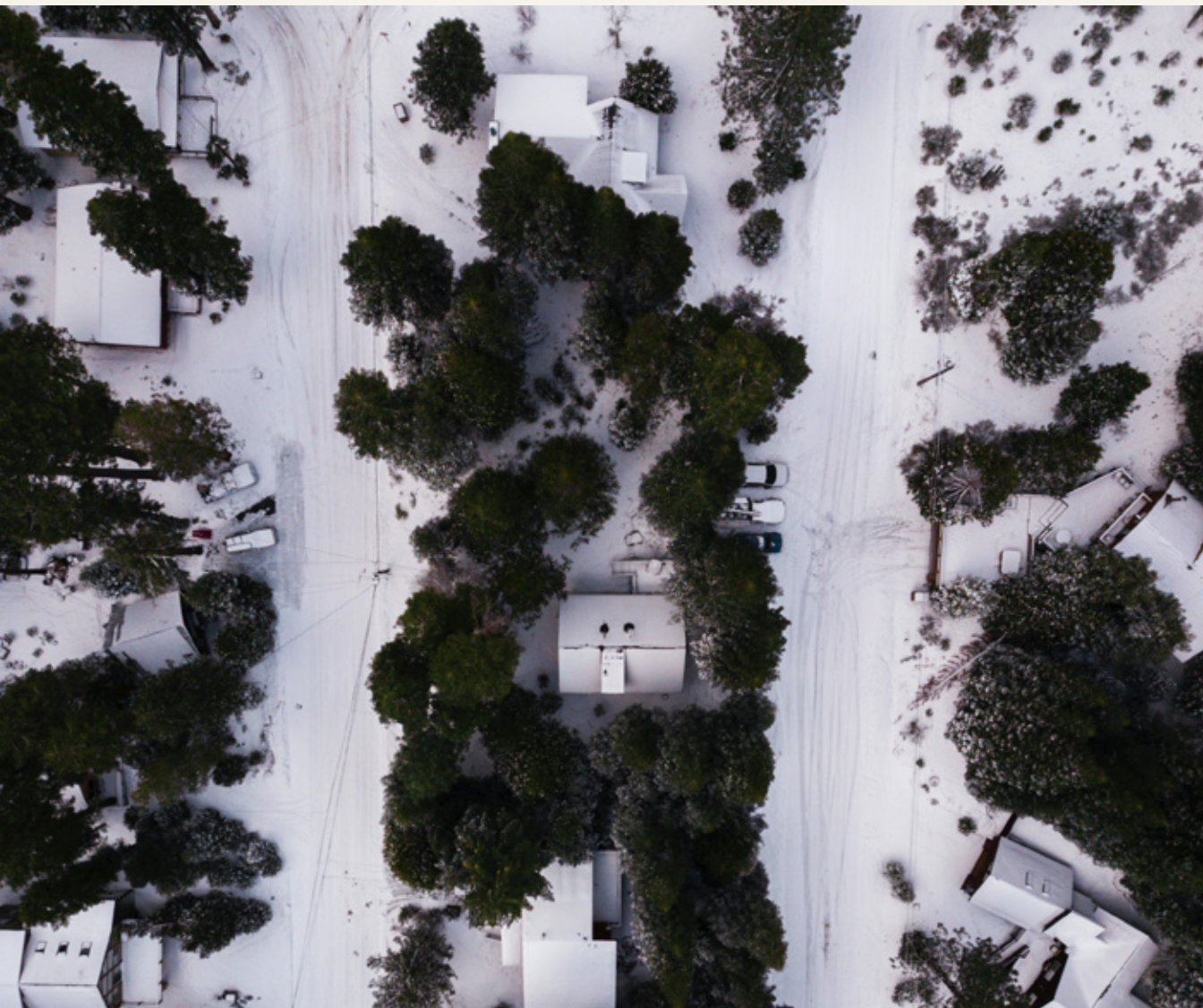
Burford

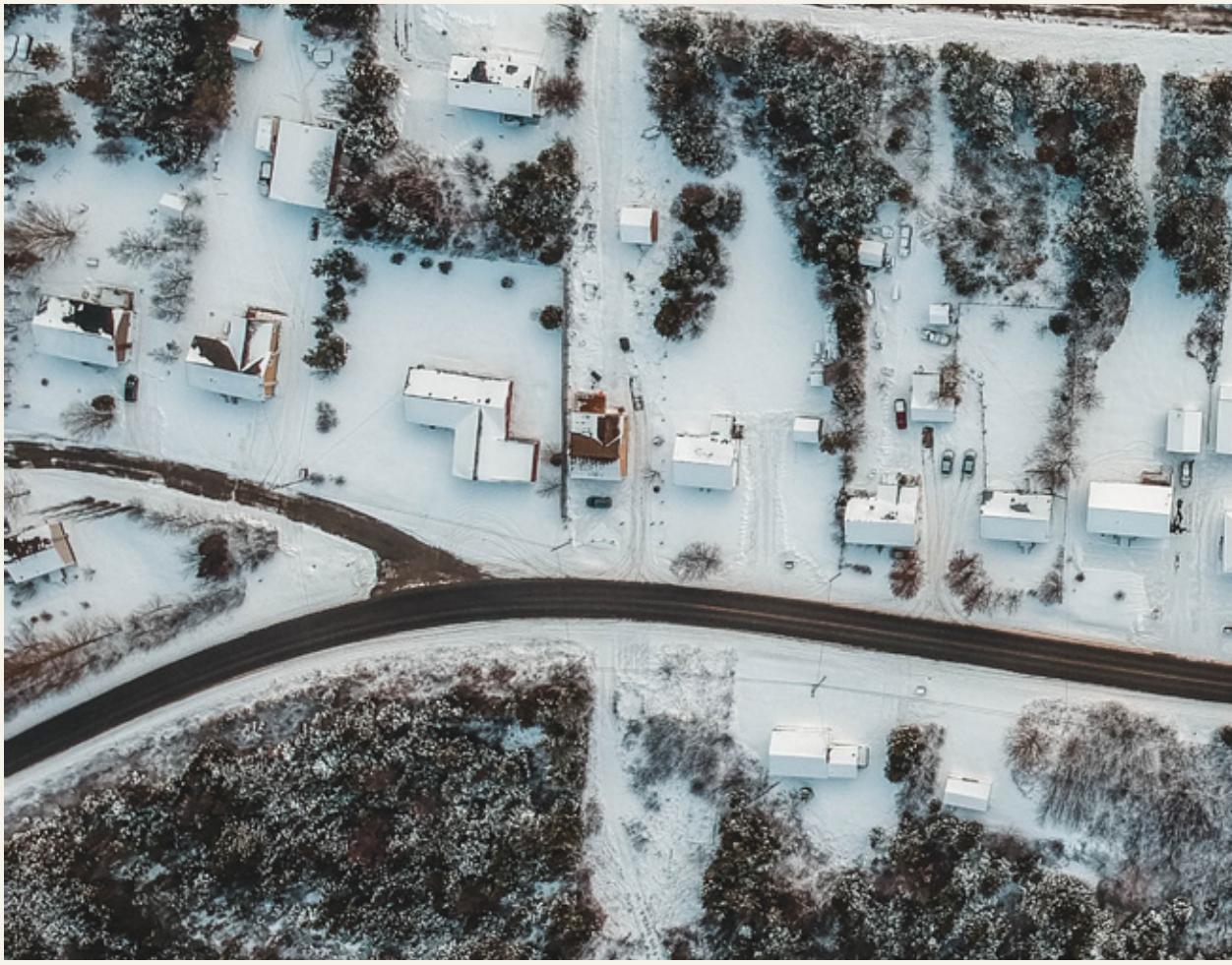
Nº1
2021

THE BURFORD Quarterly

A REVIEW OF LEGAL FINANCE

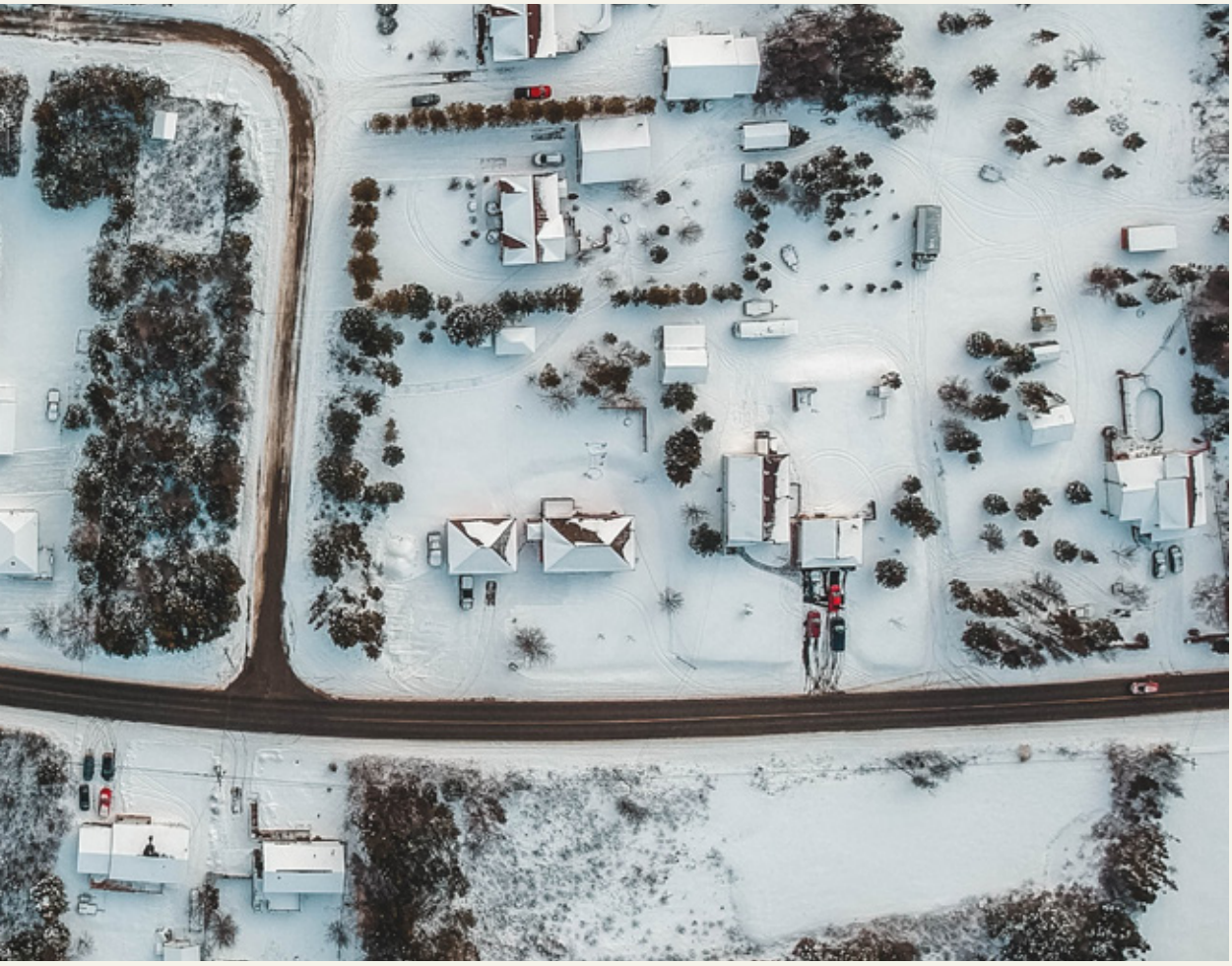
TRENDS IN MANAGING LEGAL RISK IN 2021	CFOs ON OPTIMIZING LEGAL ASSETS	LAW FIRM LEADERS ON HOW FIRMS ARE EVOLVING





ROUNDTABLE

Trends in insolvency litigation



In December 2020, Burford Senior Vice President Elizabeth Fisher and Director Connor Murphy directed questions concerning insolvency trends to a respected group of experts in contentious insolvency and restructuring. Their perspectives are excerpted and gathered below.

Q.

Government and world central bank stimuluses have helped keep the global economy in balance following the Covid-19 crisis. As government support is withdrawn, what insolvency and restructuring trends might we expect to follow?

Geoff Carton-Kelly:
Speaking to the situation in the UK at the time of writing, there are two broad schools of thought: (1) That we will drop off a cliff on or around March 31, when most of the forbearance and financial support mechanisms end; or (2) The government will put us on a gentle glide path to the withdrawal of those support mechanisms. Having seen how the previous financial crisis was dealt with, and having come this far in preventing a meltdown, I believe the latter strategy will be followed.

Given that we have a plethora of restructuring mechanisms available in the UK, including the new Restructuring Plan, the Moratorium, Company Voluntary Arrangements (CVAs) and Administrations we are able to preserve value in impaired companies potentially and businesses almost certainly.

If you combine the accessibility of those mechanisms with the significant amount of distressed investment capital waiting for the right moment and opportunity to be deployed, I foresee businesses that were fundamentally sound before the Covid-19 crisis but are now significantly impaired with a lack of cash being acquired. As a profession, we will get busier as we come out of the crisis and there are greater opportunities for recycling capital and a clear horizon to focus on.

Stephanie Wickouski:
There are so many variables as to fiscal support—including, obviously, a change in US administration—that it is impossible to predict specific insolvency trends with any certainty right now. A year ago, no one would have predicted $4 trillion in stimulus spending in 2020, and 2021 might be just as unpredictable.

James Vincequerra:
This is dependent in large part on the type of recovery we see. The trends will differ depending on whether we see a gradual recovery over the course of years instead of months as the vaccine is rolled out or a more rapid recovery. Regardless, there are a couple of general things to look for in the coming year.

