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Maximizing Recoveries from Post-Confirmation Litigation: Part II

Preserving Causes of Action, Reviewing Releases and Exculpations, Transferring Litigation Privileges and Protections, and Using Litigation Funding

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Editor's Note: *This is the final installment of a two-part series. Part I was published in the February 2019 issue.*

Some debtors form a "litigation trust"[1] as part of their chapter 11 plan to pursue plaintiff-side litigation after they exit bankruptcy. Successful plaintiff-side litigation can result in meaningful distributions to a debtor's constituents. There are several issues to address preconfirmation — and sometimes even prebankruptcy — to maximize recoveries from postconfirmation litigation.

Part I of this two-part series highlighted key ways for creditors receiving interests in litigation trusts (*i.e.*, "litigation trust beneficiaries") to minimize risks and maximize recoveries from post-confirmation litigation by focusing on a debtor's directors' and officers' liability insurance.[2] Part II explains why litigation trust beneficiaries who want to minimize risks and maximize potential recoveries from litigation should focus on preserving causes of action, reviewing release and exculpation provisions, transferring litigation privileges and enhancing protections for litigation trusts, and exploring the possibilities of using litigation funding to maximize recoveries.

1 This article uses the term "litigation trust" generically to describe whatever legal entity pursues litigation post-confirmation. This could be a reorganized entity that is a successor to a debtor, one or more litigation trusts created under a debtor's chapter 11 plan (frequently as grantor trusts), or any other legal entities that are assigned causes of action.

2 Holders of equity who expect to receive interests in litigation will have the same concerns as creditors who expect to receive interests in litigation. *See* Marc J. Carmel, "Maximizing Recoveries from Post-Confirmation Litigation: Part I: D&O Insurance Issues," XXXVIII *ABI Journal* 2, 28-29, February 2019, *available at* abi.org/abi-journal.

Disclose Causes of Action to Preserve the Right to Pursue Litigation

Some bankruptcy courts have held that a debtor is precluded from pursuing causes of action if the debtor knew or should have known about the causes of action and did not disclose them before plan confirmation.[3] It is not clear whether a debtor's disclosure during the plan process will remedy a failure by the debtor to disclose a cause of action in the statements of financial affairs and schedules of assets and liabilities (collectively, the "schedules"). In the interest of best preserving causes of action, a debtor should disclose them in its schedules and as part of the chapter 11 plan process.

Disclose Causes of Action in Schedules

Debtors are required to disclose a significant amount of information in their schedules, including transactions that they consummated prebankruptcy and an itemization of their assets. Even though the schedules often are filed in advance of when a large corporate debtor has catalogued its causes of action, the schedules can be amended.

The typical reported decisions that hold that a debtor is precluded from pursuing causes of action that were not disclosed in schedules are in the context of individuals who file for bankruptcy (rather than corporate entities, where the cases typically discuss preclusion based on the plan documents not properly disclosing causes of action). Nonetheless, it is prudent to ensure that the schedules accurately

3 *See, e.g., BPPIII LLC v. Royal Bank of Scotland Grp. PLC*, 859 F.3d 188 (2d Cir. 2017).

disclose causes of action to ensure that the causes of action can be pursued by the litigation trust post-confirmation.

Preserve and Disclose Causes of Action in Plan Documents

Section 1123(b)(3) of the Bankruptcy Code allows chapter 11 debtors to retain the right to pursue causes of action post-confirmation or transfer that right to third parties, which debtors frequently do with provisions in their chapter 11 plans for preserved causes of action.[4] If the causes of action are not preserved, the entry of the confirmation order could preclude the debtor or litigation trust from pursuing the litigation,[5] and the debtor could lose its standing to bring the actions (if the debtor has lost its standing to pursue the actions, then the litigation trust is equally without standing because there was nothing to transfer).[6]

Court opinions are neither clear nor consistent in prescribing what information must be disclosed in order for a debtor to properly retain a cause of action. If causes of action are not properly preserved, the ensuing litigation will be dismissed and it will be too late to remedy the deficiency. This harsh result should provide ample warning to litigation trust beneficiaries about the importance of proper disclosure of causes of action.

