Creditor Protection and Litigation Funding Arrangements in the Wake of *Bluberi*

2020 IIC Law Student Writing Award Program

Word Count: 2957

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June 15, 2020
I. **Introduction**

Should debtors be allowed to seek funding from third parties in order to litigate claims while they are restructuring under the *Companies’ Creditors Arrangement Act*\(^1\) (“CCAA”)? Litigation funding may be defined as “an agreement where an outside party with no personal interest in a litigation provides funding to a litigant for the purpose of pursuing that litigation in consideration for a financial return.”\(^2\) Generally, litigation funding is a “non-recourse transaction” because if the litigant is unsuccessful, the third-party litigation funder does not receive any financial compensation for the expenses that it paid. However, if the litigant is successful, the funder receives a share of the litigation proceeds as determined by the litigation funding agreement (“LFA”).\(^3\)

Historically, litigation funding was prohibited because it violated the doctrines of maintenance and champerty. “Maintenance” arises when a third party assists litigation that it has no personal interest in. “Champerty” is a subset of maintenance and occurs when a third party maintains litigation in exchange for a financial interest in the outcome.\(^4\) Today, litigation funding is permissible around the world and in many circumstances. Although its impact in Canada has been limited in the CCAA restructuring and insolvency context, the Supreme Court of Canada (“SCC”) in *9354-9186 Québec Inc. (Bluberi) v Callidus Capital Corp.*\(^5\) confirmed that litigation funding qualifies as interim financing under s. 11.2 of the CCAA.

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\(^1\) RSC 1985, c C-36 [CCAA].
\(^5\) 2018 QCCS 1040 [Bluberi QCCS], rev’d 2019 QCCA 171 [Bluberi QCCA], aff’d 2020 SCC 10 [Bluberi SCC].
In this paper, I will argue that CCAA courts should only allow a debtor to enter into an LFA with a third party if the agreement is disclosed in a plan of compromise or arrangement (“plan of arrangement”) that has been presented to and voted on by the debtor’s creditors. Since Bluberi is the leading Canadian case on this issue, it will guide my analysis. I will provide an overview of its facts and consistently refer to it to illustrate the benefits and costs of litigation funding. Afterwards, I will explore two sub-issues that are integral to understanding how LFAs can impact creditors in CCAA restructurings: (1) whether LFAs are akin to plans of arrangement and (2) whether creditors should be entitled to vote on LFAs.

II. Case Study: Bluberi

Bluberi, a collection of technology companies that manufactured, distributed, installed, and serviced electronic gaming machines for casinos, filed for CCAA protection in November 2015. Bluberi’s principal secured creditor was Callidus Capital Corporation (“Callidus”). In February 2017, Bluberi conducted a sale solicitation process in which Callidus purchased most of Bluberi’s assets. In exchange for Bluberi’s assets, Callidus reduced its secured claim against Bluberi to $3 million and Bluberi retained the right to pursue any claims that it had against Callidus. These claims were Bluberi’s only remaining assets. Bluberi wanted to launch a $200 million lawsuit against Callidus, and use the proceeds that it recovered in the lawsuit to fund a plan of arrangement with its creditors. Bluberi alleged that Callidus’ conduct lead to Bluberi’s insolvency.\(^6\) Since Bluberi did not have the funds to finance the litigation, Bluberi sought interim financing in the form of a litigation funding agreement (“LFA”) with IMF Bentham Limited or its Canadian subsidiary (“Bentham”). The LFA provided that Bentham and Dentons (Bluberi’s legal counsel)

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\(^6\) Michaud, supra note 2; Bluberi SCC, supra note 5 at para 7.
were entitled to a portion of the litigation proceeds and granted a $20 million super-priority charge to guarantee the obligations that Bluberi owed to them.

