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CONTENTS / MARCH / APRIL 2021

ROBOCALL ME MAYBE-FEDERAL RESTRICTIONS ON MUNICIPAL AUTOMATED MESSAGING

By: David S. Johnson, Assistant City Attorney, City of Arlington, Texas

While emergency alerts and COVID updates may generally be communicated without the recipient's prior consent, most municipal robocalls and texts, even where well-intentioned, require advance authorization.

PAGE 6

THE MUNICIPALITY AS SHAREHOLDER: SECURITIES LITIGATION IN THE AGE OF FISCAL AND SOCIAL RESPONSIBILITY

By: Joshua Grabar, Principal, Grabar Law Office, Philadelphia, Pennsylvania

Municipalities increasingly take action as shareholders, seeking recourse for corporate fraud and mismanagement and exerting pressure for social and environmental reforms.

PAGE 12

DEPARTMENTS

PAGE 12, 6, ILLUSTRATIONS BY TRUJILLODESIGN

18 AFFIRMATIVE LITIGATION

Public Sector Entities and Affirmative Litigation

By: Edward Truant, Founder, Slingshot Capital, Inc., Toronto, Ontario and Grant Farrar, Founder, Arran Capital, Inc. Evanston, Illinois

An additional mechanism to fund municipalities seeking recourse on behalf of their constituents.

22 PRACTICE TIPS

Mandatory Employee Vaccinations: Complexities Abound

By: Karen Day White, Executive Counsel, Louisiana Municipal Association, Baton Rouge, Louisiana
Covid vaccines are increasingly available. Easy answers are not.

24 SUPREME COURT

Legislators Rein in Qualified Immunity: High Court Review Ahead?

By: Lisa Soronen, Executive Director, SLLC Washington D.C.
Legislatures seek to limit QI.

28 AMICUS

About Face? Reviewing a Prior Administration's Pending Cases
By: Amanda Karras, IMLA Deputy General Counsel and Director of Legal Advocacy
A tradition of Solicitor General fidelity to prior pleadings.

32 PREEMPTION

Pandemic Proof? Cannabis Retailers Thrive in Ontario
By: Monica Ciriello, Ontario 2015, Hamilton, Ontario
A province overrides local regulatory efforts. Uncontrolled proliferation follows.

34 DIVERSITY

Diversity, Equity, and Inclusion, Oh Yes!

By: Deanna Shahnam, IMLA Associate Counsel
The law department as an investment portfolio.

36 INSIDE CANADA

Examining Racism, Bias, and Procedural Fairness
By: Monica Ciriello, Ontario 2015, Hamilton, Ontario
Recent cases of interest.

38 LISTSERV

Virtual Realities: Avoiding Mishaps While the Camera is On
By: Brad Cunningham, Municipal Attorney, Lexington, South Carolina
Do's and don'ts in a Zoom world.

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AFFIRMATIVE LITIGATION

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Public Sector Entities and Litigation Finance

Public sector entity (PSE) affirmative litigation of all shapes and sizes across the country is increasing, as PSEs with different demographics and economic circumstances want to ensure their right of access to the courts.

Introduction

This article discusses state and local governments' assumption of their leading role in shaping policy and litigation priorities in the United States. When this context is viewed through the prism of post-Covid imposed budget stress, legal financing may be uniquely positioned to provide a creative budget and policy solution for PSEs. Concerns expressed relative to PSE legal finance resemble similar objections to private sector legal finance. These objections merit consideration, but a full treatment of these points exceeds the scope of this discussion. Lastly, impact investing mandates may generate significant new investment opportunities for PSE legal finance.

PSE Market Size and State of Play

There are approximately 90,000 units of local government. This number is broken out in approximate numbers as follows:

- 35,000 cities, towns, villages, and townships;
- 3,000 counties;
- over 52,000 special districts (such as airport, harbor, water and/or sanitary districts); and
- the remainder are school districts and other miscellaneous units.

