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## SALVAGE THROUGH LITIGATION IN INSOLVENCY: > CONSIDERING THIRD-PARTY FUNDING

In this article we asked Corrs Chambers Westgarth and Slaughter and May to consider how maritime salvage principles have been used in Australia and the United Kingdom to ensure insolvency practitioners are paid for the costs and expenses properly incurred in the care, preservation, and realisation of assets (including for the costs of litigation funding arrangements).

What we at Vannin Capital observe in practice is that while the priority status of insolvency practitioner fees and expenses is largely the same in Australia and the United Kingdom, there is a stronger reliance in the United Kingdom on detailed statutory provisions, which stipulate what constitutes litigation costs and expenses that are properly incurred and, therefore, reimbursable.





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#### Application of the salvage principle in *Universal Distributing*

In 1933, the Australian High Court drew on the law of salvage in holding that a liquidator is entitled to an equitable lien for the costs, charges and expenses incurred by the liquidator in realising assets brought into the estate, which takes priority over a creditor's security.<sup>1</sup> The rationale is that those taking the benefit of the liquidation should not escape bearing the burden of the proper cost of it.<sup>2</sup>

In *Universal Distributing*, Dixon J held that while the creditor's security had priority over the general costs and expenses of the liquidation, the expenses incurred by the liquidator in the actual realisation of the assets subject to the security should be charged upon that fund.<sup>3</sup>

The principle draws its foundations from the law of salvage where, in return for work and labour done, or money expended, by a third party to salvage any ship (or its cargo), a reasonable amount is to be paid to the salvor by the owner of the ship, cargo or equipment saved.

#### Priority ranking under the Corporations Legislation

Pursuant to the *Corporations Act 2001 (Cth) s 556 and Corporations Regulations 2001 (Cth) Sch 8A reg 4*, an insolvency practitioner (including a deed administrator) must apply the property of the company coming under his or her control under this deed in the order of priority specified in *Corporations Act 2001 (Cth) s 556*, in priority to "all other unsecured debts and claims". Expenses (except deferred expenses) properly incurred in preserving, realising or getting in property of the company, or in carrying on the company's business, rank first.<sup>4</sup>

If an expense is properly incurred in preserving, realising or getting in property of the company, the liquidator (or third party)<sup>5</sup> that incurred the expense will be entitled to an equitable lien, which has priority over all other debts of the company, secured or unsecured.<sup>6</sup>

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<sup>1</sup> Re *Universal Distributing Co Ltd (in liquidation)* (1933) 48 CLR 171 (*Universal Distributing*).

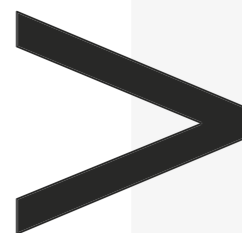
<sup>2</sup> See also *Shirlaw v Taylor (1991) 31 FCR 222, 230; Thackray and others (in their personal capacity and as receivers and managers of Great Southern Managers Australia Ltd (ACN 083 825 405) (receivers and managers appointed) (in liq)) v Gunns Plantations Ltd and others* (2011) 85 ACSR 144, [40] (*Thackray*).

<sup>3</sup> *Universal Distributing*, at 174-5

<sup>4</sup> Section 433 of the *Corporations Act* provides similarly with respect to receivers appointed prior to the winding up of a company.

<sup>5</sup> *Young v ACN 081 162 512 Pty Ltd (in liq)* (2005) 218 ALR 449.

<sup>6</sup> *Ibid*.



## INSOLVENCY PRACTITIONERS SHOULD CAREFULLY CONSIDER PROPOSED LITIGATION TO ENSURE EXPENSES INCURRED UNDER A LITIGATION FUNDING ARRANGEMENT ARE 'PROPER' AND 'REASONABLE'.

### When the salvage principles in *Universal Distributing* apply

Consistent with *Universal Distributing*, in *Stewart* the High Court found an equitable lien in favour of a liquidator, based on salvage principles as:

- (a) the relevant company was in liquidation;
- (b) the liquidator had incurred expenses and rendered services in the realisation of an asset;
- (c) the resulting fund was insufficient to meet both the liquidator's costs and expenses of realisation and the debt due to a secured creditor; and
- (d) the creditor claimed the fund.<sup>7</sup>

In both *Universal Distributing* and *Stewart*, funds were actually realised as a result of the relevant litigation.