Be sure to research the relevant standard in the jurisdiction in which the bankruptcy is pending in order to maximize the likelihood that the debtor provides sufficient disclosure to preserve causes of action.[7] Some factors to consider, subject to reviewing the case law in the relevant jurisdiction, include the following:

- *Do not rely solely on a generic statement that seeks to preserve all causes of action.* While it might not be harmful to include a "catch all" or "blanket" provision, it is likely insufficient.
- *To the extent that is possible and practical (after considering strategic concerns with disclosure at this stage), the disclosure should identify facts that give rise to the causes of action being preserved and the statutes or common law that form the basis of the causes of action.*
- *If the causes of action are known to the debtor when they are disclosed, the court is likely to scrutinize the disclosure more closely.* Litigation trust beneficiaries should keep this in mind, because the debtor's knowledge likely will be "imputed" to the litigation trust, and the litigation trust will be considered "responsible" for the debtor's level of disclosure.
- *At a minimum, the list of causes of action that the debtor discloses should list out categories and types of causes of action.*

Chapter 11 Plan and Other Documents Should Not Release Causes of Action

Chapter 11 plans and related documents frequently include provisions that release and exculpate third parties from causes of action. Litigation trust beneficiaries should scrutinize release and exculpation provisions to ensure that these provisions do not apply to the causes of action that the litigation trust will pursue.[8] Although releases and exculpatory provisions are regularly included in chapter 11 plans, they might also appear in other documents. Therefore, in addition to reviewing the plan, litigation trust beneficiaries should review all plan documents, court orders and settlements outside of the plan. Any ambiguity should be clarified prior to confirmation in order to ensure that litigation targets are not able to cite release or exculpation provisions as a basis to dismiss litigation brought by the litigation trust post-confirmation.

Chapter 11 Plan and Other Documents Should Provide Access to Information and Transfer Privileges and Protections

Litigation trust beneficiaries should make sure that the chapter 11 plan and related documents provide the litigation trust with access to relevant documents and other information, and, to the best extent possible, transfer the attorney/client privilege and other litigation privileges and protections to the litigation trust.

With the formation of a litigation trust in bankruptcy, a significant amount of time and thought is typically required to resolve these issues because of the different interests among the constituencies involved in the negotiations. Litigation targets might be involved in negotiating these issues. The targets will be motivated to impair the litigation trust's ability to bring causes of action. In addition, other constituencies might be interested in weakening the litigation trust's causes of action to secure an indirect benefit or curry favor with the litigation targets.

Litigation trust beneficiaries should consider logistical issues to ensure that the litigation trust will have access to necessary or helpful documents and other information (including computers and people). Given that the litigation could extend for years, the litigation trust beneficiaries should consider how these logistical issues might change over time, including as the parties that own and control the documents and other information might be either interested in destroying them or not interested in the storage costs that would continue to accrue. In addition, the computer resources might over the course of the case no longer be available. The litigation trust beneficiaries should also consider the extent to which they can negotiate to secure cooperation from relevant people and organizations to secure and maintain the integrity of the documents and other information that will be essential to successfully prosecuting causes of action.

The litigation trust beneficiaries should also address confidentiality, the attorney/client privilege, and other litigation privileges and protections that might be relevant. The litigation trust will benefit from having these privileges and protections transferred to ensure that (1) the litigation trust controls the privileges and protections and (2) other parties do not control them. However, there will be opposing views — some legitimate and some intended to stifle the litigation — and the litigation trust beneficiaries should negotiate to vest the litiga-

4 *See* 11 U.S.C. § 1123(b)(3):
[A chapter 11] plan may provide for —
(A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or
(B) the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest.

5 *See, e.g., In re Bankvest Cap. Corp.*, 375 F.3d 51 (1st Cir. 2004); *In re P.A. Bergner & Co.*, 140 F.3d 1111, 1117-18 (7th Cir. 1998); *In re Texas Gen. Petroleum Corp.*, 52 F.3d 1330, 1335 n.4 (5th Cir. 1995); *In re Harstad*, 39 F.3d 898, 903 (8th Cir. 1994); *In re Mako*, 985 F.2d 1052, 1056 (10th Cir. 1993).

6 *See, e.g., In re MPF Holdings US LLC*, 701 F.3d 449 (5th Cir. 2012).

7 *See, e.g., In re Mountain Glacier LLC*, 877 F.3d 246 (6th Cir. 2017); *In re SI Restructuring Inc.*, 714 F.3d 860 (5th Cir. 2013); *In re I. Appel Corp.*, 104 Fed. App'x 199 (2d Cir. 2004) (affirming *In re I. Appel Corp.*, 300 B.R. 564, 568 (S.D.N.Y. 2003), in summary order); *In re Bankvest Cap. Corp.*, 375 F.3d 51 (1st Cir. 2004); *Browning v. Levy*, 283 F.3d 761 (6th Cir. 2002).

8 *See, e.g., In re Samson Res.*, Case No. 15-11934 (BLS), Adv. Proc. No. 17-51224 (BLS), 2018 Bankr. LEXIS 2610 (Bankr. D. Del. Aug. 30, 2018) (court granting motion for summary judgment in favor of certain defendants who were "inadvertently" released by chapter 11 plan).

tion trust with the privileges and protections to the best extent possible in order to maximize the litigation's value.