Combined government spending for PSEs is \$3.7 trillion, which is 9% of US Gross Domestic Product, and double the spend of the US federal government. Given the size and differing compositions of PSEs, it is hard to pinpoint with exactitude PSE legal spend. According to the *US Census Bureau 2017 Census of Governments* (released in summer 2019), PSE legal spend in 2017 approximated over \$10 billion for the 90,000 units of local government. Another data point is found in a dedicated survey of city legal department spend, the *Governing Magazine*

2016 Study of the Top 20 Largest Municipal Legal Budgets, which indicated the total annual median expense was \$12 million. Median annual litigation expense was \$3.5 million, but it is important to note that this sum excluded staff costs. To be sure, surveys of this enormous market with differing budget data points and nomenclature cannot capture the many millions of dollars in litigation expenditures by public client law firms retained by PSEs. These litigation expenditures may either conform to traditional fee arrangements, or increasingly common alternative fee structures such as modified contingencies or hybrid hourly rate/recovery models.

Given the sizable differences among PSEs, and the varying affirmative litigation strategies across the US, no comprehensive data set or analytics currently exists to definitively measure case duration, settlement amount or damages profiles of cases. However, certain data points confirm the upswing in scope and return on PSE affirmative litigation. For example, the following settlements in the last two years provide context:

2018 – State of Minnesota settlement of PFAS environmental cases for \$850 million. Note, litigation by local governments regarding PFAS in that state is recently underway, and not impacted by this settlement.

2018 – City of Chicago settlement with Uber and Lyft for over \$10 million.

2019 – Cuyahoga and Summit County, Ohio settlement of opioid claims for \$260 million.

2019 – Several California counties settlement of lead paint abatement litigation for \$305 million.

2020 – United Kingdom Revenue and Customs Department obtaining a very large share of a £22.5 million recovery on an insolvency claim, such claim which was financed by a litigation funder.

Covid-19 economic dislocation

and cost burdens associated with the public health response imposed severe budget impacts and revenue loss on PSE in 2020, and this impact will continue to unfold over the years to come. Economic dislocation and related revenue decreases erode ability and capacity to pursue and sustain affirmative litigation. Several policy organizations recently provided the following statistics to capture the amount of reduced PSE revenues, with such shortfalls constituting the biggest cash flow crunch since the Great Depression. The National Association of Counties identified current budget shortfalls of \$434 billion for states, \$360 billion for municipalities, and \$202 billion for counties. The Brookings Institution estimates state and local revenues will be reduced 5% in 2020, 7.5% in 2021, and 8% in 2022. With the prospect of divided federal government in 2021 and beyond, federal relief of this budget stress is unlikely.

Aside from the economic reality of PSEs during and subsequent to the current pandemic, there are a lot of good practical reasons for PSEs to align themselves with litigation finance managers.

Significant benefits exist for PSEs to partner with commercial litigation funders due to their perspective on the commercial aspects of a given case, which will be important for PSEs to ensure they are delivering value to their constituencies. Funders also represent a 'second set of eyes' to determine the commercial prospects of a case (merits, collection, counsel insight, judiciary insight, counsel recommendations, case strategy, etc.), the probability of winning a case and the likely costs and timing associated with its pursuit.

The other perspective for PSEs to consider is using litigation finance as a financial hedge against other actions where they may be listed as

the defendant. If the PSE does not actively consider plaintiff side claims, they are missing an opportunity and exposing their constituents to downside risk associated with defense side litigation without benefiting from the upside inherent in plaintiff side litigation. However, the PSE doesn't have to assume this risk alone. Instead, PSEs should consider partnering with litigation financiers to share the risk associated with plaintiff side litigation.

Implementing Legal Finance for PSEs

With budget and resource scarcity juxtaposed alongside policy consensus in many PSE jurisdictions supporting affirmative litigation strategies, PSEs could benefit from an infusion of investment capital to ensure public access to the courts and a level litigation playing field. The complex cases being maintained by PSEs, such as opioid claims, public nuisance claims regarding alleged environmental harms, or whistleblower actions, often require a sustained and intensive budget and legal resource commitment. This commitment is required regardless of whether these cases utilize outside counsel, staffing a case(s) with additional government lawyers, or some combination of the two. Given shrinking state and local budgets and the growing list of potential big-ticket claims, legal finance in the public sector could offer budget flexibility to public servants, just as it offers flexibility to private sector businesses. Financing could permit governments to exercise a newfound ability to fund strong, effective legal counsel. In the alternative, governments could fund operations if they have the capacity to prosecute litigation with internal legal staff. By law, PSE budgets must be balanced every year, during a time where revenue shortfalls typically reflect 10-30% downturns. Thus, PSEs have a statutory mandate

to address budget and policy allocations in a very tight time frame. This creative new optionality could address and overcome budget and operational pressures resulting from these severe revenue shortfalls.