In February 2018, Bluberi filed an application seeking court approval of the LFA, and in March 2018, the supervising judge approved the LFA along with the super-priority charge. His decision was overturned by the Court of Appeal of Quebec (“QCCA”), but was recently reinstated by the SCC. The reasoning of the supervising judge and the SCC is diametrically opposed to the QCCA’s analysis. While the supervising judge and SCC accepted that the LFA did not constitute a plan of arrangement because it minimally affected creditors’ rights, the QCCA found that the LFA implicated creditors’ rights, altered their share in the litigation proceeds, and should have been submitted via a plan of arrangement for their approval. I agree with the overarching principle established by the SCC – that LFAs should be permitted in CCAA restructurings because they provide financially-distressed debtors with much needed resources and flexibility – but I believe that the QCCA was correct in concluding that LFAs should be subject to creditor scrutiny.

III. LFAs can be Integral to the Restructuring Process

Litigation funding “thrives in a milieu where the high cost of war-of-attrition-style litigation…must be borne by financially strapped litigants.”\(^7\) This is particularly prevalent in the CCAA restructuring and insolvency context as debtors often have valuable claims against directors and officers, lenders, suppliers, competitors, etc., but no financial means to pursue them. If a debtor has claims against one of its creditors, the CCAA process can actually shield the creditor from potential liability. For example, Callidus knew that Bluberi did not have the resources to fund a lawsuit against it because it purchased nearly all of Bluberi’s assets. In addition, once Callidus heard that Bluberi was seeking assistance from a third-party litigation funder, it attempted to use

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\(^7\) Salerno & Kroop, supra note 4.
the CCAA process to obtain releases of liability from Bluberi’s claims against it. In particular, it sought to buy these releases from Bluberi’s other creditors by submitting a plan of arrangement whereby it agreed to pay creditors’ claims in full or in part.8 This situation illustrates how a vulnerable creditor could use the CCAA process to inhibit a debtor from pursuing meritorious claims and expanding the assets available for distribution to its creditors.

Litigation funding has the potential to increase the size of an insolvent debtor’s estate and “thereby offers the opportunity for a larger, or any return, to unsecured and other lower-ranked creditors.”9 Where there is a single asset that all creditors depend upon (such as Bluberi’s retained claims), “litigation funding is the only avenue that can potentially allow for any meaningful recovery for the creditors.”10 This was also emphasized by the Court of Appeal for Ontario (“ONCA”) in Crystallex International Corp., Re.11 Because the debtor’s only significant asset in that case was a $3.4 billion arbitration claim against the Venezuelan government for breach of contract, arbitration financing was integral to the debtor’s successful restructuring.12 In both Bluberi and Crystallex, maximizing creditor recovery took priority.13 Therefore, the debtors’ decisions to forgo a portion of the litigation proceeds and grant third-party litigation funders a super-priority charge was considered a small price to pay for the chance to increase potential returns for creditors.

Litigation funding has also been pursued (albeit not through an LFA) in the American bankruptcy context. In In re Magnesium Corp. of America,14 the bankruptcy trustee auctioned off

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8 Bluberi QCCS, supra note 5 at paras 43-44.
10 Bluberi QCCS, supra note 5 at paras 64-65, 69.
11 2012 ONCA 404 [Crystallex].
12 Ibid at paras 2-4, 72.
13 Bluberi SCC, supra note 5 at para 96.
14 Ch 7 Case No 01-14312 (MKV) (Bankr SDNY filed 24 August 2016).
a $50 million interest in the debtor’s litigation judgment, and used the auction proceeds ($26 million) to pay for appeal expenses. The appeal court affirmed the $213 million judgment awarded to the debtor. Although a third-party investor was entitled to $50 million of the litigation proceeds, this strategy significantly expanded the debtor’s estate, making more money available for distribution to its creditors.\textsuperscript{15} Because LFAs allow debtors to gain access to justice and maximize creditor recovery, they are, and should continue to be, an important tool available to debtors under CCAA protection. However, CCAA courts should not unilaterally approve LFAs as interim financing under s. 11.2 where the debtor has circumvented its creditors.

