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Feature

By Marc J. Carmel

If *Jevic* Is Your Problem, Litigation Finance Might Be Your Solution

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Editor's Note: *For more analyses on the Supreme Court's* Jevic *opinion, read the May and September 2017 cover features.*

Dismissing a bankruptcy case is one of only three ways to end a chapter 11 process. In a bankruptcy court's order approving a dismissal, debtors often incorporate provisions for the distribution of assets. In *Czyzewski v. Jevic Holding Corp.*,[1] the U.S. Supreme Court overturned a common practice when it ruled that the distribution scheme in a dismissal order must follow the Bankruptcy Code's absolute priority rule. This leaves practitioners searching for a solution when a debtor's assets are insufficient to satisfy creditors.

Litigation finance can be that solution. A litigation finance firm (*i.e.*, a litigation funder) would invest in a debtor's valuable causes of action — in exchange for a portion of any recovery — by providing the debtor's estate with cash to pay litigation costs and fund distributions. By doing so, the litigation funder can help the debtor solve its *Jevic* problem by monetizing the debtor's otherwise-unlocked value in its causes of action to satisfy all of the claims of senior creditors, or, in the alternative, it can offer a potential recovery from a pool of assets to secure the consent of creditors who will know that the litigation will be pursued and expect sufficient litigation proceeds to be distributed in the future.

An Explanation of the Problem

On March 22, 2017, the Supreme Court issued its decision in *Jevic*. After this decision, a debtor pursuing a structured dismissal must either (1) follow the Bankruptcy Code's priority scheme or (2) receive the consent of affected creditors for a proposal that violates the Bankruptcy Code's priority scheme.[2]

Debtors often seek to make distributions that vary from the Code's priority scheme. With the *Jevic* decision, the Court has provided senior creditors with additional leverage in withholding their consents to a debtor's proposed structured dismissal, knowing that a bankruptcy court cannot approve it if it violates the Code's priority scheme without the consent of affected creditors. One solution is to "fix" the distributions so that the structured dismissal does not violate the priority scheme. This requires the debtor to shift value from the junior creditors that would receive distributions in its original proposal to the affected senior creditors that are withholding their consent. This might create other problems and is almost certainly going to disappoint junior creditors.

Brief Explanation of *Jevic*

Much ink already has been spilled explaining the Supreme Court's *Jevic* opinion, and this article focuses on the relevant, applicable highlights from the decision.[3] The Bankruptcy Code sets forth three different options for a chapter 11 debtor to exit bankruptcy:[4] (1) The bankruptcy court can confirm a chapter 11 reorganization or liquidation plan; (2) the chapter 11 case can be converted to chapter 7; or (3) the bankruptcy court can dismiss the chapter 11 case.

The *Jevic* case involved this third option: dismissal of a debtor's chapter 11 case. When a bank-

1 *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017).

2 *Id.* at 978.

3 For a particularly thorough explanation, *see* Anna Haugen, Courtney A. McCormick and Kathryn Z. Keane, "Re-'Structuring' Dismissal Flexibility: An Analysis of the Supreme Court's *Jevic* Decision," XXXVI *ABI Journal* 5, 12, 71-73, May 2017. *See also* Robert J. Keach and Andrew C. Helman, "Life After *Jevic*: An End to Priority-Skipping Distributions?," XXXVI *ABI Journal* 9, 12, 72-74, September 2017. Both articles are *available at* abi.org/abi-journal.

4 *See Jevic*, 137 S. Ct. at 979.

ruptcy court dismisses a chapter 11 case, the parties are restored to their pre-bankruptcy positions, "[u]nless the [bankruptcy] court, for cause, orders otherwise."[5]

In *Jevic*, the Supreme Court decided the limited issue of whether a bankruptcy court can approve a structured dismissal that provides for distributions that conflict with the Bankruptcy Code's priority structure. The Court held in a 6-2 decision that structured dismissals must either (1) follow strict priority rules (*i.e.*, must not be "priority-violating structured dismissals") or (2) have the consent of the creditors whose claims are not being fully satisfied if junior creditors are receiving a distribution. In other words, structured dismissals cannot be used to end-run the absolute priority rule.

Previously, parties in chapter 11 cases used the "orders otherwise" language in order to justify distributions to creditors (either consistent or inconsistent with the Bankruptcy Code's ordinary priority rules), third-party releases and injunctions, among other provisions, in orders approving dismissals. When this happens, the debtor is said to be pursuing a "structured dismissal," which includes some of the benefits of a chapter 11 plan without all of the process, time and expense of a chapter 11 plan process.