In the real estate sector, I expect we will see commercial mortgage-backed securities (CMBS) largely outside of formal bankruptcies due to the structural impediments to filing that come with the Special Purpose Entities (SPEs) and the non-carve-out recourse guarantees. There will likely be an increase in special servicing situations considering the distress

that we expect to see in commercial real estate, particularly office-based real estate in major markets. But I don't think we will see traditional bankruptcy filings in the CMBS space. Instead, real estate filings will increase, and these will be more single-asset real estate cases that avoided the CMBS finance round.

The hospitality industry will not surprisingly experience significant distress. Restaurants will be particularly hard-hit: The margins in that business are already so tight that there is really not much there for formal insolvency or bankruptcy proceedings. In most restaurant cases, I think owners will simply return the keys to the landlord, shut the doors and move on. If we are going to see restaurant cases, they will be more substantial chains or restaurants where there was significant financing and branding. Hotels will face the same situation: Underperforming properties that otherwise would have limped along for years will probably wind up in insolvency, work out scenarios or formal bankruptcy proceedings.

The transport industry will see similar trends, such as in the cruise line and aviation sectors. I'm involved in a number of airline cases now and we are likely to see at least one or two more airline cases in the near- to mid-term future. Cruise lines continue to suspend global sailings. We will also see a continuation and acceleration of the retail trend of distress. Mall properties will continue to see the problems that they saw before the pandemic and so will retail businesses that didn't translate well into the e-commerce world.

Lastly, and I think most interestingly, is the potential for municipality bankruptcies as local municipalities and similar entities that have Chapter 15 available to them deal with the post-pandemic environment. Cities that have large infrastructure and fixed costs are going to have to deal with some very difficult choices. For instance, although I don't think we have to be concerned with New York City filing for bankruptcy, New York is going to face a lot of headwind in the coming years as a result of a lost tax base—as are a number of their institutions, including the transit authority. Both the city and the transit authority find themselves in the red to the tune of billions of dollars. If you combine that with what is anticipated to be an increased work-from-home environment, post-pandemic tax revenues or ride revenues for the Metropolitan Transportation Authority (MTA) are not going to return to their pre-pandemic numbers any time soon and they will continue

> “
>
> **Bankruptcy activity is obviously cyclical, and each cycle is unique.**
>
> ”

to have to pay out fixed costs such as pension obligations and employee wages. There are going to be huge budget holes that will be very difficult to fill without federal assistance. It will be interesting to see how that plays out across the nation.

Kevin Carey:
Although this came down to the last minute, US government support is continuing. It has been largely government help that has kept the economy from crashing. That does not mean certain sectors have not been affected—they have been—but the stock market continues to stay high. It is just amazing to me how quickly and routinely the government has continued to support the economy. The first answer then is: I am not sure the government, especially given the change of administration, is ever going to withdraw support. With the vaccine in circulation, support will be less necessary over time than it is now, but so far it has put off many ill-effects that we would have otherwise experienced. So what happens as that support is withdrawn? Assuming the vaccine is effective, the parts of the economy that have been adversely affected will pick back up. Does that mean restaurants that had to close will pick back up? You can't predict that, but I think you'll still find problems on both the business and consumer side.

Thus far, consumer filings have been way down as a result of the government support—and that trend may continue, given the extension of government support. If the support runs out, however, consumer filings will likely increase. From a business standpoint, it depends on the industry. Oil and gas is going to continue to be an issue; companies are overleveraged. Apart from any pandemic affect, overleverage has been an issue in our economy for an extended period.

Q.

Since the 2008 financial crisis, companies have been adding debt to their balance sheets—the US high-yield market is over six times leveraged today. How will record highs in distressed debt affect insolvency and restructuring activity? Which industries will be most affected in the long term?

