Insolvency

Litigation: funding and procedural difficulties

by Professor David Milman

Now that the substantive reforms contained in the 1985–86 insolvency legislation have had time to bed down, the focus of attention of commentators has switched to the procedural aspects of, and financial constraints upon, enforcing these new laws. It is now recognised that this was an area which was not adequately covered by the Cork Committee (Cmnd 8558, 1982) in its great study of the subject of insolvency reform.

One of the key aims of the Cork Committee was to facilitate actions against errant directors who had abused the privilege of limited liability. Such litigation might be of a private nature, for example an action brought by a liquidator for wrongful trading or to set aside a preference. Alternatively, there could be a *public* element involved in the litigation, the best example of this genre being an application brought by the DTI to disqualify an unfit director. Both types of litigation have given rise to procedural difficulty and have exposed the importance of funding considerations.

LITIGATION TACTICS

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USING REALISED ASSETS

As far as private actions are concerned, the main obstacle is one of finance. When one is litigating on behalf of an insolvent company by definition there will be limited funds available. In some cases there may be sufficient liquid funds in the pool of realised assets to justify the costs of litigation. Unfortunately, the other side will be aware of the restricted budget and may stall or initiate procedural counter-litigation simply in order to exhaust those funds. At an opportune moment an application for security for costs under the *Companies Act* 1985, s. 726 might be made by the defendant to put the plaintiff company on the spot and so stifle the action.

In dealing with such applications, the courts endeavour to balance the interests of the parties but effectively stifling the claim is often an inevitable consequence of ordering security, as they have recognised.

INDIVIDUAL CREDITORS

If a liquidator is unable to identify funds from internal sources, what other options are available? Persuading individual creditors to finance the litigation is a possibility but there are dangers for the creditor here. Firstly, there is always the risk that in the event of the action failing the court might make a costs order against the funding creditor under the *Supreme Court Act* 1981 s. 51.

At the end of the day whether this will happen again depends upon the exercise of judicial discretion in the context of the facts of the particular case but the recent ruling of Lindsay J in *Eastglen Ltd v Grafton* [1996] BCC 900 should offer some reassurance. Here a third party costs order against a funding creditor was refused by Lindsay J. The creditor had a genuine interest in the litigation, the liquidator was acting in good faith and the action was only blocked by the defendant seeking a security for costs order late in the day.

Nevertheless it must be conceded that English law offers little in the way of incentive for such a supporting creditor. We do not permit a funding creditor to receive a higher proportion of the proceeds of a successful claim than is to be awarded to the ordinary creditors of the company; the pari passu principle rules supreme. Contrast this position with that operating in Australia where under the *Corporations Law*, s. 564 the court can authorise disproportionate distributions of recoveries in favour of funding creditors – see for example *Re Glenisia Investments Ltd* (1996) 18 ACSR 84. Indeed, under this procedure in an appropriate case a funding creditor may be permitted to receive 100% of the recoveries in settlement of its claim. The nearest we can manage in this jurisdiction is to permit the liquidator to agree to an arrangement under which the litigation finance becomes a first charge on any eventual recoveries, a possibility recognised by the Court of Appeal in the recent unreported ruling in *Katz v McNally* (which represents but the latest stage in the ongoing *Exchange Travel* saga).

SELLING THE CAUSE OF ACTION

Another strategy might be to sell the cause of action or the fruits of the action. Although it is well established that liquidators do enjoy some latitude here from the constraints imposed by the bar on champerty and maintenance, that freedom has been placed into question by two recent decisions.

In *Grovewood Holdings v James Capel & Co* [1995] BCC 760 it was held by Lightman J that the freedom to sell a cause of action in negligence does not encompass the right to assign a share of the proceeds in return for litigation funding. This case has attracted much adverse comment and has not been followed by the Australian courts – see for example *Re Movitor Pty Ltd v Sims* (1996) 19 ACSR 440.

Moreover, certain causes of action are vested exclusively in liquidators and even outright sale is a matter of controversy. A typical example would be the right of a liquidator to sue directors for wrongful trading under the *Insolvency Act* 1986, s. 214. This cause of action can only be pursued by the liquidator. In *Re Oasis Merchandising Services Ltd* [1997] BCC 282; [1997] 2 WLR 764 the Court of Appeal rejected an arrangement under which the liquidator assigned the potential proceeds of a s. 214 claim in return for litigation finance from a commercial organisation specialising in such arrangements. The court found particularly objectionable the aspect of this arrangement which allowed the funder certain rights of control over the litigation because that might compromise the independence required of an officer of the court in exercising his or her statutory powers. Moreover the fruits of such an action could not be regarded as property of the company and so fell outside a liquidator's statutory power of sale.