Statements made by Maxwell P in *Primary Securities Ltd v Willmott Forests Ltd (recvs and mngrs apptd) (in liq) (2016)* 50 VR 752 suggest that the principle in *Universal Distributing* applies even where no fund is created. Maxwell P said, (in circumstances where the appointment

of the liquidator came to an end before a fund had been created):

*"Identifying the recoverable costs is made no more difficult by the absence of a fund. In every case, the question to be determined is one of fact, namely, whether the costs were incurred exclusively for the purpose of care, preservation and/or realisation of the assets... the principle in Universal Distributing does not depend for its application on the existence of a fund as the product of the liquidator's efforts..."*

However, the application of the *Universal Distributing* principle where no funds are, in fact, created departs from the original principle of salvage, which requires the creation of a benefit by the salvor.

### Universal Distributing applies to other insolvency practitioners

It is not necessary that the party claiming the equitable lien under the *Universal Distributing* principle is a liquidator.<sup>8</sup> The principle also applies to deed administrators, receivers, and receivers and managers.<sup>9</sup>

As noted by Davies J in the 2011 Victorian Supreme Court case of *Thackray*:

*"The underlying principle in each case is that it would be inequitable for the person who has created or realised a valuable asset, in which others claim an interest, not to have his or her costs, expenses and fees incurred in producing the asset paid out of the fund or property created."*<sup>10</sup>

However, deed administrators should take care not to inadvertently exclude the application of the *Universal Distributing* principle. If one or more clauses of the deed of company arrangement has the effect of detracting from the fundamental principal/agent relationship, the deed administrator may no longer be an agent of the company and a fiduciary.<sup>11</sup> In *Cresvale*, Austin J implied that the "well-established right of indemnity to recover fees and expenses out of property realised in the course of receivership, supported by an equitable lien," would not apply where the deed administrator was not an agent of the company and a fiduciary, on proper construction of the relevant deed of company arrangement.<sup>12</sup>

### Equitable lien covers expenses properly incurred

The *Universal Distributing* principle only applies where the relevant expenses were "reasonably incurred in the care, preservation and realisation of the property".<sup>13</sup> An insolvency practitioner will have an equitable lien for their proper remuneration, costs and expenses, attributable to work done exclusively in caring for, preserving and realising the company's assets.<sup>14</sup>

### A liquidator's lien includes litigation funding expenses: *IMF v Meadow Springs*

In the 2009 case of *IMF v Meadow Springs*, the liquidator arranged for the insolvent company's costs and expenses of conducting proceedings to be funded by a litigation funder pursuant to a litigation funding agreement.<sup>15</sup> The litigation funding agreement provided for the payment of fees to the funder as well as a percentage of any realisations (referred to here as the premium), after the funder was reimbursed for solicitor and liquidator fees it had incurred.

It was conceded that the funder ought to be reimbursed for the solicitor and liquidator fees, by way of the *Universal Distributing* principles. The Court of Appeal considered whether the liquidator's equitable lien ought to extend to the litigation funder's fees and premium.

The Court found that the *Universal Distributing* principle applied to the whole of the amount owing to the funder under the litigation funding agreement, including the fees and the premium, in addition to the reimbursement of the solicitor and liquidator's expenses.<sup>16</sup> As such, the Court found that an equitable lien in favour of the liquidator included the whole of the litigation funding expenses and that those amounts should be paid out of the funds realised before any amount due to the secured creditors.

With respect to the premium, the Court observed that:

- (a) the premium was one of the litigation funder's conditions for giving its support to enable the recovery of the funds from the successful proceedings;
- (b) the litigation funder "was funding the litigation not merely to achieve return of the monies it had advanced, but to obtain part of the proceeds as its commercial return for its involvement";

- (c) "the way in which it sought to structure the payment of its reward...does not affect the common sense and commercial characterisation of what that stipulation clearly was; namely, part of the price or cost of IMF's funding"; and
- (d) without the litigation funder's support, the liquidator and insolvent company would not have had the funding to pursue the relevant claim.