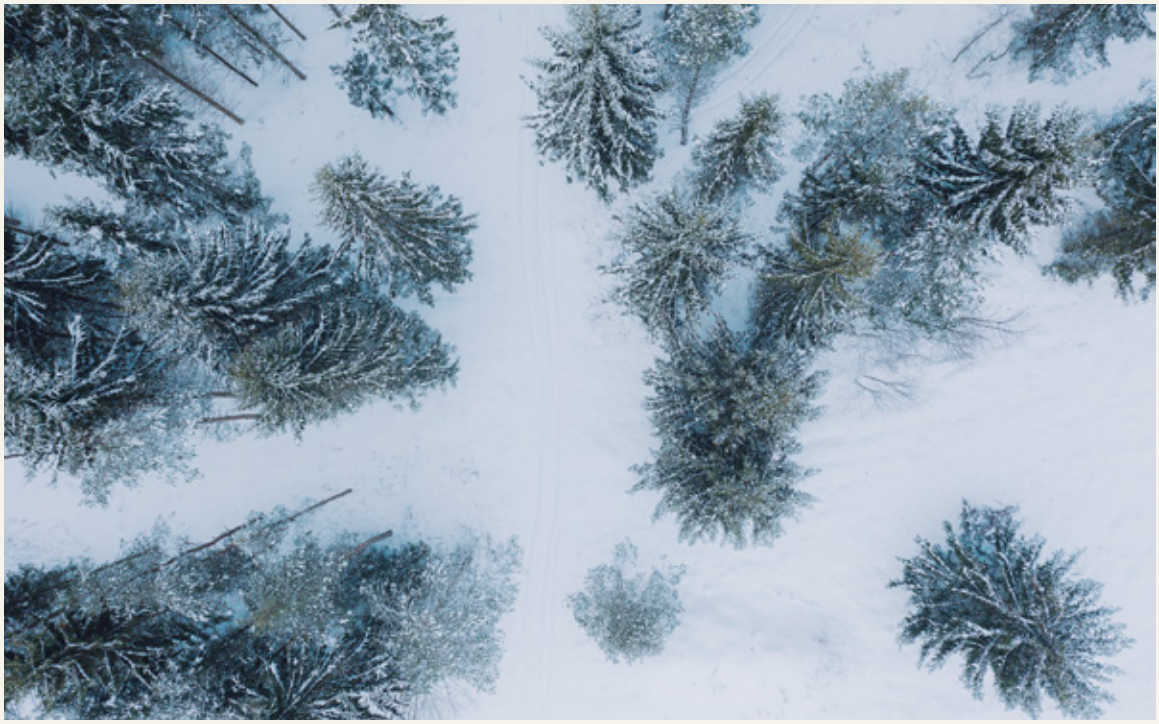
Stephanie Wickouski:
Bankruptcy activity is obviously cyclical, and each cycle is unique. The duration and intensity of restructuring activity varies cycle to cycle. One commonality in all cycles is that credit downgrades are the bellwether of a bankruptcy boom. Based on the volume of low credit ratings you are seeing, it's likely that there will be significant restructuring activity during the next two years.

Most predictions point toward energy and commercial real estate continuing to be the subject of restructuring activity, as well as airlines, aircraft leasing, live entertainment, and media/broadcasting.

For some time, I've been emphasizing strategies for monetizing illiquid recoveries such as unregistered stock, CVRs, warrants, options and interests in litigation trusts. This topic will be front and center in many restructurings.

James Vincequerra:
Levels of distressed debt will be high, and that will keep law firms' debt trading practices very busy. Debt is going to translate into increased bankruptcy filings in those industries where would-be debtors have high fixed costs, such as mining, oil and gas and brick and mortar retail businesses. Those industries and businesses will be driven to formal insolvency proceedings and significant out-of-court workouts.

Geoff Carton-Kelly:
It will depend on the attitude of the holders of such debt. Anyone who can afford to play a long game will do so. But there will be plenty of instances where the absence of cash to service high levels of debt in certain industries will cause some distress, unavoidable covenent breaches and possibly lead to restructuring and/or insolvency processes. We have already seen challenges in sectors that have attracted high levels of debt such as shopping centers, casual dining and retail which were already suffering long before Covid-19. We might see a rebalancing of the level of debt in those sectors as we emerge from this crisis but there will always be acquisition and recapitalization solutions particularly when confidence returns.



Kevin Carey:
I think it depends in large measure on how much liquidity remains in the marketplace. Right now, there is a lot of liquidity. With respect to either an industry or business, the overleverage will become too large to bear and investors are ready to step in to buy companies and debt. I think there will be an uptick in restructuring activity when that occurs, and it will continue after the effects of the pandemic go away as a result of the vaccines.

Oil and gas, hospitality, retail and restaurants have all suffered and will take time to recover, but the canary in the mine is commercial real estate. Remote work is likely to continue well after the pandemic ends: Some companies have told their workers they can stay home indefinitely, and others will be making decisions. That empty commercial space will have to be repurposed and there will be a lot of restructuring activity coming up in the next year and beyond in commercial real estate.

Q.

The modification to wrongful trading provisions in the UK was unexpectedly reintroduced on 26 November and is expected to run through 30 April 2021. Do you see this as the death of the [s214 IA86] wrongful trading provisions, as insolvency practitioners look at bringing alternate claims?

Geoff Carton-Kelly:
I was always slightly troubled by the introduction of this modification at the beginning of the pandemic (and its relaxation and reintroduction) when it did not incorporate relief from other potential misfeasance provisions elsewhere in the Insolvency and Companies Acts. Obviously, wrongful trading is a matter that will be investigated at the commencement of a formal insolvency appointment, but the loss arising remains relatively difficult to quantify. Case covering this period are going to be more challenging now, simply because of the on-off-on-off approach to the relief.

