

LITIGATION COSTS



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Creditors and insolvency practitioners continue to suffer from an inherently imbalanced and unfair costs regime in insolvency litigation giving an unfair advantage to respondents who have benefitted from misconduct.

Imagine this: An insolvency practitioner is appointed as trustee of a bankrupt, with creditors totalling £1m and a residual cash balance of £50k but no other assets of any meaningful value. On investigation, it becomes apparent that essentially all of the insolvent's other assets were transferred to two family members and another family member's company prior to bankruptcy, with the three recipients receiving a total of £500k each. So far, so familiar in any modestly contentious insolvency scenario, corporate or personal. To the IP, a clear transaction at undervalue (and misfeasance if this was a liquidation), capable of being reversed. To the creditors, an outrageous insult, facing an effective zero return while the insolvent (through his associates) merrily continues to benefit from the transferred assets.

So the IP, using the remaining cash, instructs a solicitor to issue letters before action to the recipients, seeking the appropriate remedies for the benefit of the estate's creditors. All three respondents instruct different (but expensive) firms of solicitors, claiming to have nothing to do with each other, but each seeks to assert that all transfers were legitimate and for value (if indeed there was any value to the assets, or any loss caused, which of course will need to be subject to expensive expert evidence). All respondents naturally promise to vehemently defend any claims against them. Still familiar?

The IP now faces a stark choice. By now the IP's costs are £20,000 and his solicitor is owed £15,000, leaving £15,000 in the estate. Creditors are seething about the shameless rip-off by the insolvent and want justice.

One option is to assign the £1.5m of claims to a claims purchaser, who has offered 40% of any net recovery. Another is to issue proceedings as trustee, but for that the IP will need to budget for an expert (say £100k), counsel to trial (say £250k – there are after all 3 sets of defendants) and ATE insurance (with 3 separately represented respondents, the cover limit will need to be say £1m, which comes at an upfront cost of £100k and a deferred element on success of £350k). Solicitors estimate their costs at £200k and have confirmed that they will act on a 75% CFA. The IP, wishing to act in the best interests of the estate, has persuaded his firm to allow him to work entirely contingently on this case at an anticipated future cost of £200k. A funder is prepared to lend the required £450k of hard costs to cover counsel, upfront ATE and experts for 100% return on success.

A quick projection to trial therefore shows the following calculation for a successful outcome:

	£ ('000)	£ ('000)
Claim value	1,500	
Cost recovery (say 70% plus all experts)	415	
Total recovery		1,915
Less		
Deferred ATE premium	(350)	
Funder return	(900)	
Solicitors' costs including uplift	(350)	
IP's fees	(200)	
Total costs		(1,800)
Anticipated net recovery		115

Clearly, no one in their right mind would deem a 6% recovery rate a commercially sensible outcome or a safe bet as far as litigation outcomes are concerned. One could of course hope for an early settlement which could produce a more beneficial return to the estate, but to embark on fully-fledged legal proceedings without an eye on the final outcome would be madness.

And this calculation is unsurprisingly wildly unrealistic. The IP shouldn't have to agree to act fully on risk without any upside, a 75% CFA is perhaps optimistic and only a 1x multiple at trial for a commercial funder is the stuff of sparkly unicorns and rainbows when in reality it is entirely possible that a funder may not even consider funding a case with such a projected outcome. The assignment option therefore looks quite attractive – once a well-funded assignee gets involved, the respondents may ultimately be persuaded to settle, but at this point, the estate will have already given up its right to 60% of any net recovery, still resulting in only a fractional return.

And before anyone raises their hand to point out that the costs are too high for this clear-cut scenario: this is an entirely made-up example with fairly arbitrary numbers. However, the correlation between recovery and cost values is probably not too far from reality in many corporate and personal insolvency contexts, which may often produce similarly uncommercial outcomes.

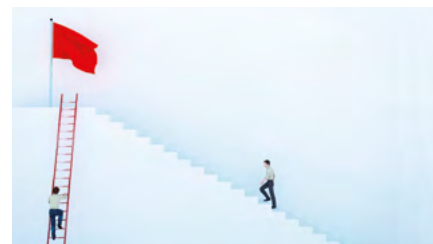
Armed with such commercial experience, any smart respondent will simply adopt the dual strategy of 1) waiting to see if the claim is issued and 2) making the IP incur as much cost as quickly as possible. Being a commercial beast by definition, no IP will be able to justify taking this claim very far. (I hope I haven't given away the holy grail of defending insolvency claims here but suspect I have not...)

The truth is that the Legal Aid, Sentencing and Punishment of Offenders Act 2012 has taken away any commercial edge IPs used to have, especially in any remotely complex litigation with values in anything below the tens of millions. Prior to the end of the insolvency claims exemptions from LASPO in 2016, the respondents in this scenario would have faced a much greater adverse costs exposure, including £450k of ATE premiums and the solicitor's CFA uplift, resulting in an improvement to the estate's projected net recovery of more than £550k.

That improved return and potential damage would have respectively incentivised the IP to bring proceedings for the benefit of creditors, and the respondents to sensibly engage with the process, without the need to involve a claims purchaser.

None of this is meant as a criticism to the claims purchasing market, which is of course a valuable tool for de-risking litigation by taking on claims that IPs are unable to bring, or creditors are unwilling to fund.

But in a world where IPs are increasingly expected by regulators and creditors to be aggressive and litigious to achieve recoveries, they need to be equipped with the right armoury to not be outgunned by well-funded (often through the very act that gives rise to the claim) and litigation-smart respondents.



LASPO's insolvency exemptions urgently need to be reversed, and in my humble opinion ought to go further. The IP essentially acts for the victims of a wrongful act in the context of insolvency. Those victims are bound through the collective nature of insolvency and have little way to seek redress other than through the IP who has the legal standing to bring claims and make recoveries on their behalf. To have those recoveries diluted by the cost of achieving them goes wholly against the underlying principles of justice. All costs associated with claims by an insolvent estate ought to be recoverable, especially where "claw-back" insolvency claims are concerned. That should include at least the IP's own costs in investigating and prosecuting such claims. Similarly, where an estate has lost assets that require an IP to issue claims to bring them back (or seek a contribution) into the estate, any cost of funding that the IP might reasonably require should be capable of being recovered in order to get proper justice for creditors.

When the Court has the power to award payment out of central funds in private prosecution cases to compensate a prosecuting victim for costs incurred, then should provision not be made for officeholders and their stakeholders to have similar recourse, say to allow for funding of court fees or other necessary hard costs to prosecute misconduct in insolvency for commercial restitution on behalf of creditors?

The urgent need for change has rarely been clearer than in the current climate.

With £5bn of bounce-back loans lost to fraud (and it's unclear whether that figure includes bounce back loans "improperly" used in the 106,000 legitimate companies that have already fallen behind with repayments), and an average loan size of only £31k, it is clear that a change to the cost regime in insolvency litigation is now urgently required if officeholders are to be properly equipped to attempt recovery in low to mid-size misconduct claims.

