U.S. Restructuring Outlook: Third-Party Litigation Financing

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In the past decade, third-party litigation financing (TPLF) — an arrangement where a nonparty funder provides financing for the prosecution of a lawsuit in exchange for an interest in the potential recoveries — has become increasingly accessible in the U.S. In the bankruptcy context, where a debtor's estate may otherwise have limited resources to pursue valuable causes of action, the availability of TPLF provides restructuring professionals with a key tool to improve litigation outcomes and maximize the value of estate assets in the face of liquidity constraints. However, in structuring a TPLF arrangement, care must be taken to ensure that the introduction of a nonparty funder with purely economic interests does not shift the dynamics of the underlying litigation in a manner that is inconsistent with applicable state law or the Bankruptcy Code. Whatever the consequences may be of TPLF's proliferation, as we discuss below, we expect TPLF to remain an important option in U.S. restructuring cases in 2024.

TPLF was historically limited in the U.S. by state laws incorporating common-law prohibitions against maintenance, champerty and barratry.[1] In recent years, however, various states have begun relaxing these laws, allowing TPLF arrangements to be structured in ways that fall outside the scope of applicable state law prohibitions.[2] Courts in New York, for example, have upheld the provision of TPLF to law firms, finding that such financing supports adjudication of litigation on the merits (and not based on economic pressures).[3] These developments have spurred the rapid growth of the litigation finance industry, with industry participants reporting $15.2 billion in assets under management in 2023.[4]

In a U.S. bankruptcy case, the bankruptcy court will generally look to applicable state law to determine whether a TPLF arrangement is enforceable. Accordingly, the increasing consideration of TPLF in bankruptcy tracks the introduction of more permissive state laws with respect to TPLF. In addition to applicable state law, the bankruptcy context also specifically affects certain considerations regarding TPLF arrangements, including with respect to the applicable disclosure requirements and a debtor's fiduciary duties.

With respect to disclosure, although Congress previously considered legislation that would mandate the disclosure of TPLF arrangements, there is currently no Federal Rule of Civil

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[1] "Maintenance refers to 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." U.S. Gov't Accountability Off., GAO-23-105210, Third-Party Litigation Financing: Market Characteristics, Data, and Trends (2022) (citing *In re Primus*, 436 U.S. 412, 424 (1978)).

[2] *E.g.*, *Hamilton Cap. VII LLC v. Khorrami LLP*, 22 N.Y.S. 3d 137, at *5-6 (Sup. Ct. N.Y. Co. 2015) (distinguishing provision of financing secured by a law firm's accounts receivable from impermissible fee-sharing agreements).

[3] *Lawsuit Funding LLC v. Lessoff*, 2013 WL 6409971, at *6 (Sup. Ct. N.Y. Co. Dec. 4, 2013) (commenting that "proliferation of alternative litigation financing in the United States [is] partly due to the recognition that litigation funding allows lawsuits to be decided on the merits").

[4] Westfleet Advisors, *The Westfleet Insider: 2023 Litigation Finance Report* 3 (2023).

Procedure requiring such disclosure, and litigation-funders have typically avoided disclosure of their investments in civil court settings.[5] In contrast, a debtor or a liquidation trustee in a bankruptcy case may be required to seek bankruptcy court approval of a TPLF arrangement under the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure.[6] Where court approval is required, a debtor or liquidation trustee must meet its burden to demonstrate to the court that the TPLF arrangement is in the best interests of the debtor's estate, which will typically require the disclosure of, among other things, the TPLF funding agreement. These public filings also provide important insights into the details of any proposed arrangement, which often will drive the state law analysis.

In *In re Sears Holdings Corp.*, for example, the official committee of unsecured creditors (the "Sears UCC") filed a motion seeking authority for the debtors to enter into a TPLF arrangement, which included a copy of the term sheet executed by the debtors' estates and the proposed litigation funder.[7] Although the Sears UCC indicated in the motion that the term sheet would be supplemented by the filing of a copy of the definitive agreement in advance of the hearing to consider the motion,[8] bondholders represented by Wilmington Trust as indenture trustee and collateral agent objected, saying that such "piecemeal disclosure" of the TPLF arrangement violates Bankruptcy Rule 4001.[9] Although a settlement in the underlying litigation ultimately mooted the motion for litigation funding, the objection highlights the heightened emphasis on disclosure of TPLF arrangements in a bankruptcy setting.

A debtor's ability to enter into a TPLF arrangement is also affected by a debtor's fiduciary duties in bankruptcy. Because a debtor has a fiduciary duty to maximize the value of the estate, it cannot cede control over litigation strategy or decision-making authority to a TPLF provider.[10] In *Valley National Bank v. Warren*, the defendant in the underlying litigation objected to a motion filed by the liquidating trustee to enter into a TPLF arrangement, arguing, among other things, that such an arrangement would permit the trustee "to divide his loyalty between creditors and a third-party financer."[11] In upholding the TPLF arrangement at issue, the U.S. District Court for the Middle District of Florida found it significant that the liquidating trustee

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[5] *See* U.S. Gov't Accountability Off., GAO-23-105210, Third-Party Litigation Financing: Market Characteristics, Data, and Trends at 26. While there is no disclosure requirement originating in federal law, applicable state law may impose such a requirement for TPLF. *See, e.g.*, Litigation Financing Transparency and Consumer Protection Act, Mont. Code Ann. § 31-4-101 (2023); Act of March 7, 2019, art. 6N, § 46A-6N-6 (codified at W. Va. Code § 46A-6N-6); 2017 Wisconsin Act 235, § 12 (codified at Wis. Stat. § 804.01(2)(bg)).

