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# 2019 Southwest Bankruptcy Conference

## Third-Party Litigation Financing

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## ***Third Party Financing of Commercial Litigation in the US***

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## ***Third Party Financing of Commercial Litigation in the US***

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## Third Party Financing of Commercial Litigation in the US

- Form of specialty finance based on the value of litigation
- Allows a plaintiff to monetize a contingent asset
- Nonrecourse investment...*not* a loan
- Proceeds fund costs of litigation (and potentially working capital)
- Used by businesses and noncorporate entities
- Available at any point in the litigation lifecycle
- Available to plaintiffs and law firms
- Occurring in the US and abroad
- The form and substance of deals vary significantly
- Today's focus is on commercial, not consumer, applications, and especially bankruptcy-related considerations



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## Key Definitions for Litigation Finance

- Capital Provider or Funder
  - Third party provider of non-recourse capital secured by a litigation asset
- Litigation Asset
  - Litigation or group of litigations (a portfolio) in which the funded litigant expects to win –
    - For plaintiffs, value or cash proceeds;
    - For defendants, varied definitions of success (complete dismissal, settlement, defense verdict)
- Funded Party
  - Litigant (company) or law firm that is counterparty to a litigation finance transaction
- Litigation Finance Transaction
  - Agreement between Capital Provider and Funded Party, key consideration is:
    - *Capital Provider's Investment*: A non-recourse investment of a defined amount of capital based on the value of the litigation asset
    - *Capital Provider's Return*: Risk premium earned by Capital Provider if litigation is successful
      - For plaintiffs, a portion of any value generated (generally cash value);
      - For defendants, a premium on the amount of invested capital paid by defendant



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## Types of Claims for Which Funding is Available

- Bankruptcy estate claims and causes of action brought by DIP, Liquidating/Litigation Trustee, and Ch.7 Trustee
- Antitrust and trade regulation claims
- Class actions (*Opt-in vs Opt-out; US vs Non US*)
- General commercial disputes – contract claims, fiduciary duty claims, fraud claims, insurance coverage disputes, securities claims
- Intellectual property claims - including patent, trademark, copyright, and trade secret
- *Qui tam* and whistleblower actions (*not all litigation funders will provide financing*)
- Forums – state and federal court (trial and appeal), domestic and international arbitration, bankruptcy and other specialty courts



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## What Makes a Litigation Attractive to an Investor?

- Plaintiff has meritorious litigation with high probability of success
- Plaintiff's law firm is experienced and has a successful track record and willingness to take case on partial contingency and share risk
- Litigation expected to result in settlement or judgment that is monetary or capable of being valued
- Damages are well supported and significantly exceed the requested amount of financing
- Defendants have an ability to satisfy settlement or judgment



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## The Litigation Funding Process

- NDA
- High-level discussion of litigation
- Term sheet
- Due diligence/underwriting process
- Negotiation of litigation funding agreement
- Investment committee
- Capital deployment
- Monitoring



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## The Due Diligence Process

- Maintaining communication privileges (attorney-client and work product) as well as confidentiality is crucial
  - Only share confidential and/or privileged information with a written confidentiality agreement/NDA in place
  - Attorney-client privileged communications should not be disclosed to funder
  - Work product protection exists notwithstanding Acceleration Bay\*
- Information the funder will require to underwrite the claim
  - General information about the case and likely damages
  - Key documents necessary to establish the elements of the claim
  - Information about potential settlement range
  - Budget of legal fees and costs through trial and appeal
  - Information about any additional amounts of financing

\*See *Miller UK Ltd. v. Caterpillar*, No. 10 C 3770, 2014 WL 67340 (NC Ill. Jan. 6, 2014); *Acceleration Bay LLC v. Activision Blizzard Inc.*, No. 16-cv-00538 (W.D. Pa. Dec. 19, 2017)



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## How can Litigation Finance Proceeds be Used?

