

TOP NEWS

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Litigation funding in bankruptcy 'should be in every trustee's toolkit'

By Alison Frankel

One of the big winners last week when the 2nd U.S. Circuit Court of Appeals affirmed a \$213 million judgment against billionaire Ira Rennert and The Renco Group was the litigation funder Gerchen Keller, now part of Burford Capital. Last summer, before oral arguments in Rennert's appeal, Gerchen Keller agreed to pay \$26.2 million to acquire a \$50 million interest in the judgment from the bankruptcy trustee for Magnesium Corporation of America. Thanks to the 2nd Circuit's MagCorp affirmance, the litigation funder will end up with nearly double its money from a six-month investment.

The deal between the MagCorp trustee, Lee Buchwald, and Gerchen Keller was apparently the first time a bankruptcy trustee has auctioned off a piece of a litigation judgment via an open proceeding overseen by a federal bankruptcy judge. It should not be the last, according to Buchwald's lead counsel, **Nicholas Kajon** of **Stevens & Lee**. Kajon, whose law firm bio highlights his expertise in helping clients "assert litigation claims without committing their own capital" said in an interview Tuesday that risk-hedging through deals with litigation funders "should be in every trustee's toolkit."

Off-loading litigation risk by selling an interest to a litigation funder won't make sense for every bankruptcy trustee pursuing claims, Kajon said. But as fiduciaries, he said, trustees ought to consider whether the bankruptcy estate is better off monetizing a piece of its potential recovery to assure itself of liquidity to keep litigating and some cash for creditors even if it ends up losing the case.

"We think this is an absolutely perfect fit for bankruptcy," he said.

It's easier to understand how these deals would work through the specifics of the MagCorp transaction. In the 1990s, MagCorp was one of North America's largest producers of magnesium and magnesium alloys. Its parent company was (almost) wholly owned by Rennert and Rennert trusts. MagCorp ran into serious problems with the Environmental Protection Agency, however. According to the bankruptcy trustee, Rennert interests engaged in complicated financial shufflings, including a MagCorp debt offering, that essentially diverted all of the value of the company to them while isolating the environmental exposure. MagCorp entered bankruptcy in 2001.

million for the trustee in September 2015. Rennert brought in **Orrick Herrington & Sutcliffe** to appeal to the 2nd Circuit. Buchwald countered with appellate counsel **Kellogg Huber Hansen Todd Evans & Figel**.

Buchwald and his Stevens & Lee lawyers were confident the judgment would stand. But they were also worried about liquidity. MagCorp had less than \$1 million in the bank. “The judgment was the only asset we had,” Kajon said. “It was the only chance of recovery for the creditors.” If the trustee lost at the 2nd Circuit, Kajon said, creditors might walk away empty-handed. Even if the 2nd Circuit ordered a new trial, Buchwald wasn’t sure the estate could afford it.

Buchwald and Kajon decided to test the market to find out whether they could lock in about \$20 or \$25 million in recovery by selling an interest in the judgment. As Buchwald explained in an August 2016 declaration in bankruptcy court, he wanted to sell the interest before the 2nd Circuit heard oral arguments because that would change assessments of the risk for investors.

The trustee asked Kajon to reach out to his litigation funding contacts. He reached out to nine prospective bidders, eight litigation financiers and one from another industry Kajon declined to specify. Several reviewed documents, including the Kellogg Huber opening appellate brief, and engaged in negotiations with the trustee. In June 2016, the trustee selected Gerchen Keller as the stalking-horse bidder, proposed an auction process and moved for approval of that process from U.S. Bankruptcy Court Judge **Mary Kay Vyskocil** of Manhattan.

The Rennert defendants opposed the novel sale proposal. So did Jefferies LLC, one of the largest holders of MagCorp notes, which said the trustee hadn’t provided enough information about why it was in creditors’ best interests to rush to sell a piece of the judgment at a late stage in the litigation. Judge Vyskocil nevertheless ordered the auction to take place.

Rennert tried to submit a bid – in exchange for the entire judgment, the defendants would pay \$45 million if the 2nd Circuit ruled for them and \$100 million if the trustee prevailed on appeal – but the trustee disqualified the offer. (In addition to what he considered an inadequate offer, he said he couldn’t be sure the proposed Rennert vehicle itself was well-financed.) A Rennert lawyer actually showed up for the auction but was asked to leave. The litigation funder Juridica, however, emerged to bid against Gerchen Keller, which revised its stalking-horse bid. It agreed to pay an additional \$1 million and to take \$3.75 million less.

In his declaration supporting a motion for Judge Vyskocil to approve the final offer, Buchwald explained why the deal was good for MagCorp and its creditors. “The sale will hedge the estates’ downside exposure on the appeal and any further proceedings against the defendants at a reasonable price; ... provide much needed liquidity to the debtors’ estates; and guarantee that there will be funds available to pay long-suffering general unsecured creditors irrespective of the outcome of the appeal,” Buchwald wrote. “All litigation is fraught with peril and unpredictability. Litigation claims are inherently speculative. Therefore, I believe it is

to gamble everything on the appeal.”

The judge agreed, despite objections from the Rennert defendants and Jefferies. She approved the sale to Gerchen Keller in late August.

Kajon told me he’s previously been involved in cases in which sophisticated creditors, such as distressed debt funds, agreed to fund litigation by a bankruptcy trustee. He said he’s also seen instances in which litigation financiers have funded post-confirmation claims by a bankruptcy trustee. What’s different about the MagCorp case, he said, is that the sale process was an open auction and the outcome was approved by the court as being in the best interests of MagCorp’s creditors.

Travis Lenkner of Burford, who was on the Gerchen Keller team that made the MagCorp investment, told me Judge Vyskocil’s “blessing with a capital B” should open the way for other bankruptcy trustees to work with litigation financiers – a concept he’s pushing with trustees and their lawyers. In a way, the MagCorp deal is an example of the classic litigation funding model of buying an interest, at a discount, in a judgment. But applying the model in a bankruptcy proceeding is a new and evidently profitable avenue for funders.

Lenkner said he regards litigation finance as a complement to investments by sophisticated distressed debt funds that buy up the notes of companies in bankruptcy in the expectation that litigation recovery will drive up the value of the debt. Distressed debt investors are among the shrewdest litigation analysts in business, and Lenkner agreed their due diligence is similar to what litigation funders would consider before investing in a bankruptcy trustee’s case. But litigation financiers invest only in the outcome of the case, not in the debt itself.

I suspect that if bankruptcy trustees really start off-loading risk by selling interests in judgments to litigation funders, distressed debt funds will figure out a way to get in on that action. But that’s jumping ahead a few steps. First let’s see whether Burford’s hefty return in the MagCorp case prompts a wave of litigation funding deals with bankruptcy trustees.