I would not necessarily say this will cause the death of the provisions, because they are still a useful weapon in the armory. Heading down the misfeasance route regarding specific liabilities that have been created by the directors is easier to quantify and arguably easier to prove but combining these two heads of claim may often get you the result you were looking for.

Q.

How have recent decisions on avoidance actions and the evolution of the law around the 11 U.S.C. 546(e) bankruptcy safe harbor affected the chances of creditor recovery?

James Vincequerra:
In light of the US Supreme Court's refusal or denial of cert for the *Tribunes II* bankruptcy case coming out of the Second Circuit, I think that the market is finally learning the parameters of the Supreme Court decision in the *Merit*[1] case and the implications for large leveraged buy-out (LBO) situations and other similar transactions involving financial institutions that could result in a fraudulent conveyance action. I think many of those transactions will be structured to fall within the new parameters of 546(e). After *Merit*, everyone understood that the 546(e) safe harbor does not protect transfers against a potential fraudulent conveyance argument where the financial institution is neither the transferor nor the transferee. What *Tribune II* in the Second Circuit set out for us was that if you structure your transaction with your qualifying financial institution properly, you the transferor or transferee can be deemed a customer of that financial institution and be brought within the ambit of the safe harbor. I think for the larger potential fraudulent conveyance action in the LBO space, we are going to see those transactions structured more carefully to fall within the *Tribune* fact pattern. The transferor uses the financial institution as an agent, and at least in the Second Circuit that brings the transaction under the ambit of 546(e). Less sophisticated parties or smaller transactions may not get the benefit of that advice and there will be transactions being done outside the 546(e) safe harbor, but the reasoning behind the *Tribune II* decision is likely going to inform a lot of LBO structuring activity moving forward. Which should show us a diminution in the anticipated creditor recoveries where 546(e) is implicated.

Stephanie Wickouski:
The Second Circuit's broad interpretation of the safe harbor defense has curtailed creditors' ability to claw back payments and other transfers made in the context of LBOs and mergers. A recent example is Nine West, in which the United States District Court for the Southern District of New York dismissed the trustee's suit against dozens of shareholders who received redemption payments in connection with the Jones Group LBO. The Court dismissed the trustee's state law claims as well, finding those claims were also precluded by the safe harbor.

> "Legal finance affects the insolvency landscape only positively. With the increased liquidity[…], entities in distress have more flexibility to do the things that they otherwise would not be able to do."

The Nine West trustee, in light of the Second Circuit's *Tribune* case, had tried to avoid the Southern District of New York as a venue by commencing the cases elsewhere, but the cases ultimately ended up in the SDNY.

What surprises me is that litigation continues to be waged by some litigation trustees, in spite of legal barriers to recovery. I suspect that the trustees do this because there is always the chance that defendants will simply settle to avoid litigation expense or the possibility that the Second Circuit might revisit its prior decisions or be overturned by the Supreme Court. Most of us believe that a change in the Second Circuit law on the safe harbor is extremely unlikely.

Kevin Carey:
This is a fascinating legal issue—a bit intricate and one I have a long history with it. *Tribune* was my case when I was sitting on the bench in Delaware, and the case that made it to the Supreme Court in *Merit* originated out of another case that I had while I was on the bench. This came from the Seventh Circuit to the Supreme Court because the post confirmation liquidating trustee did not want to bring a lawsuit concerning the safe harbor issue in the Third Circuit because the Third Circuit had already issued an opinion giving a broad reading to the safe harbor in 546(e). The litigation trustee went to the Seventh, which had not yet ruled on the issue, in hopes of having a better shot and it made it to the Supreme Court, and then we have *Merit Management*, which said conduits cannot be tagged with liability.

In *Tribune*, during Chapter 11, when the debtor said it was not going to pursue state law constructive fraudulent transfer claims, creditors who otherwise under state law would have had the right to bring them came in and wanted relief from the

state and wanted me to rule that they had the right to bring them. I did not feel that that ruling was necessary to get the company to give a confirmation of a plan. So I said, "Look I'll give you relief from the state to the extent you need it, but I will take no position on whether you have the right to bring it." They ended up in a multi-district litigation in federal court in the Southern District of New York and that went up and down the appellate chain. In the meantime, the Supreme Court decided *Merit Management*, yet the Second Circuit said there is no standing to bring such a claim. In any event, federal law preempts state law—many saw this decision as the Second Circuit trying to get away around the Supreme Court decision of *Merit Management*.