Legal finance could address the asymmetrical funding gap between PSEs and corporate defendants. Irrespective of the merits of their defenses, many corporate entities in high stakes PSE affirmative litigation have the means, the money, and the motivation to hire the best legal talent money can buy to wear down their opponents. Returning to the inherent optionality of legal finance, a PSE is in a new position to get exactly the law firm it wants, not just the law firm that can take a matter on contingency. With a financing option in place, a specialist law firm that may have a long-standing relationship with a PSE could in fact offer better value, dedication and results than a volume dependent, contingent fee practicing law firm. However, as is the case in the private sector legal market, this does not necessarily present a downside risk for law firms. The law firms with a public client practice, with possibly a burgeoning desire to expand their contingent fee practices, can benefit from financing which supports firm liquidity and client retention goals. Instances of avoided or deferred litigation would be reduced if a PSE felt it had access to new financial tools to undertake litigation. While this discussion focuses only upon legal finance as applied to the affirmative litigation environment, the authors believe there is a significant potential for legal finance in a defense context as well.

So how might legal finance work in the new PSE market? The competitive landscape in the litigation financing market is siloed, and concentrated in the plaintiff/consumer

Continued on page 20

or private sector commercial litigation worlds. PSEs can benefit from funders that are conversant with the public sector, informed by subject matter expertise and a national network. Tapping into this niche requires relational and subject matter expertise to understand, approach, negotiate, and close deals in the public sector entity market.

While the existence of a funder's direct contract with an entity is likely disclosable under relevant government Freedom of Information Act laws, this may not necessarily constitute a market negative outcome for the legal funder that already understands such an outcome going into prospective deals. First, the contents of the litigation funding agreement should be exempt from full disclosure pursuant to applicable statutory exceptions exempting production of confidential, proprietary, or trade secret information. Second, an agreement between a funder and a law firm representing a PSE (not the PSE itself) should be exempt from production as it is privileged, and also not a public record. Third, it may actually be a net positive outcome, because if a defendant knows a public entity cannot be outspent, or that it will succumb to financial pressure exerted by a free-spending defendant, a more open and positive case settlement dialogue may occur sooner rather than later. The authors understands from first-hand experience over numerous seven-and eight-figure litigations in his career, that defendants bank on "outspending" and "burying" public sector entities with litigation costs. Quicker, fairer settlement outcomes can relate back to what the Federal Rule of Civil Procedure 1 states, that there is a goal of the "just, speedy and inexpensive resolution of every proceeding." Fed. R. Civ. P. 1.

Legal financing will interject a

new component into media coverage of PSE litigation. Newly conferred budget and operational flexibility is an attractive counterpoint to the standard narrative of reciting how public entity funds are being depleted during litigation. This type of budget flexibility promotes organizational stability for elected officials, chief financial officers, and the legal team. There could also be more dollars potentially available in a recovery that could be directed to the public good. Depending on deal terms and the waterfall, there may be more flexibility in litigation resolution returns, meaning, more dollars returned to taxpayers, as opposed to the recoveries obtained under the traditional contingent fee model. On any deal involving legal financing, there may be concern over the amount of returns recovered by a funder on a successful outcome. Funders should be mindful and respectful of the intrinsic nature of operating in this space, and simply put, not seek too much. Also, some jurisdictions, like the state of Ohio, have statutorily mandated fee schedules with a hard cap on recoveries paid to non-governmental entities. Of course, the PSE needs to be mindful that this is an investment that requires a return that cannot be measured off of the outcome of a single investment, but rather must be viewed in the context of the funder's portfolio (including write-offs included therein).

PSE Legal Finance and the Public Interest

Several concerns and arguments against legal finance for PSEs exist, which closely resemble arguments interposed against contingent fee lawyers and law firms maintaining public sector affirmative litigation. Many of these arguments are discussed at great length in law review articles and legal symposia. As such, thoughtful consideration of those points far exceeds this forum.

