Validity of Liquidator's Litigation Funding Arrangement Dependant Upon Disposal! Movitor Confirmed

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The recent decision of Lindgren J in Re *Tosich Construction Pty Limited* on 28 February 1997, in the New South Wales Federal Court ("*Tosich*") (to be reported in 23 AC SR) is the latest of several cases concerning the validity of agreements between liquidators and insurers for the funding of litigation ("insurance litigation funding arrangements"). The decision identifies the characteristics of a valid insurance litigation funding arrangement. It serves as an important reference for insolvency practitioners to avoid the consequences of entering an invalid funding arrangement.

In *Tosich*, the liquidator sought Court direction as to whether he had power to enter into an insurance agreement with FAI General Insurance Company Limited ("FAI") dated 26 November 1996.

Background Facts

The insurance agreement was for the funding of proceedings against National Australia Bank Limited (the "Bank") making claims under (Division 2 subsection 588FA-588FJ) of Part 5.7B of the Corporations Law.

The insurance agreement comprised a facility (containing the standing terms) and a letter of offer concerning the particular proposal for insurance by the liquidator ("Insurance Agreement"). The liquidator accepted the offer of insurance with the concurrence of the Committee of Inspection on 26 November 1996.

During the course of the hearing before Lindgren J the terms of the Insurance Agreement were amended and, for present purposes, included terms that made it clear that:

(a) The liquidator was disposing to FAI a share of any amount to be received by way of settlement, judgment or order against the Bank (this share was the premium); and

(b) the liquidator retained the unfettered power to conduct and settle the proceedings notwithstanding that FAI had a proprietary interest in any moneys obtained from settlement, judgment or order in the proceedings.

After detailing the relevant facts, Lindgren J said:

> *"There is evidence from which I infer that the creditor's committee of inspection desires the liquidator enter into the proposed Insurance Agreement, that the ASC and the ACCC have been notified and raise no objection, and that it is in the interests of creditors that the liquidator pursue the proceeding. The only issue for decision is whether the proposed insurance agreement infringes the rule against maintenance and champerty."*

Reasoning of Lindgren J

In Halsbury's Laws of Australia, Volume 6, para 110-7135, "maintenance" is defined as: "assistance or encouragement, by a person who has neither an interest in the litigation nor any other motive recognised as justifying the interference, to a party to the litigation."

"Champerty" is defined in the same work at para 110-7140 as: "a particular form of maintenance namely maintenance of an action in consideration of a promise to give and maintain a share of the proceeds or subject matter of the action."

If an agreement contravenes the rules against maintenance and champerty it will be treated as contrary to public policy and illegal.

In the Insurance Agreement before Lindgren J, FAI was to give financial assistance to the liquidator and Tosich as applicants in the proceedings in consideration for a share in the recoveries. The Insurance Agreement was champertous and illegal, unless it fell within an exception.

The "Statutory Power of Sale Exemption"

Lindgren J noted two exceptions to the rules of maintenance and champerty, being the "general commercial interest" exception and the "statutory power of sale" exception. The first is not relevant for present purposes, but the second exception is founded on the statutory powers of trustees in bankruptcy and liquidators of companies to sell "the property of the bankrupt" and "the property of the company", respectively. The reasoning being that if a cause of action is sold pursuant to the statutory power of sale it could not be invalid by virtue of the rules of maintenance and champerty.

Lindgren J reviewed 4 decisions relevant to the "statutory power of sale exception": the English decisions of *Grovewood Holdings Plc v James Capel & Co Limited* [1995] 2 WLR 70 ("Grovewood") and *Re Oasis Merchandising Services Limited* (1995) 2 BCLC 493 ("Oasis"); and the Australian decisions of *Re Movitor Pty Limited* (1996) 14 ACLC 587 ("Movitor") and *UTSA Pty Limited v Ultra Tune Australia Pty Limited* (1996) 14 ACLC 1262 ("UTSA").