What's happened since then: There has been a petition for certiorari filed; the Supreme Court has asked the Solicitor General to weigh in; and there is a view that the Second Circuit decision is out of line with what Supreme Court held in *Merit Management*—but that remains to be seen.

One effect it may have is that other individuals who are federal receivers may choose to stay out of the Second Circuit when bring a receivership action if they can because there is now an anomalous situation in which the claims may be good or not good depending on whether or not you are in a bankruptcy proceeding. I think many people are hoping the Supreme Court will pick up the case and address what the Second Circuit did in *Tribune*.

Q.

***The Economist* estimates that the current economic crisis will expose a decade's worth of corporate fraud. Where an insolvent company has clear claims as against its directors, but the de jure directors have few visible assets, how can insolvency practitioners recover value for creditors?**

Geoff Carton-Kelly:
It is rare that the true asset position of potential targets such as directors would be clear at the commencement of a case. Using investigators and deploying other search and data analytics can throw up hidden assets for the purposes of securing value in the event of a successful claim. Some directors or boards might have D&O cover, which should be invoked immediately upon appointment and extended if necessary. The various antecedent provisions within the insolvency legislation also allow a look back to previous transactions and behavior that might give rise to claims against third parties, including recipients of assets at undervalue and preferences and, increasingly, potential claims against advisors such as auditors and even banks under recent reported cases.

Stephanie Wickouski:
Cases brought against directors and officers who lack recoverable assets can be settled for insurance coverage. As a practical matter, these cases do not go to trial for numerous reasons, including the risk of triggering a policy exclusion upon a finding of fraud.

Most cases are brought so they can be settled, not tried. Defendants always have more resources to settle a case than what is on their balance sheet. No defendant wants to be the subject of judgment enforcement.

James Vincequerra:
I've run into this issue in years past and the most straightforward answer is the D&O insurance. Any practitioner who's been confronted with this issue is going to know that in the absence of a bankruptcy filing, you will often in D&O claims run into the typical problem of Insured v. Insured exceptions to coverage in D&O policies. Outside a bankruptcy scenario, the workaround to those Insured v. Insured exceptions in D&O policies is that it does not cover in most cases the scenario where the claiming party is a trustee in the bankruptcy or a creditors committee in the bankruptcy case. If there are substantial D&O recoveries that have significant D&O insurance coverage, we will see a potential trend there in filings.

Kevin Carey:
For many years because of the over-leveraging of companies, the only source of recovery for unsecured creditors has been D&O claims and, of course, you look for insurance coverage for that. If there is insurance coverage and you have good D&O claims and you either get a judgment or you settle; there is something to recover for the unsecured creditors. If there is no insurance, there may be no recovery for creditors—and that's a problem.

To the corporate fraud issue, there is always fraud to be found. Will the current economic crisis be the cause of the fraud? I'm not so sure, except when you look at the pandemic overlay and government relief. Any time you have a massive government relief program of the magnitude the government has enacted in the US, you are bound to find fraud in the implementation and use of the loans and other relief that has been granted. For that reason, I would not be surprised if there was a lot of fraud. Does that fall on directors and officers? Perhaps. But again, it will be a question of whether or not there is insurance coverage that will determine if there may be value available for creditors.

"As a profession, we will get busier as we come out of the crisis and there are greater opportunities for recycling capital and a clear horizon to focus on."

Q.

How will the increased availability of legal finance capital and new products such as monetization help distressed companies or insolvency practitioners recover value for creditors in the coming months?

James Vincequerra:
Legal finance affects the insolvency landscape only positively. With the increased liquidity that comes from having Burford out there and making its financing available, entities in distress—whether they are in bankruptcy or not—have more flexibility to do the things that they otherwise would not be able to do. And with that flexibility will likely come a larger appetite for risk in terms of taking actions to have more substantial recoveries for their creditors. Under those circumstances I would imagine that the increased availability of legal finance capital should most certainly lead to greater returns for creditors and distressed entities.

Geoff Carton-Kelly:
There are more products, more funders and a lot more innovation in the market now, which is a good thing for practitioners. For instance, many are looking to buy claims—not just fund them. However, we expect there to be a lag in the commencement of claims in insolvencies arising from this period.

It will take a while, but I think we will be looking back on 2020 and perhaps the early part of 2021 for many years to come in relation to the behavior of directors. It is certainly true to say that the increasing range of facilities available at increasingly competitive rates will make it easier for cases with no obvious assets to be taken on in the interests of creditors by insolvency practioners. Not all insolvency practitioners like taking on contingent work nor indeed bringing proceedings but there are plenty of us out there who are willing and able to do so and to work alongside lawyers and counsel on the same basis for the ultimate benefit of the creditor constituency.

