

Insolvency & Restructuring
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Insolvency

IS THE OPENING OF LITIGATION FUNDING INDUSTRY GOOD NEWS FOR LIQUIDATORS?

A common and difficult problem faced by the liquidators and trustees in bankruptcy in administering the assets of the company or the estate of the bankrupts is the lack of funding to finance the litigation. While it is a statutory duty for the liquidators and trustees in bankruptcy to investigate into the affairs of the companies or bankrupts and to make appropriate applications for setting aside improper transactions, the claims of liquidators are often questioned and even frustrated by the defendant on the ground of maintenance and champerty in that the defendant raises queries as to the source of funding of the liquidators or trustees in bankruptcy.

THE DECISION OF RE CYBERWORKS

In April 2010, finally comes the long-awaited decision of **Re Cyberworks Audio Video Technology Ltd** [2010] 2 HKLRD 1137, where the Court of First Instance held that as an exception to the rules on champerty and maintenance, it is legal for

liquidators to assign a cause of action vested in the company to a third party funder. Following the decision, a third party funder can fund a lawsuit in return for an option to take an assignment of those lawsuits and causes of action.

ISSUES FOR LIQUIDATORS

Whilst this is a welcome decision by the litigation funding industry, we have identified the following issues which liquidators should pay special attention when entering into litigation funding arrangement with third parties.

A FIRST INSTANCE JUDGMENT

Re Cyberworks is a decision of the Court of First Instance. The decision may be overruled by a higher court or a higher court may hold different views as to the propriety of liquidator's litigation funding arrangement with third parties.

PREFERENCE CLAIMS ASSIGNABLE?

The decision in **Re Cyberworks** only allows the assignment of a cause of action to a third party funder. However, it did not rule on whether the assignment extends to a cause of action that is vested in the liquidators such as unfair preferences.

Position in foreign jurisdictions

Different jurisdictions have different treatments to this issue. In the UK, it was decided that a liquidator is prohibited from assigning proceeds recovered from a successful claim of fraudulent trading, transaction at undervalue or unfair preference.^[FN1] In Australia, it was held that these are the general assets of the company under the administration and control of the liquidators.^[FN2]

Current position in Hong Kong

It is envisaged that judges in Hong Kong will most likely follow the UK decision. There is also no equivalent provision in Hong Kong on related laws in Australia. Therefore, we have to look at whether there are any venues that justify the fruits recovered from preference claims can be treated as general assets of the company. At present, there is still no authority authorizing the assignment of preference claims subsequent to the decision in **Re Cyberworks**.

Practical advice to funders and liquidators

Care should be observed in the drafting of the third party financing agreement. As it is still unlawful for liquidators to assign the causes of action including the fruits of proceeding for preference claims to a litigation funder, liquidators should pay special

attention to the wording and the arrangement in the funding agreement so as to avoid rendering it invalid.

LIQUIDATORS' COSTS AND EXPENSES RECOVERABLE FROM PREFERENCE PROCEEDS?

Position in foreign jurisdictions

Again, different jurisdictions have different treatments to this issue. In the UK, the liquidator cannot recover his expenses in the winding up out of preference proceeds on the reason that they are not property of the company. In Australia, the liquidators may sell the preference proceeds and claim the general costs and expenses of the winding up out of preference proceeds.

Current position in Hong Kong

This issue is closely related to the issue as to whether claims relating to preference claims, fraudulent trading are assignable by the liquidators to third party funders. There is no equivalent provision in existing laws in Hong Kong similar to Australia that allow us to recover expenses and costs in the winding up from the proceeds of the lawsuits.

Practical advice for liquidators

At present, the only avenue available right now for liquidators to recover his costs and expenses relating to unfair preference claims is from the remaining estate of the company. If the remaining estate of the company is not sufficient to cover the liquidators' expenses, the liquidators can only look to the existing creditors' assistance. In the event

that no creditors are willing to put up any funding, the liquidators will be barred from pursuing further these claims due to lack of funding. It is therefore essential for liquidators to obtain proper legal advice as to the merits of the available preference claims in order to illicit the necessary financial support from the creditors.

IMPERFECTIONS OF THE EXISTING THIRD PARTY FUNDING PRACTICE

Liquidators and trustees in bankruptcy are usually accountants who abide by their own code of conduct namely “Code of Ethics for Professional Accountants”, in particular those provisions safeguarding the accountant’s objectivity and independence from influences which could affect his or her duty to the company in liquidation.^[FN3] If a liquidator may legally assign the fruits of proceeding for a claim for breach of contract by a third party to the company in liquidation, we fail to see any policy reason in prohibiting a liquidator in assigning the proceeds of a preference claim to a third party.

FOOTNOTES

[FN1] In the United Kingdom, the court in *Oasis Merchandising Services Limited (in Liq)* [1977] 1 All ER 1009 drew a distinction between a cause of action vested in the company at the time of commencement of the liquidation (e.g. breach of contract, tort, etc.), and those arising after the liquidation of the company. The former falls within the property of the company; while the latter does not.

[FN2] In *Movitor Pty Ltd (recs and mgrs apptd) (in liq) v Sims* (1996) 19 ACSR 440, the Australian court distinguished *Oasis* on the basis of slight differences of wordings between two applicable statutes, and held that fruits of proceedings recovered from a successful claim of fraudulent trading, transaction at undervalue or unfair preference, are general assets under the administration and control of the liquidators. The liquidator is entitled to recover the proceeds “as a debt due to the company”.

[FN3] Code of Ethics for Professional Accountants, Hong Kong Institute of Certified Public Accountants, issued on December 2005, particularly Section 432 on Integrity, Objectivity and Independence in Insolvency. The section put emphasis on them overriding importance in an accountant’s integrity and objectivity in the acceptance and conduct of insolvency work as in any other area of professional life.

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Should you have other enquiries, please feel free to contact us.

CONCLUSION

Re Cyberworks marks an important step in the development of litigation funding industry in Hong Kong, but it is only the first step in the litigation funding industry in Hong Kong. There are still crucial issues which remain undecided. They are whether the preference claims are assignable, and whether the liquidators can recover his costs and expenses in relation to the unfair preference type of claims. Based on the existing authority, the Hong Kong court will most likely decide these issues in a negative way, and may continue to close the door for third party funding for these types of preference claims.

At present, apart from the landmark decision in **Re Cyberworks** in Hong Kong, the underdeveloped jurisprudence in this aspect in Hong Kong does not provide for any precedents to assist in the drafting of the litigation funding agreements. We very much look forward to the birth of new cases to provide more guidance on the various unresolved aspects relating to the litigation funding industry in Hong Kong.