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Litigation-Settlement Financiers, a Secured Claim Might Be Illusory

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In *In re Reviss*,[1] the U.S. Bankruptcy Court for the Eastern District of New York forewarns litigation-settlement financiers that their springing security interest in settlement proceeds might be in peril when the security interest has not yet attached and a chapter 7 debtor attempts to exempt the same settlement proceeds from property of the debtor's bankruptcy estate. This article first provides a brief overview of the Bankruptcy Code sections related to property of the estate (§ 541) and exemptions (§ 522), then provides a primer on litigation funding and agreements related to such funding. The article also analyzes *Reviss*, which concludes both that (1) a debtor is entitled to exempt his interest in litigation proceeds, despite the pre-petition assignment of his interest in those proceeds; and (2) the security interest that the litigation-settlement financier bargained for is unenforceable.

A Pre-Petition Cause of Action Is Property of the Estate

Section 541 of the Bankruptcy Code's broad reach brings "*all* legal or equitable interests of the debtor in property as of the commencement of the case" into the bankruptcy estate.[2] This "central aggregation and protection of property" is intended to foster the frequently invoked "breathing room" afforded to debtors and ensure equal distribution of assets among creditors.[3] However, the bankruptcy estate cannot succeed to a greater or different right than the debtor possesses upon filing: Section 541(d) notes that when "the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ... [the property] becomes property of the estate ... only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."[4]

While bankruptcy law governs what property becomes property of the estate, state law determines whether a debtor had a pre-petition interest in property and the extent of that interest.[5] In the context of *Reviss*, "a cause of action is a property interest of the individual in whose favor it arises"[6] and, consequently, is generally deemed property of the bankruptcy estate under § 541 upon the bankruptcy petition's filing.

Bankruptcy Exemptions 101

Section 522 of the Bankruptcy Code permits individual debtors to "exempt" certain property from a bankruptcy estate in order to maintain "sufficient assets for a minimum standard of living" after a bankruptcy petition has been commenced.[7] A debtor generally has the option to protect certain property under either a state statutory exemption or the federal exemption.[8] Subject to periodically adjusted limits and objections timely advanced by creditors or the estate trustee, the Code's exemption regime includes the ability to exempt proceeds from a personal-injury action.[9] Courts must recognize and permit properly invoked exemptions, and if an exemption is recognized, it consequently is protected from the reach of the estate's creditors.[10]

Litigation-Funding Agreements Under State Law

In the context of civil litigation, conventional wisdom holds that the passage of time nearly always favors the litigation defendant.[11] A small fraction of tort cases commenced in federal and state courts are actually tried to verdict,[12] resulting in the vast majority being resolved via consensual settlement.[13] According to at least one commentator, the vast majority of plaintiffs "settle because they are unable to wait the nearly two years elapsing before the average case comes to trial."[14] The friction resulting from this delay, and the tort plaintiffs' strong desire to receive proceeds from litigation as soon as practicable after the suit is com-

1 628 B.R. 386 (E.D.N.Y. 2021).
2 11 U.S.C. § 541(a)(1) (emphasis added).
3 5 *Collier on Bankruptcy* ¶ 541.01 (2021).
4 11 U.S.C. § 541(d).
5 *Butner v. United States*, 440 U.S. 48, 55 (1979).
6 *In re Mucelli*, 21 B.R. 601, 621 (Bankr. S.D.N.Y. July 13, 1982); *see also* 5 *Collier on Bankruptcy*, ¶ 541.07[01] (2021).
7 Margaret Howard, "Exemptions Under the 2005 Bankruptcy Amendments: A Tale of Opportunity Lost," 79 *Am. Bankr. L.J.* 397, 397 (2005).
8 Pursuant to § 522(3)(A), debtors may elect to use exemption limits set by state rather than federal law, but the election of state or federal law applies to all exemptions (*e.g.*, a debtor cannot elect to use a state exemption for their home but the federal exemption for their personal motor vehicle). *See also In re Wiggs*, 610 B.R. 57, 64 (Bankr. D. Conn. 2019).
9 This is not an exhaustive list of the exemptions contained in 11 U.S.C. § 522(d).
10 *Law v. Siegel*, 571 U.S. 415, 423-24 (2014).
11 Jean Hellwege, "David vs. Goliath Revisited: Funding Companies Help Level the Litigation Playing Field," Trial (May 2001), at 14.
12 George Steven Swan, "The Economics of Usury and the Litigation Funding Industry: *Rancman v. Interim Settlement Funding Corp.*," 28 *Okla. City U. L. Rev.* 753, 758 (2003).
13 *Id.*
14 *Id.*

menced, have spawned an industry of litigation-funding lenders.[15] Essentially, litigation financiers offer loans to the tort plaintiff that are secured solely by the anticipated recovery in pending litigation.[16] The financers provide the funding on a contingency basis. If the tort plaintiff loses, the funder is not repaid, including losing its principal.[17]