According to the Supreme Court in *Jevic*, the "cause" provision used by a bankruptcy court to order otherwise (*i.e.*, providing ways in which the dismissal will not return the parties to their prebankruptcy positions) is included in the Bankruptcy Code in order "to give courts the flexibility to 'make the appropriate orders to protect rights acquired in reliance on the bankruptcy case.'"[6] However, the *Jevic* decision states that this provision cannot be used to justify nonconsensual "priority-violating structured dismissals."[7]

How Litigation Finance Works

Litigation financing is a non-recourse investment in the outcome of a meritorious legal claim. With litigation finance, a litigant (who is almost always the plaintiff) or law firm secures capital from a litigation funder based on the value of litigation. The litigation funder sometimes invests in a single litigation matter, and the investment is sometimes in a portfolio of matters. Litigation funders generally provide capital to litigants to pay attorneys' fees and expenses incurred as part of the litigation. In certain circumstances, the litigation funder's capital might also be used to pay operating expenses, make distributions to constituencies or for other corporate purposes. When litigation funders provide capital directly to law firms, the capital is typically used by the law firm to pay its operating expenses.

Generally, if the litigation is resolved successfully — through settlement, award or judgment — the litigation funder is repaid its investment and an agreed-upon return. If the litigation is unsuccessful, the litigation funder is owed nothing.

There are a number of reasons that a litigant seeks litigation finance. Such reasons might include (1) having a third party (the litigation funder) pay the litigation costs because the litigant does not have the resources to pay those costs itself because of liquidity or budgetary constraints; (2) having the litigation funder pay litigation costs (even if it has the resources) because it wants to use its resources for other purposes; (3) proceeding with the litigation on a contingency basis, with the litigation funder assuming responsibility for the litigation costs; (4) enabling the litigant to retain the law firm(s) of its choice; and (5) avoiding the adverse impact on corporate balance sheets, income statements and earnings that litigation costs would otherwise impose.

Although there has only been a limited number of litigation-finance arrangements in bankruptcy to date, nothing prevents a debtor from entering into such an arrangement with bankruptcy court approval, if necessary. Simply put, a debtor's meritorious litigation claims are assets, and litigation finance is often the best way to maximize the value of those assets.

How Litigation Finance Can Solve a Debtor's *Jevic* Problem

Under the right set of circumstances, a debtor can use litigation finance to solve the problem that the *Jevic* decision has created. When a debtor and its constituencies want some of the benefits of a confirmed chapter 11 plan, including bankruptcy court-approved releases and distributions of proceeds, the parties might consider a structured dismissal to exit the bankruptcy process in a cost-effective manner.

The debtor's senior creditors are typically focused on ensuring that the chapter 11 case is resolved in a manner that results in a desired distribution of value (seeking the largest-possible distributions in the quickest amount of time), and provisions that provide for the waiver and release of claims and causes of actions by the debtor and third parties to maximize the likelihood that the senior creditors' recoveries and other assets are not at risk of a later challenge. A debtor considering a structured dismissal must consider the interests of any official committee of unsecured creditors. This constituency is influential in the bankruptcy process and will typically demand distributions for its constituents in exchange for supporting — rather than opposing — the structured dismissal.

Where there is insufficient value to distribute to all the creditors senior to general unsecured creditors, the debtor will need to propose a "priority-violating structured dismissal" if it wants to provide distributions to those creditors. In some situations, there will not be enough value to distribute to the creditors that are senior to the general unsecured creditors, and to the general unsecured creditors, to secure both the consent of the affected creditors (to address the *Jevic* problem) and the support of the general unsecured creditors and their official committee. Litigation finance might solve that problem by enhancing the debtor's liquidity, which can be used to satisfy affected creditors or, at least, to enhance the debtor's distributable value to obtain the consent of affected creditors.

5 11 U.S.C. § 349(b).

6 *Jevic*, 137 S. Ct. at 984 (internal cites omitted).

7 *Id.* at 984-85 ("Nothing else in the [Bankruptcy] Code authorizes a court ordering a dismissal to make general end-of-case distributions of estate assets to creditors of the kind that normally take place in a Chapter 7 liquidation or Chapter 11 plan — let alone final distributions that do not help to restore the status quo ante or protect reliance interests acquired in the bankruptcy, and that would be flatly impermissible in a Chapter 7 liquidation or a Chapter 11 plan because they violate priority without the impaired creditors' consent. That being so, the word "cause" is too weak a reed upon which to rest so weighty a power.").