CONDITIONAL FEES

It was hoped that the introduction of conditional fees might have an impact here. Arrangements under which firms of solicitors assume some of the risks of litigation were first permitted by the *Conditional Fee Agreements Order* 1995 (SI 995/1674) and the *Conditional Fee Agreements Regulations* 1995 (SI 995/1675). Unfortunately it appears that they are not making a major contribution by increasing the amount of litigation in this field. Ironically it is now apparent that this type of risk-sharing arrangement has been operating within the professions on an informal basis for many a year and the formalising of the practice has not necessarily been viewed as a positive move.

THE PUBLIC PURSE

Returning to the second species of insolvency litigation the problem of money is again beginning to impact upon the development of the law.

Although disqualification applications are funded by the state, the public purse is not unlimited. Hence if the application succeeds the respondent director can expect to be held liable in costs. Indeed some commentators might argue that the operation of the disqualification regime is now dominated by financial considerations. It was such considerations that led the National Audit Office to press the Insolvency Service to increase the number of cases on which action was taken in order to show that it was providing value for money.

'CARECRAFT' PROCEDURE

The inevitable consequence of this is that a much greater number of cases are now coming before the courts. That flood of litigation has of necessity spawned cost-saving proposals. The most celebrated of these is the *'Carecraft'* procedure (originating in the judgment of Ferris J in *Re Carecraft Construction Ltd* [1993] BCC 336; [1994] 1 WLR 172) under which the respondent directors and authorities can agree a set of facts and 'suggest' to the presiding judge that those facts merit the proposed disqualification.

To an outside observer this summary procedure looks remarkably like a form of plea bargaining, but one must always remember the inbred sensitivity of the English judiciary to such a conclusion being drawn. Hence in recent cases they

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have been at pains to reassert their ultimate authority. Thus we have been reminded that the procedure can only be properly used where there is genuine agreement as to the facts and that consensus must leave no room for secondary inferences to be drawn (*Re P S Banarse & Co (Products) Ltd* [1997] BCC 425). Moreover, as the Court of Appeal emphasised in *Secretary of State for Trade and Industry v Rogers* [1997] BCC 155 the final disposition of the case (i.e. whether a disqualification is to be ordered and the length of such a disqualification) is entirely a matter for the trial judge; the judge is not bound by any private agreement between the parties.

This latter case is significant for a number of other reasons. First, it makes it clear that once a trial judge accepts a case under the summary procedure he should not add his own 'spin' on the agreed facts because to do so would be to undermine the basis of the proceedings. If he is not prepared to go along with the procedure in a particular case he should make this clear when presented with the papers. The case also provides an illustration of the procedure being invoked for a more serious case where the proposed disqualification of eight years fell within the middle range on the spectrum of seriousness. Finally, in giving the main judgment of the Court of Appeal, Scott VC expressed his support for the use of formal binding undertakings not to act as a director in lieu of disqualification proceedings; but he indicated that legislation would be required here to give such an undertaking the same effect as a court order.

LOOKING AHEAD

It is apparent from the foregoing survey that issues of finance do pose particular difficulties in these areas of litigation. However there are signs that efforts are being made both by the judiciary and the legislature to remove disfunctions from the system. Those efforts have produced some positive changes but more could be done. For example, the idea of a public fund to finance litigation brought on behalf of insolvent companies should be given some thought. Recoveries could be used in the first instance to reimburse the public purse. Such a proposal was raised in recent law reform reports in Australia and New Zealand. The possibility of establishing such a scheme at least deserves an airing here. Equally, the traditional fear of trafficking in litigation, which is at the heart of concerns about liquidators raising litigation finance through various modes of assignment, should be cast aside.

The latest signs are that the required change of attitude is beginning to take root. On the issue of disqualification proceedings, procedural innovations should be encouraged and traditional judicial fears of case disposition outside the courtroom should be reassessed in the light of the need for the authorities to be seen to be acting upon reports of unfitness and of the requirements of an efficient case disposal system. Again, there are welcome indications that the courts are aware of the possibilities for alternative case disposition mechanisms.

However if disqualification cases continue to increase and these alternatives fail to alleviate matters then more radical questions will have to be asked about the legal processing of such cases. For example, should the court system be bypassed altogether in favour of a specialist tribunal? Should the option of an agreed disqualification 'through the post' be made available? We await developments in this field with interest.

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