Consider Litigation Finance to Fund Litigation and Maximize Recoveries

Post-confirmation litigation frequently is missing a key ingredient to success: sufficient money to engage the best lawyers, retain necessary experts, and pay other expenses necessary to pursue the litigation with the appropriate strategy. Litigation finance solves that.[9]

With litigation funding, a litigation funder invests in the litigation controlled by the litigation trust on a non-recourse basis and provides capital to the litigation trust to pay litigation costs. If the litigation is resolved successfully, the proceeds received by the litigation trust are shared with the litigation trust beneficiaries and the litigation funder. If the litigation is unsuccessful, the litigation funder is not owed anything from the litigation trust. There are several ways for litigation trust beneficiaries to best position themselves in a chapter 11 process to benefit from litigation finance.

Receive the Debtors' Most Valuable Litigation and Use Litigation Finance to Pursue Causes of Action

In many chapter 11 cases, creditors that will receive litigation interests are forced to make tough choices when negotiating for their recovery. If the litigation is meritorious, the creditors could benefit from focusing on receiving as much plaintiff-side litigation as possible. However, litigation is a contingent asset that can only be monetized with a significant investment, and it might take years to receive a recovery. For the litigation interests to be converted to distributable cash by the litigation trust, the litigation trust beneficiaries need a considerable amount of money and patience.

Complex litigation pursued by litigation trusts is very expensive, and securing money from the litigation trust beneficiaries to fund the litigation is generally either impossible or impractical. Litigation trusts sometimes can retain attorneys using a contingency arrangement, but that significantly limits the attorneys who are willing to represent the litigation trust. It still does not address expert witnesses, document production, travel, depositions and other litigation expenses.

As a result, litigation trust beneficiaries usually believe that they must also negotiate for cash from the debtor to fund the litigation. This dynamic cedes leverage to more senior creditor constituencies who would otherwise receive the cash that is used to fund the litigation trust for the benefit of the litigation trust beneficiaries.

In addition, if the litigation trust can secure sufficient litigation funding to allow the trust to retain its ideal lawyers and experts to pursue the most appropriate litigation strategy, litigation trust beneficiaries will not be forced to accept a quick settlement that undervalues potential recoveries or to abandon the litigation without any recovery. If the litigation is sufficiently valuable, a litigation funder might be willing to provide additional funding that could be used to lock in a minimum distribution for litigation trust beneficiaries, to allow the litigation trust to pursue other assets, or to fund other litigation trust obligations.

Include Provisions in Plan Documents to Secure Litigation Finance Easily

The chapter 11 plan documents forming the litigation trust generally provide the litigation trust with the authority to monetize causes of action by prosecuting and settling litigation and might grant the litigation trust the authority to enter into financing arrangements. Whether litigation finance arrangements require subsequent bankruptcy court approval depends on the specific language of the chapter 11 plan documents. If the documentation is silent regarding the ability of the litigation trust to enter into financing arrangements, bankruptcy court approval might be required.

Litigation trust beneficiaries are positioned best if the chapter 11 plan documents state clearly that the trust can consummate litigation finance arrangements without further bankruptcy court approval. Where litigation trusts have sought bankruptcy court approval for litigation funding post-confirmation, there have been issues.

First, litigation targets often object to the financing. While some objections might address legitimate issues, there are obvious reasons why litigation targets would prefer that the litigation trust not receive litigation funding. Litigation targets often want to learn more about the litigation finance arrangement, including the proposed litigation budget (which might divulge the litigation strategy) or the amount of funding available (which reveals the amount of litigation that the litigation trust can sustain before running out of money). Second, there could be other parties that object to the litigation funding for legitimate (or illegitimate) reasons. Third, the bankruptcy court might not approve the litigation financing arrangement.

To avoid the delays and risks attendant with seeking further bankruptcy court approval, the chapter 11 plan documents should explicitly authorize the litigation trust to consummate litigation finance arrangements. If there are reasons to limit the authority based on case-specific dynamics, the constituents can require that the litigation trust exercise its authority subject to certain conditions that address these dynamics.

Conclusion

With proper planning, litigation trust beneficiaries can maximize the value of the plaintiff-based litigation that they receive and enhance their likelihood of securing litigation finance. Litigation trust beneficiaries should negotiate to receive interests in a debtor's most valuable litigation and make sure that the debtor has addressed insurance issues, preserved causes of action, did not otherwise provide releases or exculpation, and transferred litigation privileges and protections to the trust. Hopefully, with these efforts, the litigation interests will result in a valuable settlement or judgment. abi

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9 The terms "litigation finance," "legal finance" and "litigation funding" are used interchangeably. Similarly, the term "litigation funding" and "litigation financier" are used interchangeably.