IV. \textbf{Are LFAs Akin to Plans of Arrangement?}

The ONCA in \textit{Crystallex} held that the interim financing used by the debtor to fund its arbitration claim did not constitute a plan of arrangement because it did not compromise the creditors’ indebtedness or take away any of their legal rights (e.g. to vote on a plan of arrangement).\textsuperscript{16} For similar reasons, the SCC also held that the LFA between Bluberi and Bentham did not constitute a plan of arrangement (and did not need to be accompanied by one).\textsuperscript{17} Both courts found that the debtors intended to present plans of arrangement to their creditors at a later date, and as a result, creditors did not lose their opportunity to provide input or their right to vote.\textsuperscript{18} Moreover, the assessment of both courts suggest that litigation funding was a means to achieve restructuring, but these arrangements did not rise to the level of a formal restructuring plan because the LFAs did not focus on distributing proceeds to creditors or compromising their claims.\textsuperscript{19}


\textsuperscript{16} \textit{Crystallex}, \textit{supra} note 11 at paras 92-93.

\textsuperscript{17} \textit{Bluberi SCC}, \textit{supra} note 5 at paras 101, 115.

\textsuperscript{18} Michaud, \textit{supra} note 2; \textit{Bluberi SCC}, \textit{supra} note 5 at para 106.

\textsuperscript{19} \textit{Bluberi SCC}, \textit{supra} note 5 at para 111.
A “plan of compromise or arrangement” is not defined in the CCAA, but it can be described as a deal that is presented to creditors, which outlines how their claims will be treated in order to allow the debtor to restructure. Plans can deal with compromising creditors’ legal rights and include “any scheme for reorganizing the affairs of the debtor.” The QCCA adopted a similarly broad interpretation in Bluberi, finding that “an arrangement or proposal can encompass both a compromise of creditors’ claims as well as the process undertaken to satisfy them.” Therefore, any transaction that affects creditors’ claims properly falls within the scope of a plan of arrangement, including LFAs.

Advocates of third-party litigation funding argue that LFAs do not directly affect creditors’ claims because they are non-recourse transactions. In particular, the litigation funder only receives a conditional claim over a specific asset of the debtor (i.e. the litigation proceeds, if there are any) rather than a super-priority charge over the debtor’s assets generally. If litigation is unsuccessful, the debtor does not have to reimburse the litigation funder for expenses incurred to pursue the lawsuit. However, an LFA functions as a plan of arrangement although the potential impact on creditors is uncertain.

For example, in situations where retained claims are the debtor’s only remaining valuable asset, the litigation funder effectively acquires a super-priority charge over the debtor’s entire estate. Therefore, the debtor agrees on behalf of its creditors to subordinate their claims in the event that litigation is successful. The SCC held that subordination is permitted under s. 11.2 of

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22 *Bluberi QCCA*, supra note 5 at para 85.
23 Moysa, supra note 3.
24 Naufal, supra note 3 at 16.
the CCAA and does not necessarily convert interim financing into a plan of arrangement.\textsuperscript{25} However, a super-priority charge disturbs the existing priority ranking. It also automatically compromises creditors’ claims where the litigation proceeds are less than anticipated or insufficient to compensate the third-party litigation funder. Although LFAs may not expressly contemplate how litigation proceeds are distributed amongst creditors, their terms inherently shape any eventual distributions.