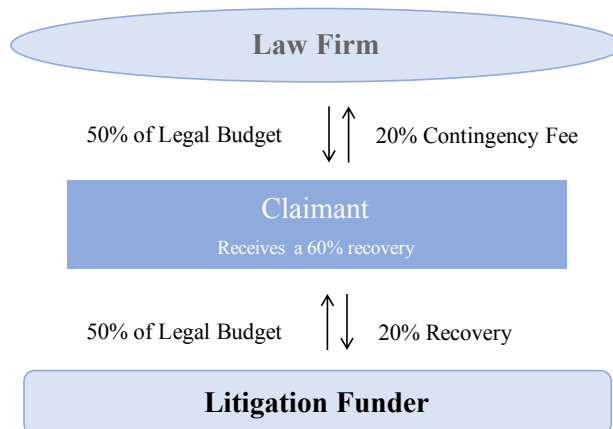
- Fund legal fees or expenses of litigation
- Finance portfolios of litigation for companies and law firms
- Transfer or share risk in matters
- Monetize litigation assets
- Provide working capital to bankruptcy and receivership estates
- Trace assets; finance, sell, or enforce judgments
- Pay chapter 11 administrative expenses and priority claims to allow for plan confirmation
- Fund post-confirmation trust investigation and/or administrative costs
- Fund a distribution to creditors in bankruptcy context



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## Single-Case Financing Structure

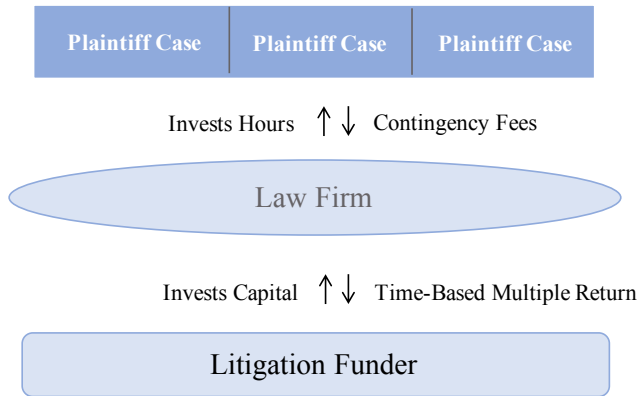
### Baseline Model:



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## Portfolio Funding Structure

### Baseline Model:



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## Funder Relationship

- Litigation finance providers in the US are passive investors
- There should be no interference with lawyer/client relationship
  - Funders do not control litigation strategy or settlement decisions
  - Funders do not typically take assignment of litigation claim, but there may be exceptions
    - Funders require reporting of developments in cases after investment
    - May offer case-related advice, but they are not acting as lawyers and do not have decision-making authority
- Parties to funding agreement should discuss the contours of the litigation: potential challenges to jurisdiction and/or venue, addition or subtraction of defendants, appeals (including interlocutory appeals), etc.
- Consideration of confidential and privileged information
  - Case law confirming work product protection applies to funder communications and documents, provided an NDA is in place
  - Professional litigation finance providers carefully manage diligence to avoid risking waiver of protected communications



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## Legal Considerations and Potential Pitfalls

- Champerty and Maintenance
  - Maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome; and barratry is a continuing practice of maintenance or champerty
  - A successful challenge on this basis would impact the enforceability of the funding agreement but not the underlying case
- Restrictions in approximately 20 states
  - See *Maslowski v. Prospect Funding Holdings, LLC*, No. A16-0770, 2017 WL 562532 (Minn. Ct. App. 2017); *Boling v. Prospect Funding Holdings, LLC*, No. 1:14-CV-00081 (W.D. Ky. 2015); *Telesocial v. Orange*, No. 3:14-cv-03985 (N.D. Cal. 2015)
- Otherwise self-regulated in US – subject to judicial control and legal ethics rules
- The ABA, NY State Bar, NYC bar and other state bars have issued guidance to lawyers advising clients about litigation finance



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## Ethical Considerations & Model Rules

- Model Rule 1.6 (confidentiality of Information)
- Model Rule 1.7(a)(2) (material-limitations conflicts rule)
- Model Rule 1.8(a) (regulation of business transactions with clients)
- Model Rule 1.8(e) (financial assistance to clients)
- Model Rule 1.8(f) (limitations on accepting representation of client with fees paid by third party)
- Model Rule 1.8(i) (acquiring a proprietary interest in a client's cause of action)
- Model Rule 2.3 (hybrid confidentiality rules governing provision of evaluations to third party)
- Model Rule 5.4 (prohibition on fee-splitting)
- See American Bar Association Commission on Ethics 20/20 Informational Report on Alternative Litigation Finance in accompanying appendix