At top of mind, however, is the contention that legal finance may deprive elected officials of their constitutional and statutory power to control public expenditure, or that legal finance processes may be non-transparent. However, as local democratic citizen participation on budget matters makes clear, and which is repeatedly expressed in "Zoom" or in-person Council/Board meetings, those objections may run into trouble in the public forum. The vast majority of law firm retentions must and do comply with applicable public sector procurement regulations, which typically implicate public bidding or a lengthy Request for Proposal ("RFP") process. In the end, this review and approval process regarding expenditure of public funds is usually publicly approved by the governing body, and requires the passage of some time. In some states and localities, legal financing arrangements between a funder, and a PSE as a counterparty, will likely be subject to an RFP or bidding process. However, in cases where a funder and the law firm are the counterparty, public bidding and review may not occur, as the transaction remains by and between those two entities. RFP and bid responses typically remain confidential as proprietary business information, with the caveat that some public entities may publish a proposer's winning bid/response as a policy custom or statutory practice. And, in some states and localities, legal finance may never be utilized as it might be disallowed under the same laws that prohibit contingent fee law firm public client work. All told, the opportunity costs implicated by the different characteristics of the PSE marketplace can be fairly weighed against the market size and opportunity.

It is asserted that legal finance could promote the de-evolution and ceding of prosecutorial authority to funders. Yet it is hard to imagine an

ethically rigorous funder who assumes the obligations of operating in the public environment, with documents maintaining any say in legal strategy or case control. PSE contracts with affirmative litigation firms and applicable procurement statutes typically state in black letter law that PSE maintain strategic primacy, and retain full and final settlement authority in litigation. Legal finance is complementary to, not a driver of, PSE affirmative litigation. Other objections stating that legal finance is a clumsy way to resolve questions that should be the sole province of legislatures or city councils, do not necessarily focus an objection upon PSE legal finance, but rather a more comprehensive objection to affirmative litigation itself.

ESG / Impact Investing Opportunities in PSE Legal Finance

A corollary consideration relevant to the possible upswing in PSE legal finance is the intersection it may have with impact investing, or Environmental, Social, or Corporate Governance (“ESG”) investing. The uncorrelated nature of legal finance coupled with the ongoing emphasis for certain institutional investors to make sustainable investments, will likely open up the market for PSE legal finance. Investors can broaden their portfolios and their allocation strategies into this “niche of a niche.” PSE financing advances a central thesis of all litigation, the aspiration to see the rule of law upheld. This aspiration is a shared goal of all citizens, regardless of partisan or political persuasion.

One specific litigation area that will continue to fall into the impact investing orbit is the PFAS/PFOS water contamination cases filed across the US and the world. This subject matter garnered new attention following the fall 2019 release of the motion picture, “Dark Waters.” The existence and toxicity of PFAS “forever chemicals” in drinking water in the state of Minnesota triggered the settlement of state claims against 3M Corporation for \$850 million in 2018. In the months

since, other states such as New Jersey, New Hampshire, North Carolina, Michigan, and Ohio, have filed suits which may potentially result in recoveries running into the billions of dollars. Litigation funders and their investors are bound to take a close look at these cases, and those to be filed in the years to come, through the prism of ESG allocations and their potentially attractive return profiles.

Conclusion

PSEs are in the forefront of addressing and resolving policy and litigation issues in the US. Legal funders, prospective litigants, and law firms will likely work together to unlock this previously unrealized PSE legal market. Investors looking for a compelling new alternative investing strategy can expect to pay attention to this niche in the years to come.

Investor Insights

The PSE sector is a vast segment of every country’s economy and litigation funders should be aware that significant opportunities may exist in the public sector given the sheer size of these organizations and the claims they may attract. While PSE motivations may be different than those of commercial entities, PSEs should understand that commerce lies at the core of litigation finance and that investors need returns commensurate with the risk they assume to ensure the long-term viability of the asset class. Disclosure and RFP processes may be problematic in the context of litigation finance given the nature of the financing, and so this issue needs to be dealt with early on in the process. PSEs should think about litigation funders not just as sources of capital, but trusted advisors that can add value above and beyond the capital they may provide. For litigation funders, PSE claims would likely qualify as ESG investing activities, given the social benefits that are derived from these activities.



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