The Court said:

*"It follows that the realisation of the resolution sum in the winding-up, through the efforts of the liquidator funded by IMF, was achieved because the liquidator and Meadow Springs agreed to incur obligations to IMF to pay to it all the amounts due under the IMF funding agreement. The payment of liabilities created by the liquidator in achieving the realisation of the fund that was constituted by the resolution sum must be borne by that fund in accordance with the Universal Distributing principle."*<sup>17</sup>

Insolvency practitioners should therefore carefully consider the proposed litigation, as well as the availability and terms of litigation funding, to ensure that expenses incurred under the terms of a litigation funding arrangement are 'proper' and 'reasonable'.

<sup>7</sup> *Stewart v Atco Controls Pty Ltd (in Liquidation)* (2014) 252 CLR 307, [35] (*Stewart*).

<sup>8</sup> *Arms v WSA Online Ltd (subject to a deed of company arrangement)* [2007] FCA 1712 at [11] (Arms) per Ryan J; *Wellnora Pty Ltd v Fiorentino* (2008) 66 ACSR 229 (*Wellnora*), [24] quoting Austin J in *Cresvale Far East v Cresvale Securities (No 2)* (2001) 39 ACSR 622 (*Cresvale*), [70].

<sup>9</sup> *Ibid.* Note also that the *Universal Distributing* principles have been codified in Australia, pursuant to Corporations Act 2001 (Cth) s 556 and Corporations Regulations 2001 (Cth) Sch 8A reg 4.

<sup>10</sup> *Thackray* at [41].

<sup>11</sup> See *Cresvale* (2001) 39 ACSR 622, [70].

<sup>12</sup> *Ibid.*

<sup>13</sup> *Universal Distributing* at 174.

<sup>14</sup> *Coad v Wellness Pursuit Pty Ltd (in liq)* (2009) 71 ACSR 250, [96]; *Universal Distributing* at 175.

<sup>15</sup> *IMF (Australia) Limited v Meadow Springs Fairway Resort Limited (in liquidation)* (2009) 69 ACSR 507 (*IMF v Meadow Springs*).

<sup>16</sup> *IMF v Meadow Springs* (2009) 69 ACSR 507, [49]-[51], [72]-[73].

<sup>17</sup> *IMF v Meadow Springs* (2009) 69 ACSR 507, [72]-[73].

Considerations impacting funding arrangements

In the 2002 Supreme Court of New South Wales decision of *Re ACN 076 673 875 LTD (rec and mgr apptd) (in liq)* (2002) 42 ACSR 296, Austin J outlined a number of the factors that should be considered by insolvency practitioners before bringing proceedings and entering into third-party litigation funding arrangements. The relevant factors included:

- (a) the liquidator's prospects of success in the litigation;
- (b) the interests of creditors other than the proposed defendant;
- (c) possible oppression in the bringing of the proceedings;
- (d) the nature and complexity of the cause of action;
- (e) the amount of costs likely to be incurred in the conduct of the action and the extent to which the financier is to contribute to those costs;
- (f) the extent to which the financier is to contribute towards the costs of the defendant in the event that the action is not successful, or towards any order for security for costs by the court before which the action is to be heard;
- (g) the extent to which the liquidator has canvassed other funding options;

- (h) the level of the funder's premium;
- (i) the risks involved in the claim; and
- (j) the liquidator's consultations with creditors.<sup>18</sup>

The matters considered by the Court in *IMF v Meadow Springs* also provide an indication of what circumstances will support the reasonableness of propriety of incurring litigation funding expenses (and ultimately, the recovery of such expenses).