The Court in *Grovewood* held that the statutory power of sale (given to the liquidator under the Insolvency Act 1986 (UK)) which conferred immunity from the law of mainte-

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nance on a sale of the liquidator of a bare cause of action, could not be extended to confer immunity on "sales of the fruits of the litigation which include provision for the purchaser to finance the litigation".

The Court in *Oasis* held that an agreement by a liquidator to assign the fruits of a section 214 action (the insolvent trading provision of the Insolvency Act (UK)) did not attract the statutory power of sale exemption as the fruits of section 314 were not "property of the company". Of relevance to the Court was the fact that an application under section 214 could only be made by the liquidator.

Both *Grovewood* and *Oasis* were English decisions. The decision of Drummond J in the Federal Court of Victoria in *Movitor* departed from English Law in two important respects:

(a) Drummond J held that paragraph 477(2)(c) of the Law which empowers a liquidator of a company to "sell or otherwise dispose of, in any manner, all or any part of the property of the company," not only exempted the sale of a cause of action by the liquidator from the rule of maintenance but also exempted the sale of a share in the fruits of an action belonging to the insolvent company; and

(b) Drummond J held that the statutory causes action under s 588M and s 588W of the Corporations Law (the subject of the funding agreement) were "property of the company". Justice Drummond distinguished the English decisions on section 214 (of the Insolvency Act (UK)) on the basis that these were differences between section 214 and the Corporations Law Provisions of s 588M and s 588W. It was irrelevant that the action under s 588M and s 588W was, in most cases, to be taken by the liquidator because the damages recoverable are treated in the Law "as a debt due to the company".

In *Movitor* Drummond J held that:

> "... *for purposes of s 477(2)(c) of the Corporations Law, that section authorises the liquidator to make an agreement to pay a percentage of such recoveries in return for assistance in running the action, because the section empowers the liquidator not only to sell, but to 'otherwise dispose of, in any manner' any part of the property of the company.*" (at 595-596)

UTSA concerned an assignment by the liquidator of the causes of actions of UTSA, as opposed to a sale of part of the fruits of the action. The Court held that the assignment was valid, relying on the statutory power of sale exemption. Interestingly, the Court was of the view (obiter) that a claim under s 588FF of the Corporations Law was personal to the liquidator and was non-assignable.

Conclusion in Tosich

Lindgren J in *Tosich* addressed the issues raised in the cases by reference to three topics:

> "*1. The exclusion of a sale or other disposition by a liquidator or a share of recoveries from the prohibition against maintenance or champerty.*
> *2. Whether there is a sale or disposition of the recoveries or a share of them in the present case.*
> *3. The question of intervention in the conduct of the litigation.*"

Issue 1

The exclusion of a sale or other disposition of a share of recoveries from the prohibition against maintenance or champerty.

Lindgren J agreed with the approach taken in *Movitor* to this question and declined to follow *Grovewood*. Lindgren J held that the statutory exemption applicable to dispositions of bare causes of action extended to dispositions of recoveries. He held that any recoveries under s 588FA-FJ will be "property" of Tosich because orders under s 588FF and s 5889FJ provide for remedies resulting in a payment to the company, or a debt due to the company, respectively.

Issue 2

Was there a sale or disposition of the recoveries or a share of them in this case.

Lindgren J noted the following:

> "*In Grovewood and in Movitor, Lightman J and Drummond J respectively treated the contractual arrangement in question as a 'sale' by the liquidator. There was, however, no analysis of the relevant terms of the contractual arrangement by reference to the concept of a sale. Prior to the amendment made in the course of the hearing in the present case, FAI and the insured proposed to agree that FAI be paid the Premium 'from the Resolution Sum on resolution' ... and that at Resolution the Insured instruct The Argyle Partnership to distribute the Resolution Sum in accordance with the Insurance Agreement ... In my opinion, those provisions did not provide for a sale or other disposition of recoveries. They were a contractual promise by the Liquidator to FAI that the Liquidator would give a direction to the Solicitor. It was not plain to me that what was intended was a sale or other disposition of future property; cf Meagher Gummow and Lehane, Equity: Doctrines & Remedies (3rd Ed, 1992) at [683], [684], pp 197-198, and cases there referred to. But the amendments made during the hearing have overcome this difficulty. Paragraph 4 of the amended letter will provide in terms that the Insured "disposes to FAI a share of the Resolution Sum (as the Premium to be remitted to FAI) ...". In my view, this amounts to a disposal by the Liquidator of future property of Tosich in exercise of the power given to a liquidator by para 477(2)(c) of the Law, and, as such, is excepted from the rules against maintenance and champerty.*"

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Issue 3

Intervention in the conduct of the proceedings.