Another concern is that both the creditors’ and the litigation funder’s returns depend on the amount of the debtor’s claims, estimated expenses, and eventual judgment. Even if the debtor is successful, it might not receive the award that it requested. There is no guarantee that the litigation will increase the size of the debtor’s estate to be distributed to its creditors. Therefore, the extent that creditors will have to compromise their claims directly depends on the debtor’s obligations to the litigation funder as outlined in the LFA. Because creditors and the litigation funder are competing for distribution from the same asset, creditors should have a say in determining whether the LFA’s terms are fair and reasonable. Otherwise, the LFA will be negotiated in the debtor’s and the litigation funder’s self-interest. For example, Bluberi’s creditors were prejudiced because the LFA did not contain any information regarding payment to them despite the fact that it prescribed how Bentham would be paid. This discrepancy is amplified by the fact that Bluberi’s claims against Callidus were the only assets left from which the company could pay its creditors.\textsuperscript{26} Bluberi’s LFA with Bentham effectively outlined a restructuring scheme akin to a plan of arrangement, but absent input from Bluberi’s creditors.

\textsuperscript{25} \textit{Bluberi SCC}, supra note 5 at para 114.  
\textsuperscript{26} \textit{Bluberi QCCA}, supra note 5 at para 92.
V. **Should Creditors be Entitled to Vote on LFAs?**

Creditors should be entitled to vote on LFAs because they are akin to plans of arrangement. Sections 4 through 6 of the CCAA set out the rules that govern creditor meetings and plan approval. This ensures that creditors are involved in any restructuring arrangements that could alter their legal rights. The SCC in *Bluberi* rejected this argument because CCAA courts are statutorily authorized to unilaterally approve interim financing (such as LFAs) under s. 11.2 of the CCAA. 27

Court approval of LFAs along with their consideration of the specific factors enumerated in s. 11.2(4) of the CCAA minimizes prejudice to creditors. 28

While under CCAA protection, a debtor’s activities are supervised by both a Monitor and the courts. Courts in particular are given broad discretionary powers to further the CCAA’s purposes. 29 Three primary objectives of the CCAA are maximizing creditor returns, protecting stakeholders’ interests, and debtor rehabilitation. 30 The first and third objectives in particular benefit from litigation funding. However, third-party litigation funding is contentious. Creditors strongly contest transactions that could alter their priority ranking, but are also unwilling to lend more money to the debtor for the benefit of the group. This forces debtors to look to third parties for assistance. CCAA courts have the power under s. 11.2 to unilaterally approve financing arrangements and grant a super-priority charge to secure the financing required by a debtor prior

27 *Bluberi SCC, supra* note 5 at para 96.

28 Michaud, *supra* note 2; CCAA, *supra* note 1 at s 11.2(4).


to implementing a formal plan of arrangement. However, courts should always make these decisions in accordance with the “purpose and spirit of the CCAA.”

Because two objectives of the CCAA are maximizing creditor returns and protecting stakeholders’ interests, courts arguably act with creditors’ best interests in mind. In addition, CCAA courts are not motivated by self-interest unlike creditors, and their assessments of litigation funding arrangements consider what is best for the group of creditors as a whole. Therefore, their review and approval of LFAs can be an appropriate substitute for creditor approval. The SCC in Bluberi found that the supervising judge considered the factors set out in s. 11.2(4) of the CCAA and the criteria for third-party litigation funding developed by Canadian courts in class action and private commercial litigation cases in his decision to approve the LFA as interim financing. Since the LFA was necessary, legal, and helped achieve the CCAA’s purposes, creditors did not need to vote on it.

However, CCAA courts should not substitute creditors’ judgments for their own before giving creditors the opportunity to express their opinions on the transaction, propose alternatives, and vote. A CCAA court should reserve its broad discretionary powers to unilaterally approve financing arrangements where creditors have made an unjust decision. LFAs can be compared to sub rosa plans in the American bankruptcy context. Sub rosa plans are transactions entered into by the debtor outside a plan of arrangement that has a significant effect on the debtor’s reorganization. They can be used to sidestep creditor protections in the United States’ Bankruptcy

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31 CED 4th (online), Companies' Creditors Arrangement Act, “Matters Arising During CCAA Process: Approval of Financing Agreements and Other Contracts” (XIII.4) at §625 [CED]; Michaud, supra note 2; CCAA, supra note 1 at s 11.2.
32 CED, supra note 31 at §625.
33 Bluberi SCC, supra note 5 at paras 105-107.
Code, particularly protections embedded in the plan confirmation process.\textsuperscript{35} The plan confirmation process encourages debtors and creditors to negotiate a “reorganization that is acceptable to all interested parties.”\textsuperscript{36} Effectively, sub rosa plans are de facto plans of arrangement and should be treated as such.