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## Disclosure of Funding Agreement Outside of Bankruptcy

- Generally, disclosure of existence of funding is at the discretion of the parties
- Proposed revision to FRCP 26(a)(1) to require automatic disclosure rejected as premature by the FRCP Advisory Committee in December 2014, resubmitted in November 2017 and currently under consideration
  - The N.D. Cal amended their standing order to require disclosure of any litigation finance arrangements in class or other representative actions
- Increasingly the subject of discovery requests
  - *Lambeth Magnetic Structures, LLC v. Seagate Technology (US) Holdings, Inc., et al.*, 2:16-cv-00538 (W.D. Pa. 2017) ("Plaintiff's agreement ... was undisputedly prepared in anticipation of the instant litigation and for the purpose of pursuing the litigation. As a result, all of these materials are shielded under work product protection.")
- Certain rules of arbitral bodies suggest disclosure by neutral (E.g., Canon II(A)(2) of the AAA Code of Ethics)
- Proposed Litigation Funding Transparency Act of 2019
- Judge Polster's Order Regarding Third-Party Litigation Financing, No. 1:17-MD-2804 (N.D. Ohio filed May 7, 2018)



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## Disclosure of Funding Agreement in the Bankruptcy Context

- Is bankruptcy court approval needed to enter into litigation funding agreement?
  - Is the underlying claim and related proceeds an estate asset?
  - Who is seeking the funding and under what authority?
  - Can you have agreement and court order approve provisions such as who is to determine the role and power of Trustee or DIP regarding legal issues to be pursued, scope and expense of discovery, settlement authority, etc.?
- Potential challenges to the funding agreement when there is an intervening bankruptcy filing (affects the funder, primarily)
  - Recharacterization, equitable subordination
  - Fraudulent conveyance
  - Validity of security interest and perfection



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## Case Study: MagCorp\* Liquidation

*Successful use of litigation finance to guarantee creditor recovery*

- Magnesium Corp of America (“MagCorp”), an operating subsidiary of Renco, filed for bankruptcy in 2001, eventually converting to a Chapter 7 liquidation
- In 2003, the MagCorp chapter 7 liquidation trustee initiated an adversary action against Renco for fraudulent transfer, fraudulent conveyance, breach of fiduciary duty and unjust enrichment, resulting in a \$213 million judgment after trial against Renco in 2015
- In 2016, with \$670,000 of cash left, the chapter 7 liquidation trustee executed a 363 sale of a right to MagCorp’s litigation proceeds if the judgment was sustained on appeal

*\*In re MagCorp liquidation, Case No. 01-14312 (Bankr. SDNY)*



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## Case Study: MagCorp Liquidation

- Public auction generated \$26.2 million for MagCorp on a *non-recourse* basis
  - If the case had to be retried or lost on appeal, guaranteed recovery for creditors and war chest for further litigation
  - If case won, litigation funder would receive \$50 million plus interest
- Bankruptcy court approved transaction as reasonable and in the best interest of creditors
  - Court supported the rejection of an alternative offer by Renco
  - Court rejected objections of some noteholders that transaction was unnecessary and too expensive
- MagCorp’s judgment was ultimately affirmed



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## Case Study: FastShip

*Successful use of litigation finance to access chapter 11 and pursue claims*

- Company with patents for oceangoing vessels had discovered apparent patent infringement by US Navy, but had no funds to pursue case, including estimated \$2-4Mil in discovery and expert costs.
- Claims were deemed meritorious by prospective contingency-fee law firm and litigation finance source, both of which required 1<sup>st</sup> lien on outcome of case
- Majority of creditors were secured by IP and litigation proceeds, with no indenture trustee with whom to negotiate for subordination
- Creative use of Ch.11 to subordinate creditors<sup>1</sup>
- Successful litigation in Court of Claims<sup>2</sup>
- Ongoing trade secrets litigation<sup>3</sup>