While common law has generally forbidden the assignment of personal-injury causes of action, the assignment of the proceeds of such causes of action have generally been permissible, even if the assignment occurred prior to entry of judgment or settlement.[18] In turn, a pre-judgment assignment of litigation proceeds creates an equitable lien in the proceeds,[19] with the tort plaintiff retaining legal title to the cause of action.[20] Courts have recognized that the assignment of future proceeds creates a springing lien, which becomes enforceable "only when a judgment is entered or a settlement is reached and the *lien does not relate back to the date of the assignment*."[21] Given the contingent nature of the litigation financier's interest in the settlement proceeds, including only springing-lien rights, the conflict arising from a tort plaintiff's bankruptcy filing *before* the judgment is entered, or settlement effectuated, is in focus.

The *Reviss* Facts

In *Reviss*, Hon. **Elizabeth S. Stong** considered thorny issues arising when a chapter 7 debtor files a bankruptcy petition *after* the debtor's assignment of the litigation proceeds to a litigation financier but *before* the litigation is reduced to a judgment or a settlement. The chapter 7 debtor, Vladimir Reviss, had entered into a series of pre-petition agreements[22] with a litigation financier.[23] Under the terms of the agreements, Reviss assigned a portion of his interest in litigation proceeds to the litigation financier and granted it a security interest in those proceeds.[24] At the time of the agreements, Reviss had not anticipated filing for bankruptcy,[25] but the agreements' terms provided that, in the event of a bankruptcy, the assigned proceeds would be considered an asset of the litigation financier rather than a debt or obligation on Reviss's behalf.

Reviss ultimately filed for chapter 7 protection prior to the conclusion of the litigation; no judgment had been entered, and no settlement had been reached.[26] He claimed "federal personal injury and 'wild card' exemptions, totaling $39,040 ... pursuant to sections 522(d)(11)(D) and 522(d)(5) (the 'Exemption')."[27] Reviss listed the litigation financier as an unsecured creditor for the amount borrowed.[28] The litigation financier timely filed a secured proof of claim in the amount of $49,560.[29]

Ultimately, the litigation settled, and subsequently the chapter 7 trustee filed a motion "seeking permission to settle the personal-injury action for $75,000 and to disburse funds equal to the claimed Exemption" to Reviss,[30] but the litigation financier opposed.[31] The sole matter to be determined by the court was whether the chapter 7 trustee should transfer to Reviss an amount of the settlement proceeds equal to the exemption, or transfer those proceeds to the litigation financier.[32]

Analysis

Because the scope of the debtor's bankruptcy estate is limited to property possessed by the debtor at the time of the petition, the first question considered by the *Reviss* court was whether the litigation funds comprised property of the debtor's bankruptcy estate. Looking to state law for this analysis, the court was specifically required to determine the scope of the debtor's interest in the litigation, including whether the interest was "legal or equitable or undivided."[33] In turn, this determination informed the nature of the estate's interest in the settlement proceeds.[34] Since the debtor remained owner of the cause of action as of the petition date, it became property of the estate upon the filing. The debtor's pre-petition assignment of the litigation proceeds did not alter the court's § 541 analysis[35] insofar as Reviss only assigned his equitable interest to the litigation financier.[36]

Once the court determined that the cause of action remained property of the debtor's bankruptcy estate, it analyzed the enforceability of the litigation financier's security interest in the settlement proceeds. As noted herein, at the time the debtor entered into the agreements with the litigation financier, it granted the litigation financier a security interest in the settlement proceeds. However, according to the court, a settlement or judgment must occur before the security interest can arise,[37] and in this case, the settlement occurred post-petition. As of the petition date, Reviss retained his interest in the proceeds of the case and they became property of the estate.[38]

The court also addressed and quickly disposed of the litigation financier's alternative argument that a constructive trust had been created by the pre-petition agreements.[39] Property held in a constructive trust is excluded from property of the estate.[40] The most important element is unjust enrichment, which, within the Second Circuit, requires "some