Drummond J in *Movitor*, said this in relation to *Grovewood*:

> *"Lightman J held that, because there was no sale of a cause of action belonging to the company by the liquidator which would have been within the exemption from maintenance and champerty, the fact that the purchaser from the liquidator of a share in the fruits of the litigation was to be involved in the conduct of the litigation made it champertous."* (at 594).

Similarly, in *Magic Menu Systems Pty Limited v AFA Facilitation Pty Limited* (1996) 137 ALR 260 (appeal dismissed on 20 January 1997, unreported), the court held that:

> *"... if the purchaser of a share of the fruits of litigation between others is also entitled, under the purchase agreements to involve himself in the litigation, that will be sufficient to turn an otherwise lawful transaction into one that involves both unlawful maintenance and champerty."* (at 272).

Lindgren J did not need to formally address the issue, because he concluded that under the amended agreement FAI had no more than a right to be kept informed and to invoke mediation procedures described in the Creditors Recovery Service Facility, while leaving ultimate control of the proceedings with the Insured.

Lindgren J concluded that the liquidator of Tosich had the power to enter into the insurance agreement with FAI.

Summary

In order for an insurance litigation funding arrangement to be valid it must satisfy the following requirements:

(i) it must effect a sale or disposition of the cause of action or of the fruits (or a share of the fruits);

(ii) it must constitute a bona fide exercise of power by the liquidator. In this respect it will be important for the liquidator to obtain the consent of the creditors or a committee of inspection or of the Court to the proposed assignment; and

(iii) where there is a sale or disposition of the recoveries, the funder should not have control over the conduct of the proceedings.

Consequences of Invalidity

If an insurance litigation funding arrangement does not comply with above requirements the possible consequences of invalidity include the following:

(a) the insurer will not be able to require payment of the premium notwithstanding funding having been provided;

(b) liquidators who have paid a premium in advance of funding, may not be able to receive compensation from the company's assets:

(c) indemnities for adverse costs orders granted by insurers are unenforceable;

(d) liquidators who have borrowed funds mistakenly believing that the debt is underwritten by the insurer are left with personal exposure; and

(e) parties who have been sued by liquidators in reliance upon litigation funding will seek a stay of proceedings (on the grounds that the insurance litigation funding arrangement is invalid) to frustrate the liquidator's activities and diminish his resolve in the proceedings.

Given the possible consequences of invalidity of a litigation funding arrangement and the rapid expansion in their use by liquidators in the last two years, Lindgren J's decision in *Tosich* is an important one.

NEEDED

Chairpersons of Disciplinary and Inability Appeal Boards

The Commissioner for Public Employment, Mr David Hawkes, is responsible for administering the *Public Sector Employment and Management Act.*

Since 1993 a Disciplinary Appeal Board and an Inability Appeal Board have been established under this legislation.

Chairpersons of these Boards have generally been local legal practitioners and the Commissioner seeks further Expressions of Interest from any practitioners nominated as a chairperson for either of these two Boards.

Anyone interested in obtaining further information can do so by contacting the Commissioner's office on 8999 5511 (ph) or 8941 1895 (fax).

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sion has created something of a demise in the mentoring system and the ability to network personally. Karen's law association is working very hard to rectify some of these problems.

Members of the profession in NTAG's department are indeed fortunate in being able to tap into the knowledge and experience Karen has brought with her from Canada, and even more fortunate that this expertise is accompanied by the enthusiastic intelligence (and possibly even a liking for lawyers) that Karen exhibits.

The Law Society wishes Karen every enjoyment of her time in Darwin and her subsequent travels in Australia.