<sup>1</sup>*In re FastShip, Inc., Et Al.*, No. 12-10968 (BLS) (Bankr. D. Del. 2012)

<sup>2</sup>*FastShip LLC v. USA*, Case No. 1:12-cv-00484-CFL (Ct. Fed. Claims 2012),  
*aff'd* *FastShip LLC v. U.S.*, Case Nos. 17-2248, 17-2249 (Fed. Cir. 2017)

<sup>3</sup>*FastShip LLC v. Lockheed Martin Corp., et al.*, Case No. 17-02919 (NLH) (D.N.J. 2017)



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## Case Study: Epicenter\*

- Funder Ganymede Capital provided third party litigation financing to Epicenter for lawsuit.
- Verdict entered in favor of plaintiff Epicenter, but defendant had no cash and transferred its real property to Epicenter.
- Funder and contingent fee law firm took first and second deeds of trust with maturity dates.
- Funder and law firm sold claims and assigned their deeds of trust to CPF
- After maturity, CPF pursued deed of trust sales.
- Epicenter filed bankruptcy to stop trustee's sale, filed an objection to the claims and filed an adversary proceeding to subordinate the liens for fraudulent transfer, equitable subordination and recharacterization

*\*In re Epicenter Partners, et al.*, Case No. 16-5493 (Bankr. Arizona)



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## Case Study: Epicenter

- Judge Wanslee found no grounds for equitable subordination against CPF, because CPF was found not to be an insider
- Once the Court concluded CPF was not an insider, the standard for equitable subordination was very high. "Gross and egregious conduct is required to subordinate non-insider acts, and must be proven with particularity." *Henry v. Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)*, 471 F. 3d 977, 1006 (9<sup>th</sup> Cir. 2006)
- Judge Wanslee found grounds for possible equitable subordination of the claims of STB because, "Attorneys are fiduciaries with duties of loyalty, care and obedience, . . . relationship . . . of utmost trust." *Webb v. Gittlen*, 217 Ariz. 363, 367 (2008) (quoting *In re Piatt*, 191 Ariz. 24, 26 (1996))

## Case Study: Epicenter

- Interestingly, although the Simpson Thatcher claim was assigned to the same party (CPF) as the Ganymede claim, and assigned in the same transaction, the same "cleansing" process that CPF enjoyed with respect to Ganymede under *Village at Lakeridge* was not applied to the STB claim
- Bankruptcy Court dismissed most of the adversary proceeding
- 9<sup>th</sup> Circuit Bankruptcy Appellate Panel affirmed Bankruptcy Court's decision to overrule the claim objections
- Bankruptcy Court confirmed CPF's Plan of Reorganization that provided for sale of the property and payment of the CPF claim

## Key Takeaways

- Litigation finance can be a game-changer – especially in bankruptcy
- Ability to investigate and prosecute meritorious litigation and level the playing field for plaintiffs and estate representatives with limited resources
- Work with reputable and experienced litigation funders
- Share confidential information only after executing a confidentiality agreement
- Make sure attorneys reviewing the agreements understand the relevant state laws
- Confirm that funded party and lawyers understand agreements with funders
- Ensure plaintiff/estate representative maintains control over litigation and settlement
- Like all agreements for investments, draft and review carefully



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## Additional Information

- “Creative Use of Chapter 11 to Pursue Patent Claims in FastShip (and a ‘Chapter Two’)", Howard Brod Brownstein & Raymond H. Lemisch, *American Bankruptcy Institute Journal*, June 2018
- “An Introduction to Third Party Financing of Commercial Litigation”, Cathy L. Reece
- “Litigation Funding: An Essential Tool for Maximizing the Value of the Debtor’s Estate”, By Kenneth Epstein and Eric Fisher, *The New York Law Journal*, March 15, 2018
- *Miller UK Ltd. Et Al. v. Caterpillar, Inc.*, No. 10-C-3770. N.D. Ill., 2014

### For Further Exploration

- Onika K. Williams, “Fee Financing Sails into Uncharted Waters”, *ABA Litigation News*, Spring 2019
- Danielle Cutrona, “Answers To Key Legal Finance Ethics Questions”, *Law360*, July 16, 2019



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## Questions & Answers

