SHOULD INSOLVENCY PRACTITIONERS BE CONCERNED BY THE SUPREME COURT'S LATEST DECISION REGARDING THE ENFORCEABILITY OF LITIGATION FUNDING AGREEMENTS?

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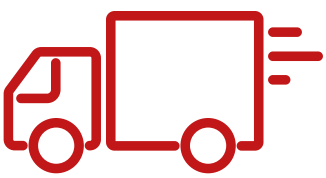
In an eagerly-awaited and significant decision, the Supreme Court, in R (on the application of PACCAR Inc and others) v Competition Appeal Tribunal and others [2023] UKSC 28 ("PACCAR"), held, on 26 July 2023, that litigation funding agreements ("LFAs") under which a litigation funder receives a percentage of any damages recovered by the claimant are damages-based agreements ("DBAs") within the meaning of section 58AA of the Courts and Legal Services Act 190 ("CLSA"). As a consequence, unless the LFAs satisfy the requirements for valid DBAs as set out in section 58AA CLSA and the Damages Based Regulations 2013 ("DBA Regulations 2013") they will be unenforceable.

The Supreme Court's decision will certainly resonate in the litigation funding industry with funders scrambling to review existing LFAs which now risk being unenforceable against the funded clients including insolvency office holders.



Background

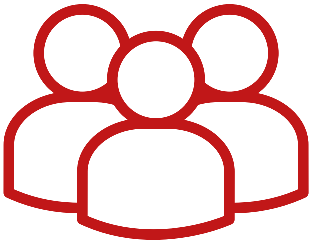
The issue arose from the applications of two claimants, UKTC and RHA, to bring collective proceedings against DAF for breaches of competition law. To obtain the collective proceedings order, UKTC and RHA needed to show that they had adequate funding arrangements in place. UKTC and RHA relied on LFAs to meet this requirement. The LFAs provided that the funder's maximum remuneration was calculated with reference to a percentage of the damages ultimately recovered. DAF argued the LFAs were unenforceable because they did not comply with the statutory rules governing DBAs. The Competition Appeal Tribunal and the Division Court both rejected DAF's arguments.

However, the Supreme Court allowed DAF's appeal. It held by a majority of four to one (Lady Rose dissenting) that where funders are entitled to a percentage of any damages recovered under LFAs, these constitute DBAs.

Section 58AA CLSA provides that where a LFA takes the form of a DBA it will be unenforceable unless certain conditions are complied with. It was common ground in this case that the LFAs at issue did not satisfy the relevant requirements and therefore, if the agreements were found to be DBAs, they would be unenforceable.

Under section 58AA CLSA, as amended in 2013, DBAs are defined as "an agreement between a person providing advocacy services, litigation services or claims management services and the recipient of those services […]". The question before the court was whether "claims management services" include the provision of litigation funding, which was the funder's only involvement in the proceedings.

The Supreme Court adopted a conventional approach to statutory interpretation and held that the words "claims management services" referred to in section 58AA CLSA were capable of including the provision of litigation funding. As a result, the LFAs fell within the definition of DBAs under the legislation and were unenforceable.



Impact on Insolvency Practitioners

Insolvency Practitioners must consider the impact of the Supreme Court's decision on cases where they have LFAs in place which provide for the litigation funder to receive a percentage of any damages recovered by the office holder. This will be the majority of LFAs, but the Supreme Court's decision in PACCAR does not affect claims Insolvency Practitioners have assigned or sold to a litigation funder.

The powers granted to office holders under the Insolvency Act 1986 ("IA") allow them to sell or realise property vested in the insolvent estate. 'Property' as defined by section 436 IA includes a cause of action. Furthermore, section 118 of the Small Business Enterprise and Employment Act 2015 inserted section 246ZD into IA, with effect from 1 October 2015. Section 246ZD IA grants a liquidator or an administrator the power to assign a right of action (including the proceeds of an action) arising out of claims under IA (the so called 'office holder claims').

Since the introduction of section 246ZD IA, many Insolvency Practitioners elect to assign causes of action to litigation funders or third parties, rather than entering into agreements for the funding of the litigation.

The Supreme Court's decision in PACCAR does not impact cases where an Insolvency Practitioner assigns a cause of action as the agreements are constructed differently to LFAs and are believed to fall outside the definition of 'claims management services' in section 58AA CLSA.

There are still instances where Insolvency Practitioners will enter into LFAs rather than assign the cause of action. For example, where an Insolvency Practitioner is appointed as a trustee in bankruptcy office holder claims are not capable of assignment under section 246ZD IA. The section only applies to administrations and liquidations.

If an Insolvency Practitioner currently has a LFA in place, it is imperative to take immediate steps to review the terms of that LFA to ensure it complies with the requirements of section 58AA CLSA and the DBA Regulations 2013. If the LFA does not comply with the requirements for DBAs, the Insolvency Practitioner will be unable to enforce the funder's obligations under the LFA. This means the funder could in theory fail to meet their obligations to pay lawyers at any stage. It could also, on a security for costs application, result in the court finding the Insolvency Practitioner does not have adequate funding arrangements in place due to the LFA being unenforceable. In cases where a LFA currently in place does not meet the requirements for DBAs, the Insolvency Practitioner should take steps to negotiate new terms with the funder and amend the LFA to ensure it complies with the requirements of DBAs. We expect to see a wave of re-drafting and re-structuring of these funding agreements.

The one question many Insolvency Practitioners and litigation funders may be asking is what, if any, impact the Supreme Court's decision in PACCAR will have on concluded cases where the LFAs did not comply with the requirements of section 58AA CLSA and the DBA Regulations 2013 and were, as a result, unenforceable. Could Insolvency Practitioners potentially face claims from creditors where part of the damages recovered was paid to the litigation funder under a LFA which is now unenforceable? Should Insolvency Practitioners review their completed cases to see whether they are obliged to recover the percentage of damages paid to the litigation funder due to the LFA now being unenforceable?

It is important to keep in mind that the Supreme Court's decision in PACCAR only rendered these LFAs 'unenforceable'. The definition of an 'unenforceable contract' is a contract that, although valid, cannot be enforced by legal action. In most of the concluded cases litigation funders have already voluntarily performed their obligations under the LFAs. Whilst the litigation funders received a percentage of the damages recovered, in many instances no recovery would have been possible if it was not for the litigation funders voluntarily complying with their obligation under the LFAs to fund the litigation.

It remains to be seen how wide an impact the decision will have on the industry, but it appears that in completed cases any claims seeking to recover, either from the Insolvency Practitioners or the litigation funders, payments received under completed LFAs are most likely not going to succeed as the obligations under these LFAs have already voluntarily been performed.