In *IMF v Meadow Springs*, the secured creditor contended that the fees and the premium exceeded reasonable expenses incurred in the care, preservation and realisation of the asset (being the cause of action).<sup>19</sup>

The Court did not agree with the secured creditor because:

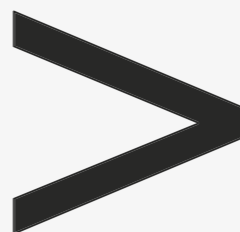
- (a) the secured creditor declined to provide funding for the proceedings;
- (b) the secured creditor was aware that the liquidator entered into the funding agreement but took no steps to challenge it;
- (c) the cause of action would become statute barred about a year after the funding agreement was made; and
- (d) the secured creditor took no steps to enforce its security, for example, by appointing a receiver.<sup>20</sup>

Position in the UK

In the UK, while the expenses of the winding up are paid in priority to distributions to creditors,<sup>21</sup> there are some exceptions for litigation expenses. Litigation expenses are those expenses that are:

- (a) incurred by the liquidator in the conduct of legal proceedings which the liquidator is entitled to bring;
- (b) properly chargeable or incurred in the preparation or conduct of legal proceedings;
- (c) more than (or in the liquidator's opinion, are likely to be more than) £5,000.<sup>22</sup>

Such expenses arguably include costs and expenses associated with third-party litigation funding arrangements.



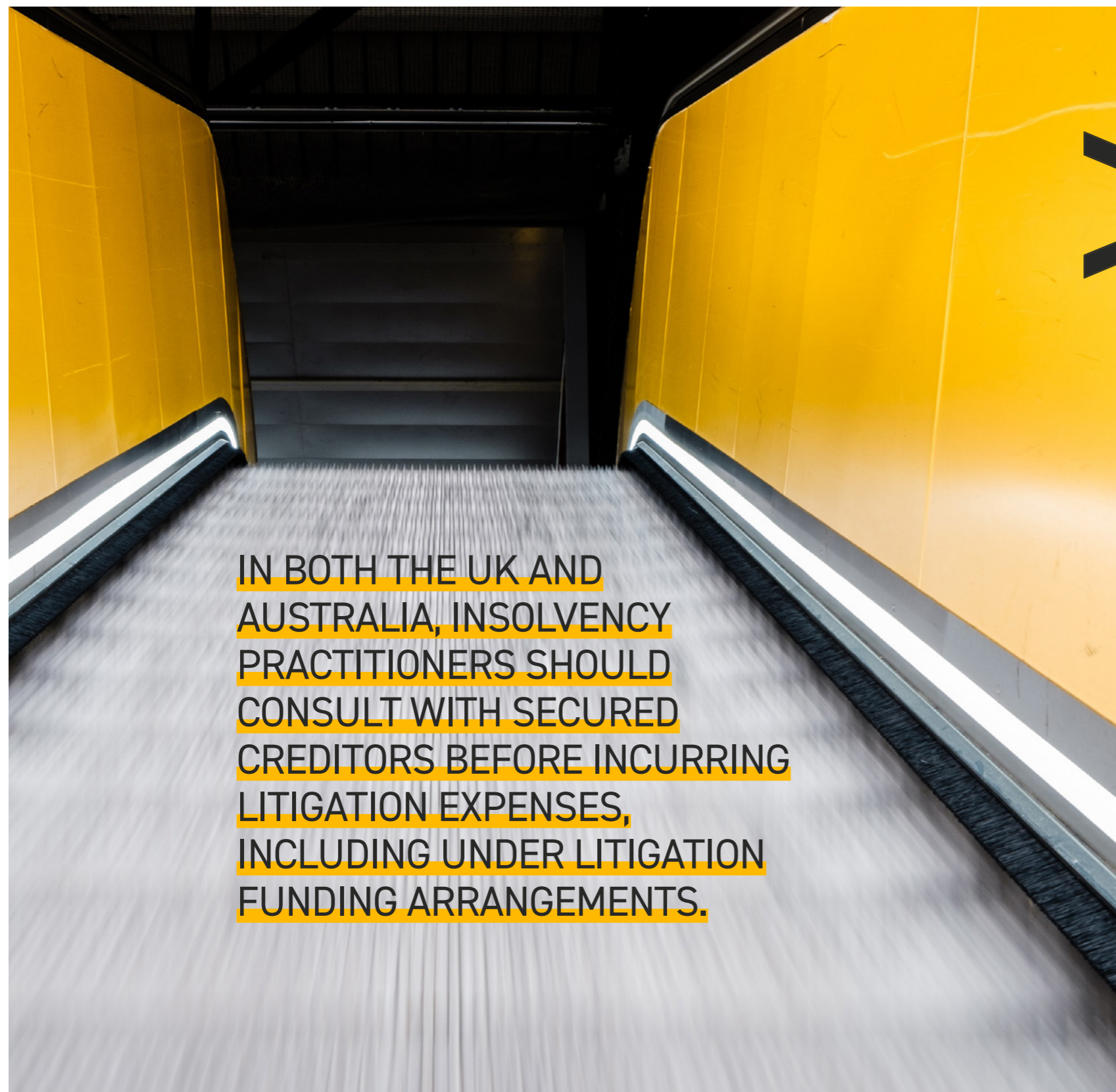
<sup>18</sup> *Re ACN 076 673 875 LTD (rec and mgr apptd) (in liq)* (2002) 42 ACSR 296, [17]-[28].

