Third party funding agreements and insolvency proceedings

***Re Patrick Cowley and Lui Yee Man, Joint and Several Liquidators of the Company* [2020] HKCFI 922 (date of judgment: 27 May 2020)**

It is common for insolvency practitioners in Hong Kong to seek Court sanction on third-party litigation funding agreements in light of the law of champerty and maintenance. In this case, the Hong Kong Court clarified that a liquidator does not require Court sanction in order to enter into a third-party funding agreement.

Maintenance and champerty

The origin of the laws of maintenance and champerty is ancient and obscure. In modern times, maintenance refers to "the giving of assistance or encouragement to one of the parties to an action by a person who has neither an interest in the action nor any other motive recognised by the law as justifying his interference", and champerty refers to "a particular kind of maintenance, namely maintenance of an action in consideration of a promise to give to the maintainer a share of the subject matter or proceeds thereof, if the action succeeds".[1]

Subject to a few exceptions, maintenance and champterty continue to apply in Hong Kong to prohibit third party litigation funding both as torts and crime.[2] One such exception is third party funding provided to insolvency practitioners in insolvency matters.

Background

The liquidators (the "**Liquidators**") of a company in voluntary liquidation (the "**Company**") (which is not named in the judgment for reasons of confidentiality) applied to the Court for sanction to enter into a third-party funding agreement.

The Liquidators made this application as they have been advised that it is necessary in the light of certain statements that appear in two cases, namely *Osman Mohammed Arab & Anor v Chu Chi Ho Ian*[3] and *Re A* [4]. In these two cases, the Court made some obiter comments to the effect that approval of the Court is necessary for funding arrangements entered into by insolvency practitioners.

Harris J considered that it was because of a series of decisions in liquidation cases commencing with his own decision in *Re Cyberworks Audio Video Technology Ltd* [5] that counsel in those two cases assumed that the Court's approval is necessary but that is not accurate.

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[1] *Massai Aviation Services v. Attorney General of Bahamas* [2007] UKPC 12
[2] *Unruh v Seeberger* [2017] 10 HKCFAR 31 and *Winnie Lo v HKSAR* [2012] 15 HKCFAR 16
[3] [2016] HKCU 149; HCB 4344B/2012, HCB 4344/2012.
[4] [2020] HKCFI 493.
[5] [2010] 2 HKLRD 1137.

The previous decisions of the Companies Court on funding agreements

Re Cyberworks

The case concerns a cause of action assigned by the company to the funder. Harris J explained that a cause of action is property of the company, which the liquidators have power to sell to a third party and therefore granted sanction to the sale.

Re Company A to G [6]

Harris J approved a funding agreement between a commercial funder and seven companies, which provided for the funder to finance the prospective litigation in return for a share of the proceeds if the litigation were to prove successful but did not involve an assignment of the chose in action.

Harris J took the view that as the litigation could not realistically be advanced without external funding and the litigation remained under the control of the liquidators it was unobjectionable and fell within what might be called the "insolvency exception" to restrictions imposed by the law of maintenance and champerty. *Re Company A* does not however address the question of whether or not it is necessary for the liquidators to obtain Court sanction of the funding agreement.

Court sanction NOT necessary for funding agreements

Sale of a chose of action

Harris J found that paragraph 1 of Part 3 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance, Cap 32 (the "**Ordinance**"), which provided that the liquidators have powers to "*sell the real and personal property and things in action of the company by public auction or private contract, with power to transfer the whole of the property and things in action to any person or company, or to sell them in parcels*", makes it unnecessary for a liquidator in either a voluntary liquidation or a winding-up by the Court to obtain the Court's sanction of a funding agreement, which involves the sale of a chose in action in return for a right to participate in the proceeds of successful litigation to enforce the chose in action.

Funding in return for a share of the proceeds in an action

Harris J referred to following provisions of the Ordinance:

- Paragraph 1 of Part 2, Schedule 25, which provides that a liquidator may "*bring or defend any action or other legal proceedings in the name and on behalf of the company*".

- Paragraph 9 of Part 3, Schedule 25, which provides that a liquidator may "*do all things as may be necessary for winding-up the affairs of the company and distributing its assets*".

Harris J considered that pursuing litigation to recover monies or other property owed to a company is covered by paragraph 1 of Part 2 and paragraph 9 of Part 3 extends to a liquidator entering into a funding agreement.

In respect of voluntary liquidations: Section 251(1)(b) of the Ordinance provides that a liquidator of company in voluntary liquidation may without sanction exercise any of the powers to be found in Parts 2 and 3 of Schedule 25. Consequently, Harris J held that the liquidators of the Company do not require the Court's

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[6] Unrep., HCCW 384/2006 & others, 8 October 2015.

sanction to cause the Company to enter into a funding agreement, which comes within the exercise of the powers granted by paragraph 9 of Part 3, Schedule 25.

In respect of compulsory liquidations: It is necessary for the liquidator of a company in compulsory liquidation to obtain the sanction of the committee of inspection or, absent a functioning committee of inspection, the sanction of the court to pursue legal proceedings under paragraph 1 of Part 2, Schedule 25. However, once sanction has been obtained, section 199(3) of the Ordinance allows the liquidator to exercise the powers under Part 3 of Schedule 25 without obtaining sanction of either the committee of inspection or the Court. Harris J concluded that the Court's sanction of a funding agreement is also not required in the case of a winding-up by the court.

Circumstances in which a liquidator may seek Court directions

Harris J commented that although the Ordinance gives a liquidator the right to seek directions from the Court, this does not mean that the liquidator can ask the court to approve any decision he is contemplating because the liquidator is uncertain about its appropriateness. A liquidator has to exercise his own professional expertise and judgment when conducting a liquidation. Hence, a liquidator cannot seek a direction which involves asking the court to approve what is largely a matter of commercial judgment.

Harris J considered that a direction sought by a liquidator from the Court must require something other than a general endorsement of a proposed course of action. In his Lordship's view, it will require the formulation of a precise issue which calls for the exercise of some legal judgment.

Takeaway points

As the decisions in *Osman Mohammed Arab & Anor v Chu Chi Ho Ian* and *Re A* introduced uncertainty as to whether or not Court sanction is required for funding agreements, Harris J was prepared to decide on and give directions on the issue in this case.

Now that the uncertainty has been clarified, it is unlikely that the Court in the future will entertain any applications by insolvency practitioners for the Court's general endorsement of funding agreements.

An application taken out by an insolvency practitioner to seek Court directions should not be a request for the Court's general endorsement of his proposed course of action. There must be a legal issue suitable for the Court's consideration.

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