Trustee Uses Litigation Finance to Secure Creditor Recoveries

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Distress visits everyone. In business, distress may lead to a spiral of disadvantageous transactions, litigation, arbitration, a visit to Bankruptcy Court, and even less pleasant adversity. Even with best intentions and extraordinary efforts, following the usual pathways can limit options. That eventually may lead to the cliff's edge.

An emergent option offers an alternative to that outcome in appropriate circumstances. Referred to generically as litigation finance, many are aware of this potential funding source. Its adaptability to creative applications, however, may be less understood by sophisticated business leaders and those who advise them.

The authors in September 2016 helped a bankruptcy trustee monetize an illiquid asset using litigation finance. The trustee obtained Bankruptcy Court approval and closed a $26.2 million sale to Gerchen Keller Capital (GKC) (later acquired by Burford Capital), the largest capital provider in the litigation finance market. GKC acquired the right to receive a portion of net recoveries on account of the $213 million judgment that the trustee had won against The Renco Group Inc. and Ira L. Rennert.[1] The judgment is currently on appeal to the 2nd U.S. Circuit Court of Appeals.[2]

Before closing with GKC, the debtors' estates had approximately $650,000 after 13 years of litigating against defendants literally worth billions. The trustee was concerned by the risk that the judgment might be reversed on appeal, and, if so, that he might have insufficient cash to fund a new trial. The trustee's concern was magnified by the possibility that creditors might never achieve any recovery.

As with many principals, the trustee was presented with limited options by the usual pathways. His available cash was minimal. His collateral, a trial court judgment subject to an appeal, was exotic, to be polite, in the context of a textbook asset valuation.

A Common Problem

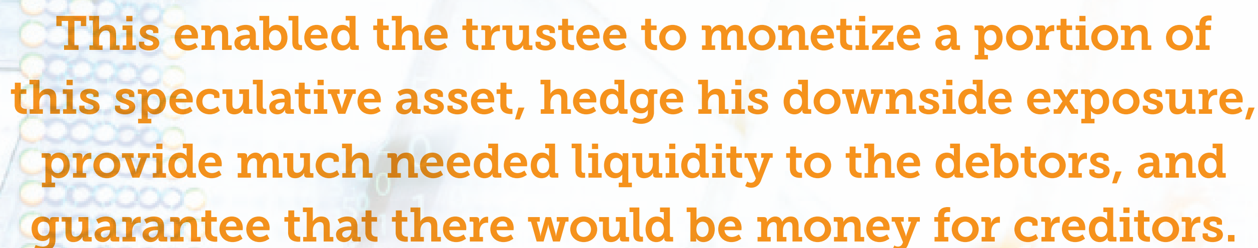
The trustee's position, while well past the inception of an action, is relatively commonplace in a bankruptcy case. There ordinarily is little or no value for junior classes of creditors absent successful prosecution of litigation claims. This is especially prevalent in cases involving fraud and other misconduct, where insiders may have looted the company of any assets that would have been available to fund a distribution to junior classes.

The U.S. Bankruptcy Code contains a number of provisions in Chapter 5 designed to remedy misconduct by insiders and others, and to facilitate the recovery of fraudulently transferred assets for the benefit of the estate.[3] Moreover, creditors of insolvent companies that are not in bankruptcy generally have standing to bring fraudulent conveyance, breach of fiduciary duty, and other claims that arise upon insolvency.[4] However, to avail oneself of such remedies in a meaningful manner, the bankruptcy trustee or other creditor representative must first have an adequate litigation war chest, which often is not the case when financial distress and fraud are present.

Even when there are assets to fund claims, parties may be reluctant to throw good money after bad to go after them, especially if resources are limited. Prosecuting claims is not only time-consuming, it is also expensive. Solvent and highly profitable companies hesitate before committing to material litigation, given its uncertainties and the income statement effects of such expenditures. As a result, justiciable claims of fraud and other malfeasance may go unremedied. Junior classes may receive little or no recovery.

In complex commercial litigation, especially when there are allegations of fraud, complicated issues of fact, consultant and expert fees, and substantial data discovery costs, even tightly managed litigation costs can grow into seven figures. Moreover, the targets of these types of claims usually have deep pockets,

continued on page 18



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continued from page 17

especially when they are financial institutions, professional firms, and/or insiders who looted the company. And all of these costs are in addition to attorneys' fees. Even if counsel can be found to prosecute claims on a contingency fee basis, a plaintiff may still need a seven-figure budget to fund other litigation expenses.