<sup>19</sup> *IMF v Meadow Springs* (2009) 69 ACSR 507, [75].

<sup>20</sup> *IMF v Meadow Springs* (2009) 69 ACSR 507, [76].

<sup>21</sup> *Insolvency Act 1986* (UK) s 176ZA; *Insolvency (England and Wales) Rules 2016 (Insolvency Rules)* rr 6.42 and 7.108.

<sup>22</sup> *Insolvency Rules* r 6.44 and 7.111.



**IN BOTH THE UK AND AUSTRALIA, INSOLVENCY PRACTITIONERS SHOULD CONSULT WITH SECURED CREDITORS BEFORE INCURRING LITIGATION EXPENSES, INCLUDING UNDER LITIGATION FUNDING ARRANGEMENTS.**

#### Litigation expenses

Litigation expenses will not be paid in priority to secured creditors and cannot be paid out of the property the subject of a floating charge, unless and until the expenses have been approved or authorised in accordance with rules 6.45-6.48 and 7.113-7.116 of the Insolvency Rules.<sup>23</sup>

Approval or authorisation under rules 6.45-6.48 and 7.113-7.116 of the Insolvency Rules is required where the liquidator:

- (a) ascertains that property is comprised in or subject to a floating charge;
- (b) has or proposes to institute, continue or defend legal proceedings; and
- (c) before or during the proceedings identifies that:
  - (i) the assets of the company available to pay the creditors are or will be insufficient to pay the litigation expenses; and
  - (ii) in order to pay litigation expenses, it will need recourse to property comprised on, or subject to, a floating charge created by the company.

If approval or authorisation is required, in order to benefit from the priority afforded by s176ZA of the *Insolvency Act 1986*, the liquidator must:

- (a) seek approval from the creditor(s) having a claim to the property subject to a floating charge; and
- (b) seek authorisation for the amount of litigation expenses the liquidator sees fit.<sup>24</sup>

#### Seeking court approval

A liquidator may apply to the court for approval of litigation expenses where:

- (a) the relevant creditor is a defendant or proposed defendant to the proceedings; or
- (b) the relevant creditor declined to approve/authorise the litigation expenses; or
- (c) the relevant creditor approved/authorised an amount which is less than the amount the liquidator considers sufficient; or
- (d) the relevant creditor made an application for further particulars or another response to the liquidator's request that is, in the liquidator's opinion, unreasonable; or
- (e) the liquidator thinks the circumstances are such that they require urgent approval/authorisation, either:
  - (i) without seeking creditor approval; or
  - (ii) before the creditor is required to respond to the approval/authorisation request.

#### Commonality of the UK and Australian positions

In both the UK and Australia, insolvency practitioners should take a number of steps before embarking on litigation, including ensuring that they consult with (and in the UK, obtain approval from) secured creditors before incurring litigation expenses, including under litigation funding arrangements.

In Australia, consultation with (and acquiescence of) secured creditors will be relevant in considering the reasonableness and propriety of the litigation expenses incurred. In the UK, without creditor approval, there is a risk of losing the priority ranking conferred by s176ZA of the *Insolvency Act 1986* (UK) for the payment of litigation expenses.

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<sup>23</sup> Insolvency Rules rr 6.44(2) and 7.112.

<sup>24</sup> Approval or authorisation must be in accordance with Insolvency Rules rr 6.46 and 7.114.