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legal update

LITIGATION FUNDING UPDATE

Tips & traps for practitioners from recent cases.

With the use of litigation funding in insolvency matters increasing, being aware of the key factors and best practice has never been more important.

As a consequence of an increase in illegal phoenix activity, many practitioners find themselves appointed to companies where there are claims available, but no funds to meet the costs of pursuing them. This presents a clear barrier to liquidators investigating misconduct.

If used appropriately, practitioners and key stakeholders can obtain considerable benefits from the use of litigation funding, including an ability to meet any security for costs requirement. Creditors providing funding may also be able to seek a priority dividend in the event of a recovery.[1]

However, funding can attract court scrutiny, particularly in company liquidations, where there is often a need to seek approval of a funding agreement under s 477(2B) of the *Corporations Act 2001* (Cth) (Act). Additionally, in some cases, courts have been unwilling to allow liquidators to provide security for costs in the form of an indemnity from a funder.

Practitioners must therefore be aware of the factors courts will assess when reviewing funding agreements, and when considering whether an indemnity is an appropriate form of security.

LEGISLATIVE FRAMEWORK

Section 477(2B) of the Act limits a liquidator's power to enter contracts on behalf of companies in liquidation. A liquidator must obtain leave of the court, approval from any committee of inspection, or approval via a resolution of creditors, if:

- the term of the agreement may end more than three months after the agreement is entered into, or
- obligations of a party to the agreement may, according to the terms of the agreement, be discharged by performance more than three months after the agreement is entered.

Almost any litigation funding agreement will require approval under s 477(2B).

In some administrations, directors or related entities may be creditors of the insolvent company. This presents a practical difficulty if those same persons (or their related entities) are the potential defendants to the action or actions for which the funding is sought.

This was the scenario in *Hughes, in the matter of Sales Express Pty Ltd (in liquidation)* [2016] FCA 423 (*Sales Express*). In this case, the liquidator sought approval of an agreement whereby the sole unrelated creditor proposed to fund public examinations of persons associated with the only other two creditors, who were each related entities. Collectively, the related entities represented a majority in both number and value of the creditors.

Edelman J granted leave under s 477(2B) notwithstanding that the liquidator had not sought approval from creditors. His Honour found that a liquidator was not required to seek creditor approval before seeking leave of the court if doing so would likely be futile.[2]

COURT ANALYSIS OF LITIGATION FUNDING APPROVALS

Sales Express also contains a list of the factors courts will consider on an application seeking approval of a funding agreement under s 477(2B).

More recently, in *Vickers, in the matter of J M Kelly Builders Pty Ltd (in liquidation)* [2019] FCA 918, Reeves J, by reference to Sales Express (at [3]), restated these factors as follows:

- The court's role is to grant or refuse entry into the agreement, and not to develop or suggest alternatives.
- Section 477 of the Act provides broad powers, and should be interpreted as permitting a liquidator to do anything expedient to the winding up of the corporation's affairs.

* Formerly of Results Legal. **1** *Corporations Act 2001* (Cth) s 564; see also *Bankruptcy Act 1966* (Cth) s 109(10). **2** At [23].

- The interests of creditors (other than the proposed respondents) and the extent of liquidator consultation with them is relevant.
- The court must be satisfied there is a solid reason for approving any funding agreement, and that approval will enhance the winding up.
- Although the court must be satisfied approval is appropriate, the court will not usually review a liquidator's commercial judgment or second-guess his or her decision.
- The prospects of success in the proposed litigation are relevant, although these will rarely be able to be assessed, other than at a high level.
- A liquidator's decision will be carefully scrutinised if there appears to be a lack of good faith, an error of law or principle, or if there is a clear basis for doubting his or her prudence.
- Approval is unlikely to be granted if the terms of the agreement are unclear.
- Any matter the court believes relevant may be considered, including the manner of funding, the risks involved in any potential action, and the terms of the agreement. In particular, any premium payable to the funder, the presence of a dispute resolution mechanism, and what control the funder has over any litigation, are relevant factors.

Reeves J approved entry into the funding agreement, finding as follows:

- The terms of the proposed agreement were clear.
- The agreement liquidator had control of the work to be performed.
- The committee of creditors of a related entity had already approved the proposed agreement.
- The liquidator's considered judgment was that the agreement was appropriate, and that it would aid a just and beneficial winding up of the companies.
- There was no suggestion of a lack of good faith, an error of law or principle, or a lack of prudence.
- There were solid reasons for concluding that entering into the proposed funding agreement would enhance the winding up process.

SECURITY FOR COSTS

Section 1335 of the Act provides a court may order a plaintiff that is a corporation to provide security for a defendant's costs. The power can be exercised where it appears by credible testimony that there is reason to believe that plaintiff will be unable to pay the costs of a successful defendant. Most courts are also given similar powers under the court rules.

Liquidators may be able to rely on an indemnity for adverse costs orders provided under a funding agreement as security. There are clear advantages to this as many funders will be unable or unwilling to provide a bank guarantee, or advance funds to be held in escrow.

INDEMNITIES AS SECURITY FOR COSTS

Equititrust Limited v Tucker & Ors [2019] QSC 51 (*Equititrust*) provides an example of where a court was not satisfied an indemnity was an appropriate form of security.

The facts in *Equititrust* are complex, but in essence, the plaintiff company commenced a proceeding seeking to recover more than $17.5 million, including as compensation for asserted contraventions of s 183 of the Act, and for breaches of fiduciary duty. The liquidators were not parties to the proceeding.

Certain defendants filed an application seeking a payment into court as security for their costs. The plaintiff accepted the defendants were entitled to security, but there was a dispute as to the quantum and the form of security to be provided.

The plaintiff proposed that a deed of indemnity for adverse costs orders from the insurer for the plaintiff's funder stand as security. As the insurer was based in the United Kingdom, the plaintiff also offered to pay a modest sum into court, for the purposes of meeting the defendants' costs of any proceedings to enforce the deed.

The court acknowledged previous cases in which a deed of indemnity had been accepted as adequate security.[3] In this case however, the court was not convinced a deed of indemnity was appropriate. Importantly, the court held there was no basis to conclude there would be any impediment to the plaintiff or the funder providing security in the form of a payment into court.[4]

It was therefore ordered that security be provided in the form of a payment into court, into a solicitor's trust account, or via a bank guarantee.

CONCLUSION AND TAKEAWAY POINTS

Practitioners seeking litigation funding must be constantly mindful of the relevant principles on any application under s 477(2B) to approve entry into litigation funding agreements. An unsuccessful application can lead to a significant amount of remuneration and expenses being incurred without benefit to the administration.

In particular, any funding agreement should maintain an appropriate balance between the rights of the funder and those of the practitioner.

If relying on litigation funding as security for costs, practitioners should ensure the agreement is drafted so as to provide defendants (as non-parties) with clear enforcement rights, and ensure there is direct evidence from the funder as to its ability (or inability) to provide a different form of security.

Editor's Note: A more recent decision in relation to the same companies approved entry by the liquidators into a revised litigation funding agreement – see *Vickers, in the matter of JM Kelly Builders Pty Ltd (in liquidation) (No.2)* [2019] FCA 1789.

3 *Re Tiaro Coal Limited (in liq)* [2018] NSWSC 746; see also *DIF III Global Co-Investment Fund LP v BBLP LLC* [2016] VSC 401. **4** *Equititrust* at [139] and [140].