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THE**RECEIVER**

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LITIGATION FUNDING FOR FEDERAL EQUITY RECEIVERS

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Introduction

A court has just appointed you the receiver of Fleece Securities upon request of the U.S. Securities and Exchange Commission. You need experienced counsel to investigate claims against Fleece's former officers and directors, who look to have perpetrated a Ponzi scheme. Moreover, you suspect there could be additional recovery from investors who were unjustly enriched, as well as from lawyers and other outside professionals who facilitated the scheme. Fleece's coffers, however, are almost empty, and your go-to firms are reluctant to take the plunge on a purely contingent basis. Third-party litigation funding may be the solution.

What is Litigation Funding?

Third-party litigation finance ("Litigation Funding") is an arrangement in which a third-party financier unaffiliated with a case ("Funder") finances some or all of its prosecution in exchange for a portion of any potential recovery. This financing is typically provided as a non-recourse loan, meaning that the Funder is compensated only if there is a successful judgment or settlement, similar to a contingency fee charged by attorneys. Some Funders are also willing to finance a defense under alternative funding agreements.

Litigation Funding is somewhat novel in the United States but is beginning to gain a foothold, especially in large commercial cases, with a number of hedge funds and even a crowdfunding platform entering the marketplace.[1] While Litigation Funding has yet to be widely embraced in American insolvency litigation, Australian liquidators and trustees have long resorted to outside financing.[2] As explained below, the time may be ripe for their United States counterparts to start doing the same.

The Litigation Funding Debate

Litigation Funding has long been a matter of debate. Opponents argue that Litigation Funding raises the same public policy concerns that were addressed by old champerty and maintenance laws. These doctrines arose in medieval Europe to combat frivolous litigation by prohibiting interference from parties with no interest in a case, and whose involvement was viewed as meddlesome and pro-litigation. While courts and state legislatures have increasingly rolled back these doctrines,[3] the U.S. Chamber of Commerce and similar organizations continue to object to Litigation Funding, or at least try to limit it.[4]

Proponents say Litigation Funding can level the legal playing field so that a case is decided on merit and not financial wherewithal. Litigation Funding increases access to justice for smaller, aggrieved parties, unaffiliated class plaintiffs, or even to larger companies who cannot afford high-stakes litigation or simply do not want to bear the uncertainty of litigation costs. It also provides an alternative to the typical contingency arrangement, offering financial flexibility to attorneys who cannot risk contingent representation. This, in turn, provides litigants a greater pool of attorneys to choose from. Moreover, Litigation Funding can help vet the merits of a case, since

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[1] *See, e.g.,* Paul M. Barrett, *Crowdsourcing Comes to the Booming World of Litigation Finance*, Bloomberg Businessweek (Nov. 20, 2014). *See also* Daniel L. Chen & David S. Abrams, *A Market for Justice: A First Empirical Look at Third Party Litigation Funding*, 15 U. Pa. J. Bus. L. 1075, 1088 (2013); Lawrence S. Schaner & Thomas G. Appleman, Jenner & Block LLP, *The Rise of 3rd-Party Litigation Funding*, Law360, Portfolio Media, Inc. (Jan. 21, 2011).

[2] *See* R. I. Barrett, *Judicial Views on Litigation Funding*, INSOL International Annual Regional Conference (Mar. 15, 2011); Nick Mavrakis, Matthew Daley & Stuart Clark, Clayton Utz, *An Oversight Regime for Litigation Funding in Australia*, U.S. Chamber Institute for Legal Reform (Aug. 2014). Notably, Australian ethical rules prohibit contingency fees charged by attorneys, but not third parties. John Emmerig & Michael Legg, Jones Day, *Litigation Funding in Australia: More Swings and Roundabouts as Lawyers Withdraw Application to be Funders*, Jones Day Commentary (Feb. 2014); *see also* Legal Profession Act 2007, § 325 *Contingency fees are prohibited.*

[3] Chen & Abrams, at 1082-83.

[4] The groups recently proposed an amendment to Federal Rule of Civil Procedure 26 that would require disclosure of any Litigation Funding arrangements at the outset of litigation. *See* Letter from U.S. Chamber Inst. for Legal Reform to Jonathan C. Rose, Sec'y of the Comm. on Rules of Practice and Procedure of the Admin. Office of the U.S. Courts (Apr. 9, 2014) (*available at* http://www.instituteforlegalreform.com/uploads/sites/1/4_-_FINAL_VERSION_-_TPLF_Disclosure_letter_4_9.pdf). Litigation Funding proponents have opposed the amendment and, in our view, have the better argument. *See http://www.gerchenkeller.com/gkc-responds-chamber-proposal-amend-civil-rules/.*

funders are typically sophisticated investors, often with strong legal backgrounds, who carefully evaluate the details of a case before investing their clients' money.[5]

How Litigation Funding Works

Parties to Litigation Funding have wide latitude to shape their relationship. The traditional hallmark is that the Funder receives payment only if the lawsuit is successful (in whole or in part). But as a matter of contract law, the parties are free to negotiate the specific terms of compensation, subject to certain professional rules, described below. For example, the parties might agree that the Funder takes a flat percentage of any recovery, a return of its investment plus interest, or a "waterfall" repayment whereby the Funder receives an increased percentage on the first dollars of an award below a certain threshold, *e.g.* 25% of any award under $1 million, and 20% of any award over $1 million.

Litigation Funding contracts are also flexible with respect to the flow of funds. Financing is often provided directly to the litigant, who then uses funds to retain counsel and finance the lawsuit. Alternatively, the Funder may finance litigation indirectly through the law firm itself, which reduces the attorneys' risk by providing working capital upfront. When the attorneys are retained on a contingency fee, this indirect financing method may raise ethical concerns with respect to fee sharing. Thus, the plaintiff's written consent to the agreement is paramount.