15 *Id.*
16 *Id.*
17 *Id.*
18 *Grossman v. Schlosser*, 19 A.D. 2d 893, 893-94 (N.Y. 1963).
19 *Id.* (citing *Williams v. Ingersoll*, 89 N.Y. 508, 521 (1882)); *see also In re Minor*, 482 B.R. 80, 84 (Bankr. W.D.N.Y. 2012).
20 *Grossman*, 19 A.D. 2d at 893-94 (citing *Williams v. Ingersoll*, 89 N.Y. 508, 521 (1882)); *see also In re Minor*, 482 B.R. 80, 84 (Bankr. W.D.N.Y. 2012).
21 *In re Andrade*, Nos. 10-42877 and 07-46595, 2010 WL 5347535, at *2 (Bankr. E.D.N.Y. Dec. 21, 2010) (citing *Law Research Serv. v. Martin Lutz Appellate Printers*, 489 F.2d 836, 838 (2d Cir. 1974)) (emphasis in *Andrade*).
22 The debtor had entered into a total of four "Case Investment Agreements" with the litigation financier that related to one personal-injury action.
23 The record is silent regarding both procedural and substantive details of the personal-injury litigation.
24 *In re Reviss*, 628 B.R. at 390.
25 *Id.* at 390.
26 *Id.* at 391.
27 *Id.*
28 *Id.*
29 *Id.* The amount borrowed was only $20,000, but the litigation financier claimed interest at an annual rate of 51.11 percent. *Id.*
30 *Id.*
31 *Id.* at 392.
32 *Id.* at 393. The chapter 7 trustee and litigation financier previously settled the trustee's application to reclassify the litigation financier's claim from secured to unsecured, which it had filed contemporaneously with its motion to pay the debtor's exemption. *Id.* at 391-92.
33 *Id.* at 394.
34 *Id.*
35 *Id.* at 397.
36 *See also id.* at 397-98.
37 "[T]he assignment of a right to receive income contingent upon the occurrence of a future event does not convey a present interest to the assignee." *Id.* at 398 (quoting *Don King Prods. Inc. v. Thomas*, 945 F.2d 529, 534 (2d Cir. 1991)).
38 *Id.*
39 *Id.* at 392.
40 *Id.* at 396. The four elements for a constructive trust under New York law are "(1) a confidential or fiduciary relationship; (2) a promise, express or implied; (3) a transfer of the subject *res* made in reliance on that promise; and (4) unjust enrichment." *Id.* (quoting *In re First Cent. Fin. Corp.*, 377 F.3d 209, 212 (2d Cir. 2004).

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pre-petition unjust conduct by the debtor relating to the subject property."[41] The court held that the litigation financier did not carry its burden of showing misconduct by the debtor.[42] It noted that nothing distinguished the case from "any other situation where a debtor receives his or her exemption in the proceeds of a personal injury claim in the course of a" bankruptcy.[43] The fact that the debtor's exemption would reduce (or eliminate) the amount available to pay the litigation financier did not suggest "bad faith or malfeasance of any kind'" that would render a constructive trust appropriate.[44]

Having determined that the proceeds of the personal-injury action were property of the estate, the court reiterated many of the same authorities that it had previously cited and noted that personal exemptions are not discretionary.[45] Because the litigation financier had never possessed more than a future lien, and the proceeds of the personal-injury action had become property of the estate, "Reviss's ability to exempt property in his bankruptcy case was triggered."[46]

41 *Id.* at 397 (quoting *In re Fetman*, 567 B.R. 702, 706 (Bankr. E.D.N.Y. 2017).
42 *Id.*
43 *Id.*
44 *Id.*
45 *Id.* at 401.
46 *Id.*

The litigation financier held merely an unsecured claim, and the chapter 7 trustee was authorized to pay the debtor an amount of settlement proceeds representing the requested exemption.[47]

Conclusion

Reviss concludes that a debtor can exempt litigation proceeds under § 522 of the Bankruptcy Code, notwithstanding that the debtor assigned those proceeds pursuant to written agreement prior to a bankruptcy petition. The case also determines that a litigation-settlement financier cannot assure itself of secured-creditor status if the underlying litigation claim has not been liquidated at the time of the bankruptcy petition. Similarly situated claimants holding contingent security interests should beware that where springing liens have no relation back to the date of assignment, their "secured creditor" status might be in jeopardy. A future fix that permits the litigation-funder to receive the benefit of its bargain, and prevents the honest-but-unfortunate debtor from receiving a windfall based on the "timing" of a petition, may rest exclusively with Congress. abi

47 *Id.* at 402.

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