It is particularly important to safeguard a creditor’s right to vote because this requirement forces a debtor to negotiate with its creditors and helps involve all interested creditors in the restructuring.\textsuperscript{37} The LFA in \textit{Bluberi} was essentially a disguised sub rosa plan used by Bluberi and Bentham to sidestep creditor protections in the CCAA for three reasons. First, it significantly affected Bluberi’s restructuring because the company’s claims against Callidus were its only remaining asset. Second, Bluberi’s decision to pursue third-party litigation funding, secure a super-priority charge for Bentham, and enter into an LFA effectively subordinated creditors and altered their share in any eventual litigation proceeds.\textsuperscript{38} Third, Bluberi did not consult or present the LFA to its creditors prior to seeking court approval, squeezing them out of the plan formation process.

Creditors’ rights should be protected throughout CCAA proceedings. The ONCA in \textit{Crystallex} justified denying creditors the right to vote on the arbitration financing because the debtor intended to subsequently propose a plan of arrangement.\textsuperscript{39} The QCCS in \textit{Bluberi} held that the super-priority charge granted to Bentham “will have no impact until proceeds are recovered through the realization of the retained claims.”\textsuperscript{40} In addition, the SCC asserted that debtors are responsible for determining how to realize value from their remaining assets, not creditors.\textsuperscript{41}

\textsuperscript{35} \textit{Ibid} at 40.
\textsuperscript{36} \textit{Ibid}.
\textsuperscript{37} \textit{Ibid} at 45.
\textsuperscript{38} \textit{Bluberi QCCA}, supra note 5 at para 83.
\textsuperscript{39} \textit{Crystallex}, supra note 11 at para 44.
\textsuperscript{40} \textit{Bluberi QCCS}, supra note 5 at para 87.
\textsuperscript{41} \textit{Bluberi SCC}, supra note 5 at para 111.
However, all three courts failed to recognize that litigation funding affects creditors from the moment that a third-party funder is sought and an LFA is signed.

A prominent concern in the literature about third-party litigation funding is that the funder will be able to exercise undue control over the litigation proceedings and force a debtor to make decisions in the best interests of the funder as opposed to its creditors. 42 For example, the funder may encourage the debtor to settle prematurely or imprudently prolong litigation. As the QCCA acknowledged in Bluberi, “[creditors] could very well receive nothing in a settlement where the funds generated were only sufficient to pay the lawyers and Bentham.” 43 Therefore, creditors should have input in determining whether entering into an LFA is an acceptable risk because how a debtor decides to realize value is inevitably linked with compromises and distribution. The best way to minimize prejudice against creditors is to allow them to exercise their rights, including their right to vote.

VI. Conclusion

In this paper, I have argued that CCAA courts should only allow a debtor to enter into an LFA with a third party if the agreement is disclosed in a plan of compromise or arrangement that has been presented to and voted on by the debtor’s creditors. An LFA determines how creditors’ claims will be treated in a manner similar to a formal plan of arrangement. In particular, it typically includes a super-priority charge that subordinates creditors’ claims to those of the litigation funder. Consequently, creditors deserve to be involved in discussions about third-party litigation funding and vote on LFAs in order to minimize prejudice and safeguard their legal rights. Otherwise,

43 Bluberi QCCA, supra note 5 at para 87.
creditors may be pushed to the side at the outset of a debtor’s restructuring and forced to accept decisions detrimental to their interests.