 years. I sought to hedge my downside exposure, build a war chest in the unlikely event the defendants won their appeal for a new trial, and guarantee that no matter what happened in the litigation, there would be money available to distribute to MagCorp's long-suffering creditors."

The solution was litigation finance. Buchwald and Kajon arranged the unprecedented public sale of an interest in the right to receive proceeds from the judgment on appeal. The $26.2 million sale to Gerchen Keller Capital (later acquired by Burford) enabled the estate to monetize a portion of a contingent asset, hedge against appellate risk, and guarantee a minimum recovery to creditors.

As the MagCorp transaction demonstrates, litigation finance can go far beyond "case funding" to pay legal fees or costs. Indeed, litigation finance generally refers to any transaction through which the asset value of a legal claim is used to secure third-party capital. The arrangements typically are non-recourse, meaning return of capital is tied to the successful outcome of the underlying claim.

Litigation finance is growing rapidly. According to the 2016 Litigation Finance (http://www.burfordcapital.com/wp-content/uploads/2016/08/Burford_2016Research_WhitePaper_Final-Web.pdf) Survey, the number of U.S. lawyers reporting that their firms have used litigation finance quadrupled between 2013 and 2016, from seven percent to 28 percent. Nonetheless, U.S. bankruptcy practitioners arguably are less aware of litigation finance than their peers in Australia and the United Kingdom, where "litigation funding" first thrived as a necessary solution to the challenges of insolvent claimants and their representatives. That lack of awareness can lead to missed opportunities.

In addition to a MagCorp-style transaction, in which a litigation finance provider purchases an interest in a high-value judgment from the estate, litigation finance can be used in variety of bankruptcy scenarios. Examples include:

- If an estate has a single, high-value claim with substantial litigation, enforcement and duration risk, a litigation financier can provide significant capital to the estate by purchasing the claim outright or purchasing the right to fund and manage the claim (in which case both the financing party and the estate will retain substantial upside from any recovery). In this scenario, the financier assumes the full litigation risk of the claim.
- Liquidating estates can use litigation finance to fund a liquidation plan or litigation trust. A litigation financier can provide non-recourse capital to cash-strapped estates and trusts whose litigation assets have substantial settlement value, thereby allowing for a faster and more efficient recovery to the estate and creditors. With increased liquidity, an estate can launch a broad litigation strategy to increase the value of its remaining claims. This option is particularly well suited where an estate's claims present varying levels of risk and expected duration, and it applies to defense as well as plaintiff matters. A recent portfolio-based financing arrangement with Grant Thornton provided a £9 million facility across a portfolio of insolvency cases in which its partners are trustees. The portfolio includes both plaintiff and defense matters and maximizes trustees' ability to return value to creditors.
- Litigation finance can provide non-recourse capital to law firms that litigate bankruptcy matters on contingency. Direct injection of capital helps smooth cash flow for such a firm and lower its risk exposure. This enables the firm to capitalize the expansion of its contingency business or take on litigation expense risk when a cash-poor estate is unable pay its own litigation expenses, either for substantial individual cases or across portfolios of cases.
- In the right circumstances, finance providers may even take on the role of litigation trustee: the financier also provides the expertise to identify the claims most likely to yield significant recoveries, select the best lawyers and negotiate the right agreements for each claim.

> By having “skin in the game,” the provider’s interests are well aligned with creditors to obtain the best recovery in the shortest timeframe.

To be sure, some cases are less attractive candidates for litigation finance. These include litigation that will not generate sufficient damages or return to the bankruptcy estate to justify outside capital.

Depending on the transaction structure, litigation finance arrangements in bankruptcy can require court approval. Those seeking outside capital should be prepared to demonstrate the economic justification for the arrangement and the wherewithal of the financing party. For that reason, it pays to partner with the most highly regarded providers of litigation finance: specialist firms that offer a high degree of legal and financial knowledge, have experience in the sector and focus exclusively on financing complex commercial cases.

Because financing in bankruptcy can be subject to court scrutiny (and thus provoke questions from creditors and challenges from litigation opponents), any transaction should be structured to maximize value and avoid potential pitfalls. For example, the MagCorp transaction was structured as a sale of an interest under Section 363 of the bankruptcy code. Timing is also important. As Buchwald explained, “We recognized that our window of opportunity was between the time our opening brief was filed and the earliest date that oral argument might be held, so we set up a process that could be run and completed between those two goalposts.”

Ultimately, the effort invested in finding a litigation finance partner is well worth it. As Buchwald said, “The liquidity that the litigation finance industry can provide is a game-changer for bankruptcy.”