It is axiomatic that sensibly funded litigation is more likely to yield positive results than if done on a shoestring budget, whether through greater leverage to garner a more favorable settlement or by increasing the likelihood of a successful litigated outcome. Furthermore, plaintiff and counsel will be better equipped to move forward aggressively, allowing a plaintiff to endure through trial.

In the Renco Group litigation, the trustee's limited options and particular constraints suggested one of two outcomes. The *status quo* could persist, with its limits and unpredictable results, or the trustee could attempt to alter the *status quo*, rather than sit idly by while the appeal progressed and hope for a successful outcome.

The emergence of litigation finance and alternative funding suggested a new path for the trustee to explore. In doing so, he and his advisors conceived and structured the sale of an interest in net recoveries from the proceeds of the Renco Group litigation. The trustee and his advisors ran a private sale process, approached and negotiated with multiple funders, and ultimately advanced a stalking horse bid. Approval of the stalking horse (subject to better bids) and other bid procedures were sought and obtained from the Bankruptcy Court. A public auction process followed approval of the bid procedures.

After three contested hearings, including denial of a motion for a stay of the sale order pending appeal, the sale was approved and closed. This enabled the trustee to monetize a portion of this speculative asset, hedge his downside exposure, provide much needed liquidity to the debtors, and guarantee that there would be money for creditors.[5] The motion seeking approval of this litigation finance transaction disclosed that it was designed, in part, to pressure defendants to the bargaining table, but unsurprisingly they failed to make what the trustee considered a reasonable settlement offer.

Insights for Businesses, Their Advisors

Litigation finance has established itself as an option adaptable to multiple circumstances, even the defense of litigation claims. In the aggregate, the top five institutions that offer litigation finance have billions of dollars available to invest.

In a typical scenario, a funder agrees to fund a prenegotiated budget with respect to one or more lawsuits against agreed defendants. The funder, in exchange, agrees to accept, generally on a nonrecourse basis, an investment return solely from any recovery in those lawsuits. The creditworthiness of a prospective party should not be relevant if its positions have merit. The relationships themselves are structured and performed with strict adherence to common law and ethical requirements. That ordinarily includes a client's retention of determinative control of an action, from before commencement through the final conclusion. It also includes noninterference with the attorney-client relationship, including its protections. Litigation finance may be ideal for businesses in financial distress that seek to claw back money or other assets improperly diverted by insiders or other miscreants. Litigation funders will also provide funding directly to law firms for operating expenses while they pursue contingent fee litigation.

Litigation finance does not come cheaply. However, paying a percentage of a recovery to a litigation funder appears to be a superior outcome when the alternatives would otherwise be not prosecuting the action at all, prosecuting it on a shoestring budget, or bearing 100 percent of the risks associated with litigation claims or illiquid assets.

Some criticize litigation finance, contending that it promotes the prosecution of frivolous claims. However, funders typically only recover from successful results. A funder's overriding interest is to ensure that it commits its capital only to meritorious claims. Those in distress, on the other hand, may hold less objective views, leading them to overestimate or irrationally promote a position. In such instances, a litigation funder may serve as a gatekeeper against frivolous claims.

Before it agrees to commit capital, a funder will undertake substantial due diligence. Getting to the table is a multistep process that requires time and patience, and is influenced by the complexity involved and the amount of funding sought. Other prudent preliminary steps include conflicts clearance, descriptive narratives, specific nondisclosure agreements, and in-person meetings. If progress continues, the time and work involved in the process can compare with what ordinarily is involved with the preparation of a justiciable complaint or defense plan, plus what might compare with assembling initial disclosures under the Federal Rules of Civil Procedure.

If mutual interest develops among the principal, attorneys involved, and funder, a prudent principal might seek additional counsel concerning the terms offered, monetary and otherwise. Once the litigation funder has agreed to fund, the parties will need to negotiate the funding documents.

Worthwhile Consideration

Businesses in distress never have many viable options to relieve or resolve the distress. Litigation finance and related alternatives merit thoughtful consideration by business principals and their advisors. While not appropriate for all or probably most business clients in disputes, it has established itself as a consideration in many circumstances.

[1] *Magnesium Corporation of America*, Case No. 01-14312-mkv, order signed on August 24, 2016, approving sale of Renco litigation interest, Docket No. 745.

[2] *In re: Magnesium Corporation*, Case No. 15-2691 (2d Cir.).

[3] 11 U.S.C. §§ 544, 547, 548, 550.

[4] See, *e.g.*, NY Debtor & Creditor Law § 271 *et seq.*; *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (creditors of an insolvent Delaware corporation have standing to assert claims derivatively for breach of fiduciary duty).

[5] To the authors' knowledge (and as reported in various media), no transaction like this had ever been done in a pending bankruptcy case.

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