[6] Depending on how it is structured, a TPLF arrangement may implicate, among other things, §§ 363(b), 364 and 1142 of the Bankruptcy Code and Rules 2014, 2016 and 4001 of the Federal Rules of Bankruptcy Procedure.

[7] Mot. of the Official Committee of Unsecured Creditors for Entry of an Order Pursuant to Bankruptcy Code Sections 105, 362, 364 and 1142 and Bankruptcy Rules 3020(d), 4001 and 9014 Authorizing Entry by the Debtors' Estates into the Litigation Funding Arrangement with Bench Walk 21p, L.P., *In re Sears Holdings. Corp.*, Case No. 18-22358 (RDD) (Bankr. S.D.N.Y. Apr. 21, 2022), ECF No. 10407.

[8] *Id.* at ¶ 4, n.4.

[9] Obj. of Wilmington Trust, National Association ¶¶ 142–148, *In re Sears Holdings. Corp.*, Case No. 18-22358 (RDD) (Bankr. S.D.N.Y. June 15, 2022), ECF No. 10486 (quoting language in Bankruptcy Rule 4001(c)(1)(A) that provides that motion to obtain credit must "be accompanied by a copy of the credit agreement").

[10] Some states have passed laws that similarly prohibit litigation funders from controlling litigation. *See, e.g.*, Me. Rev. Stat. Ann. tit. 9-A, §§ 12-104 and 12-106 (Maine law requiring, among other things, litigation financing companies to include representation in their funding agreements that they will not control underlying litigation); Ohio Rev. Code Ann. § 1349.55 (LexisNexis 2023) (requiring litigation funding agreements to include express statement disclaiming any right of litigation funder to make decisions with respect to underlying litigation).

[11] 535 F. Supp. 3d 1235, 1241 (M.D. Fla. Apr. 23, 2021).

retained ultimate decision-making authority under the funding agreement."[12] In contrast, in *In re DesignLine Corp.*, a trustee's motion to enter into a TPLF arrangement was denied on champerty grounds where the structure of the funding agreement vested the litigation funder with "significant control" over the underlying litigation.[13] Applying North Carolina law, the court took issue with provisions that gave the litigation funder (1) the power to cut off funding for the litigation on a quarterly basis, (2) consent rights over any increase in the litigation budget, and (3) consultation rights over the hiring of replacement counsel by the trustee.[14]

In determining whether to enter into a TPLF arrangement in an exercise of its fiduciary duties, a debtor, liquidating trustee or other estate fiduciary may be entitled to quasi-judicial immunity if it is acting pursuant to a court's orders. In a recent case, *In re Sanchez Energy Corp.*, the bankruptcy court dismissed, without prejudice, certain breach-of-fiduciary-duty claims stemming from a creditor representative's entry into a litigation financing agreement.[15] The bankruptcy court found that entry into such an agreement was permitted under the debtor's confirmed chapter 11 plan, and that as such, the creditor representative could only be held liable if the objecting parties could demonstrate a willful breach of fiduciary duty or gross negligence by the creditor representative.[16]

With the number of bankruptcy cases on the rise and financial markets now predicting a higher-for-longer interest-rate environment, we expect the availability of TPLF to play a meaningful role in restructuring situations in 2024. This is particularly true given the recent trend of debtors filing for bankruptcy and proposing a sale process without a stalking-horse bidder. In such cases, unless a successful bid clears the secured debt, the only value remaining for unsecured creditors may be the proceeds from estate causes of action, and TPLF may be necessary to adequately fund such litigation.

Recent filings reflect the growing awareness of TPLF among restructuring practitioners, with various debtors filing liquidating trust agreements that expressly authorize the liquidation trustee to seek litigation financing.[17] As the use of TPLF becomes more prevalent in bankruptcy cases, we expect increased competition to drive down the costs of such financing and encourage continued innovation in how such financing arrangements are structured.

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[12] *Id.*
[13] 565 B.R. 341, 349 (Bankr. W.D.N.C. Jan. 20, 2017).
[14] *Id.*
[15] 2024 WL 192622, at *7–10 (Bankr. S.D. Tex. Apr. 30, 2024).
[16] *Id.* at *10. The bankruptcy court allowed the plaintiffs to amend their complaint to allege facts sufficient to plead a breach-of-fiduciary-duty claim, noting that any such amended complaint "must allege gross negligence or self-dealing." *Id.*
[17] *See, e.g.*, Liquidating Trust Agreement § 4.6(q), *In re Pear Therapeutics Inc.*, Case No. 23-10429 (TMH) (Bankr. D. Del. Apr. 22, 2024), ECF No. 687; PHF Liquidation Trust Agreement § 3.2(f), *In re PHF Inc.*, Case No. 23-11235 (MFW) (Bankr. D. Del. Mar. 26, 2024), ECF No. 465; Liquidating Trust Agreement and Declaration of Trust § 6.6(c), *In re Vesttoo Ltd.*, Case No. 23-11160 (MFW) (Bankr. D. Del. Jan. 16, 2024), ECF No. 562.