An Example to Help Explain the Solution

Suppose that a debtor has sold substantially all its assets pursuant to a § 363 sale and is left with two buckets of assets: (1) a pile of cash that is not large enough to satisfy secured creditors in full; and (2) some litigation assets. The secured creditors would generally be willing to carve out a small portion of the recovery that they would be entitled to under the absolute priority rule to buy peace among the creditor constituencies actively participating in the bankruptcy. However, the secured creditors are likely unwilling to have a significant amount of "their cash" used to fund attorneys' fees and other costs to liquidate the litigation assets, in which case those assets will have little or no value.

For this hypothetical, the pile of cash might be $75 million and the litigation could be any meritorious causes of action (*i.e.*, chapter 5 actions, breach-of-fiduciary-duty claims, commercial claims or intellectual-property-infringement claims). The secured creditors' claims might total $100 million, and they might be willing to support distributions of $1 million for junior creditors owed $25 million ($2 million of which is made up of priority claims). With $1 million to pursue litigation claims that require a litigation budget of $8 million, the defendants will just have to wait a few months for the estate to run out of funds and abandon their efforts. In this scenario, the litigation assets are basically valueless. Even if the litigation is taken on a contingency basis, $1 million is not enough to pay the expenses, and priority creditors may not consent to the structured dismissal unless the $1 million distribution is used to satisfy their claims rather than to pursue the litigation. The debtor is confronted with a structured dismissal facing intense opposition and litigation assets whose value it cannot maximize.

Solution 1: Use Litigation Finance to Satisfy Claims of Affected Creditors in Full

If the debtor's litigation assets are meritorious litigation claims, a litigation funder will provide capital to the estate on account of those claims. If the claims are sufficiently valuable, the additional capital might be able to fund the litigation and satisfy the priority claims.

For example, a litigation funder might be willing to invest $9 million in the litigation in this hypothetical, with $8 million being used to fund litigation costs in order to enable the debtor to proceed with a value-maximizing litigation strategy and $1 million (plus the $1 million distribution) in order to satisfy the priority claims. Because the claims of "affected creditors" are satisfied in full, the structured dismissal will no longer be a priority-violating structured dismissal, and the *Jevic* decision will not be an impediment to the approval of the structured dismissal.

The premise of litigation funding "coming to the rescue" is that the estate will be able to pursue meritorious litigation. In this way, the estate will be expecting to generate significant proceeds from that litigation to be distributed. With the priority claims satisfied and the litigation costs satisfied by the litigation funding, the estate's recoveries from the meritorious litigation will inure to the benefit of the junior creditors. It is even possible that the litigation would only cost $6 million, in which case the general unsecured creditors might be able to lock in a distribution of $2 million, plus have the chance of recovering substantially more if the litigation is successful.

Solution 2: Use Litigation Finance to Convince Affected Creditors to Consent

Even if the debtor is not able to generate sufficient value from the litigation funding in order to satisfy the senior creditors in full, there might still be enough incremental value generated from the litigation funding to reach a consensual deal among the creditors.[8] Using the same hypothetical, it might be that the litigation funder is only comfortable investing $7.5 million in the litigation (instead of $9 million). Based on this change, there will be $500,000 to distribute to creditors immediately ($7.5 million from the funder, plus the $1 million distribution to satisfy $8 million of potential litigation costs).

This might be enough to convince all constituencies to support the structured dismissal. The arrangement generates "value" by (1) funding the litigation costs (of $8 million) and allowing the debtor to pursue its meritorious claims expecting to generate significant proceeds from the litigation for creditors, and (2) securing the $500,000 to be distributed to creditors. With these two buckets of value to distribute — in the form of expected later distributions from the litigation proceeds and immediate liquidity — the debtor has currency with which to negotiate with its creditor constituencies.

Conclusion

If a debtor seeks to pursue a priority-violating structured dismissal, it will need to obtain the consent of the affected creditors because of *Jevic*. Litigation finance is a relatively new tool that restructuring professionals can use to facilitate the debtor's exit from bankruptcy. If a debtor has meritorious litigation, litigation finance can enable the estate to pursue valuable litigation claims and maximize the likelihood of a favorable settlement or judgment from the debtor's litigation assets, as well as increase the funds that the debtor can immediately distribute. In the right circumstances, litigation finance can solve the problem that the *Jevic* decision has created. abi

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8 Notably, *Jevic* does not ban all priority-violating structured dismissals; it only bans them if the affected creditors do not consent.