However the financing terms are structured, parties to a Litigation Funding agreement must comply with all ethical guidelines and certain judicially-created rules. For instance, Model Rule of Professional Conduct 1.8(f) states that an attorney shall not accept compensation for representing a client from a third party unless: (1) the client gives informed consent; (2) there is no interference with the attorney's professional judgment or the attorney-client relationship; and (3) information relating to the representation is kept confidential as required by Model Rule of Professional Conduct 1.6. Rule 5.4(c) likewise requires that an attorney not permit someone paying the legal bill to direct or regulate the attorney's professional judgment. Therefore, Litigation Funding agreements should clarify that Funders disclaim any case management or oversight responsibilities and that their role is to finance or consult only. The attorneys and clients/parties should control the strategy for the case, retaining all decision-making authority, especially with respect to settlement. While Funders may be privy to settlement discussions, they should not have any approval rights.

Litigation Funding may raise tricky privilege and confidentiality issues. Funders will want to closely examine relevant documents and hear counsel's opinions both before and after funding a case. Such communications may not be subject to the common-interest/attorney-client privilege because Funders have only a business or financial interest, and not a legal interest, in the outcome of the case.[6] However, the relationship may be protected by the work product doctrine. Funding

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[5] *See, e.g.,* http://www.gerchenkeller.com/who-we-are.

[6] *See, e.g., Miller UK Ltd. v. Caterpillar, Inc.*, 17 F. Supp. 3d 711, 732-33 (N.D. Ill. 2014). *Compare Carlyle Inv. Mgmt. L.L.C. v. Moonmouth Co. S.A.*, C.A. No. 7841-VCP, 2015 Del. Ch. LEXIS 42 at *26-27 (Feb. 24, 2015) (acknowledging that the analysis becomes "blurry" considering the Funder is involved in the "business of funding litigation").

documents are prepared "because of" litigation and likely contain counsel's mental impressions, strategies and theories about the case, as well as value determinations like financing premiums and acceptable settlement conditions.[7] The parties or their counsel should take reasonable steps to guard against further disclosure by entering into confidentiality agreements with potential Funders.[8] They should also consider signing a consulting expert agreement with Funders prior to transmitting any confidential information, which would limit disclosure of the arrangement under Federal Rule of Civil Procedure 26(b)(4)(D).

Litigation Funding for Federal Equity Receivers

Litigation Funding could be a valuable tool for federal equity receivers. In most cases, the receiver must pursue claims on a tight budget and balance litigation expenses against competing needs of the estate. This may prevent pursuit of meritorious claims or at least restrict the receiver's choice of counsel. Litigation Funding can not only ease this burden, but also enable receivers to pursue valid claims against deep-pocketed defendants who otherwise might be able to prevent cost-effective litigation through obstruction and delay. And by providing a dedicated funding source for litigation, Litigation Funding can free up limited estate resources to pay other administrative expenses.

Many of the concerns raised by Litigation Funding critics are not as salient in the federal equity receivership context. Court-appointed receivers are unlikely to take chances on abusive or frivolous litigation. They also have extra incentives to resolve cases efficiently and not draw them out in the hope of a windfall recovery. Courts and claimants provide a natural check on reckless or even merely foolish litigation decisions.

Litigation Funding could be even more useful to federal equity receivers than to bankruptcy trustees. Trustees must act within the confines of the Bankruptcy Code, which regulates the entire bankruptcy process, and procedural rules governing financing and fee sharing.[9] By contrast, courts can use their broad equitable powers under Federal Rule of Civil Procedure 66 to shape a receiver's powers on a flexible, *ad hoc* basis. Additionally, while district courts review bankruptcy court decisions *de novo*, they review administrative decisions of a federal equity receiver for abuse of discretion.[10] Under this framework, a receiver could be free to promise even a sizable portion of a judgment to a Funder depending on the facts and circumstances.

Although a federal equity receiver acts as an extension of the court, it's clear that the receiver him or herself, or perhaps counsel (but obviously not the court), should be the borrower in any

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[7] *Carlyle*, 2015 Del. Ch. LEXIS 42 at *27-28 (granting protective order barring discovery of Litigation Funding materials under work product doctrine).

[8] *Miller*, 17 F. Supp. 3d at 736-37.

[9] Patrick M. Jones, Greensfelder, Hemker & Gale, P.C., *Third-Party Litigation Funding in Bankruptcy Cases*, The Bankruptcy Strategist, Vol. 30, No. 3 (Jan. 2013) (citing 11 U.S.C. § 364; Fed. R. Bankr. P. 2016(b)).

[10] Michael Z. Gurland & Phillip L. Stern, Neal, Gerber & Eisenberg LLP, *Substance Over Form: Equity Receivers in SEC Enforcement Actions*, The Journal of Corporate Renewal, Vol. 24, No. 6 (July/Aug. 2011), at 9.

Litigation Funding agreement. Receivers should consider requesting the power to enter into a Litigation Funding arrangement in the receivership order.

Conclusion

As inhibitions against Litigation Funding continue to wane, federal equity receivers should not hesitate to consider the practice. In fact, in many respects, receivers are ideal candidates for Litigation Funding: They are experienced and practical owners of sound claims who, by reason of potential defendants' wrongdoing, lack the resources to prosecute them. In the right circumstances, Litigation Funding may not only help receivers maximize recoveries for victims and creditors but, more broadly, promote the interests of justice.

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