Kevin Carey:
Litigation financing is a practice and industry that has grown rapidly over the last five to ten years. It's a good thing for liquidation or litigation trustees that are post-confirmation entities. It will allow them to pursue claims that have merit where there is not much cash. We are going to see more and more of it because it is the only way, as a practical matter, value can be extracted: Contingency plaintiffs firms often will not take cases unless they have that kind of support.

With respect to monetization, I think of that more as distressed debt trading—trading on the secondary market—which has been very active for many years. It is a way of providing liquidity to creditors or companies who might not otherwise have it available. To the extent there are now direct distressed debt lenders, those loans come at high

rate of interest, high cost and other constraints on the company. But again, when there are people with money available and traditional lenders or sources are unavailable to a company, they will take advantage of that. At the end of the day, that might be something you could question directors and officers about approving such arrangements, because some of them can be expensive and one sided. But if a company is in distress and running out of liquidity, sometimes the choices are limited.

Stephanie Wickousk:
There is no question that legal financing is bringing about a dramatic change in creditor recovery. Going forward, litigation financing may be the single most important factor in recovering value for creditors. Many companies are extremely over-leveraged, making a recovery to anyone other than that most senior tranche of creditors either non-existent or insufficient. Those out-of-the-money creditors will have to look beyond the enterprise value and pursue litigation in order to get any recovery.

As suggested by *The Economist*, systematic schemes to remove value from creditor groups (i.e., corporate fraud) will be exposed in the next round of Chapter 11 cases. Legal finance will provide the means for many of these defrauded groups to pursue recoveries.

[1] Merit Management Group, L.P. v. FTI Consulting, Inc. ("Merit")

PARTICIPANTS

Kevin Carey

The Honorable Kevin Carey (Ret.) is a partner in Hogan Lovells' business restructuring and insolvency practice, resident in the firm's Philadelphia office. Judge Carey joined the firm following his time on the US Bankruptcy Court, District of Delaware, where he earned a reputation as one of the nation's top bankruptcy judges. He is a fellow of the American College of Bankruptcy, sits on the Executive Committee of the Board of Directors of the American Bankruptcy Institute, and serves as Vice President of Membership.

Geoff Carton-Kelly

Geoff Carton-Kelly is a partner and Licensed Insolvency Practitioner at FRP in London. He has more than 35 years' experience, and has been taking appointments since 1998. More recently his primary focus has been on international cases, real estate, contentious insolvency and charities. He advises boards and stakeholders, claimants and government agencies on a range of contentious insolvency and restructuring matters

James Vincequerra

James Vincequerra is a partner at Alston & Bird's Financial Restructuring & Reorganization Group. His primary practice is representing businesses in a variety of commercial transactions and matters. He has significant experience representing debtors, lenders and other creditors, committees, bondholders, and asset acquirers (in and out of court) in high-stakes matters across industries, including finance, retail, education, real estate, hospitality, new media, e-commerce and telecommunications.

Stephanie Wickouski

Stephanie Wickouski is a partner at Locke Lord LLP in New York in the Bankruptcy, Insolvency and Restructuring practice. With more than 35 years of experience handling complex reorganization cases throughout the country, Stephanie has served as lead bankruptcy counsel in multiple high-profile cases. She is the author of three books: *Indenture Trustee Bankruptcy Powers & Duties*, *Bankruptcy Crimes* and her most recent book, *Mentor X – The Life-Changing Power of Extraordinary Mentors.*

MODERATORS

Elizabeth Fisher | +44 (0) 20 3814 3685 | efisher@burfordcapital.com

Elizabeth Fisher is Senior Vice President with responsibility for developing and expanding Burford's relationships with law firms and companies across the UK and Europe. She served in numerous leadership positions at Axiom, the global leading alternative legal services provider, including as Vice President, EMEA Head of the Banking & Regulatory Practice.

Connor Murphy | +1 646 849 9419 | cmurphy@burfordcapital.com

Connor Murphy is a Director with responsibility for originating new business with US law firms and companies. Prior to joining Burford, he was Managing Director, Advisroy, at BDO Advisory USA, where he led global business development for forensics, concentrating on cross-border disputes and investigations.

If you found this article interesting, please download the full issue of the Quarterly here.

Burford Capital is the leading global finance and asset management firm focused on law. Its businesses include litigation finance and risk management, asset recovery and a wide range of legal finance and advisory activities. Burford is publicly traded on the New York Stock Exchange (NYSE: BUR) and the London Stock Exchange (LSE: BUR), and it works with companies and law firms around the world from its principal offices in New York, London, Chicago, Washington, Singapore and Sydney.

www.burfordcapital.com

Burford