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Case Comment

Recovering costs of litigation as a liquidation expense

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Legislation: Insolvency (Amendment) (No. 2) Rules 2002 (SI 2002 2712)

Insolvency Rules 1986 (SI 1986 1925) r.4.218, s.4.220(2)

Cases: Demaglass Ltd (In Liquidation), Re [2002] EWHC 3138 (Ch); [2003] 1 B.C.L.C. 412 (Ch D)

Lewis v Inland Revenue Commissioners [2001] 3 All E.R. 499 (CA (Civ Div))

Toshoku Finance UK Plc (In Liquidation), Re [2002] UKHL 6; [2002] 1 W.L.R. 671 (HL)

***Comp. Law. 84 Further developments**

The spate of cases dealing with the question of whether a liquidator can treat the costs of any litigation that she initiates or pursues in the exercise of her statutory functions as a liquidation expense payable in priority to other creditors shows no sign of abating. This is hardly surprising bearing in mind that a number of issues were left unresolved by the Court of Appeal in *Re Floor Fourteen Ltd*, *Lewis v Inland Revenue Commissioners*.¹ One such case, *Re Demaglass Ltd*, *Lewis v Dempster*² is the subject of this note. The likely implications of the Insolvency (Amendment) (No. 2) Rules 2002³ are also briefly considered.

Facts

In *Demaglass*, the relevant companies were concurrently in administrative receivership and liquidation. The liquidators applied for an order requiring the receivers to pay them a sum out of floating charge realisations to enable the liquidators to fund an investigation with a view to possible litigation. It was taken as read that liquidation expenses are payable out of floating charge assets in the hands of an administrative receiver. In other words, the correctness of the Court of Appeal's interpretation of the Insolvency Act 1986, s.175 arrived at in *Re Leyland Daf Ltd*, *Buchler v Talbot*⁴ was assumed. Thus, the main question was whether the liquidators were entitled to call for the establishment of a "fighting fund" and this, in turn, depended on whether the items of anticipated future expenditure were liquidation expenses.

Decision

In the light of the House of Lords decision in *Re Toshoku Finance (UK) Plc*, *Kahn v Inland Revenue Commissioners*,⁵ it was common ground that r.4.218 of the Insolvency Rules 1986⁶ is "a complete statement of liquidation expenses, subject only to the qualifications contained in the Rules themselves".⁷ The first and key issue arising for determination was whether *prospective* ***Comp. Law. 85** expenditure, as opposed to expenditure already incurred, could be recovered in principle under r.4.218. The liquidators contended that their claim fell within all or any of paragraphs (a), (m) and (n) of r.4.218(1). The deputy judge rejected this contention on the following grounds:

(1) The heads of expense set out in r.4.218(1) were all couched in the past tense suggesting that an item of expenditure can only be treated as a liquidation expense if it has already been paid or incurred. The word "expenses" denoted sums of money that had been expended. It would also extend to liabilities that had actually been incurred but not yet paid.

(2) The references to "disbursements" in paragraph (m) and "remuneration and emoluments" in paragraph (n) were clearly references to sums already expended, a point reinforced in the case of

paragraph (n) by the use of the past tense in the phrase “any person who has been employed”.

(3) Similarly, r.4.218(1)(a) could not be construed as entitling a liquidator to call on floating charge realisations held by a receiver in order to fund future activities. The phrase “expenses ... incurred” could not possibly refer to prospective expenditure or liabilities that had not yet arisen. The phrase “expenses ... chargeable ... by the ... liquidator” referred to expenses or liabilities that had been incurred but not yet paid. It should not be construed as having a forward-looking effect. Moreover, the expenses within paragraph (a) had to be “properly” chargeable or incurred and it was difficult to see how a judgment could be made about that unless a liability to make payment had already arisen.

(4) In principle, a fiduciary was not normally entitled to withdraw money from funds under her control until a positive event had arisen entitling her to make the withdrawal.

In the light of this reasoning, it was unnecessary for the deputy judge to decide whether the prospective expenditure was of a type falling within the substantive heads of r.4.218(1). However, as all the expenditure related to the investigation and pursuit of a range of possible clawback proceedings, he held that it could not have been treated as a liquidation expense in any event following the line of authority commencing with *Re MC Bacon Ltd (No. 2)*⁸ and culminating in *Re Floor Fourteen Ltd, Lewis v Inland Revenue Commissioners*.⁹

The second issue was whether the liquidators could claim the costs of prospective proceedings out of the assets of the companies in priority to other creditors under the court's inherent jurisdiction. In *Floor Fourteen*, Peter Gibson L.J. refused to speculate about the precise source and scope of the court's discretion under the inherent jurisdiction. However, the position was clarified in *Toshoku Finance* where Lord Hoffmann¹⁰ identified *Re London Metallurgical Co*¹¹ as the original source of the discretion, adding that it had been preserved in what is now r.4.220(2). Thus, the inability of a liquidator to claim her costs out of the assets under r.4.218 is not necessarily the end of the matter. However, in *Demaglass* the deputy judge held that r.4.220(2) did not assist the liquidators because it had not been invoked and, in any event, could only be invoked with regard to costs already incurred.

The third issue was whether, in an appropriate case, a liquidator could seek a declaration in advance as to whether prospective expenditure would fall within the established categories of liquidation expense once it had actually been incurred. The deputy judge saw no reason in principle why a liquidator should not be able to make such an application (indeed, he thought that *Floor Fourteen* involved this kind of application) but there would need to be sufficient detail for the court to assess whether the expenditure would be properly incurred.¹² So it appears that there is scope for the development of a pre-emptive costs jurisdiction along the lines of the well-established *Beddoe* jurisdiction governing the treatment of costs incurred by trustees in the execution of the trust.¹³ However, it will always be difficult for a court to judge whether or not the prospective expenditure is justifiable.¹⁴

Comment

The *Demaglass* decision provides further confirmation, if any were needed, that r.4.218 is, by and large, an exhaustive code. Generally speaking, an item of expenditure can only be treated as a liquidation expense if:

- (i) it is of a type falling within the categories in r.4.218(1); and
- (ii) it has already been expended or incurred.

The effect of r.4.220(2) is that the court has a discretion to order costs incurred “in the course of legal proceedings by or against the company” to be paid out of the assets. In this respect, *Demaglass* builds on Lord Hoffmann's observations in *Toshoku* and it also holds out the possibility that liquidators may in future be able to seek some form of anticipatory relief perhaps by way of analogy to that which has evolved for trustees in the wake of *Re Beddoe*.¹⁵

It is important to note that r.4.218(1)(a) of the Insolvency Rules has been amended by the Insolvency (Amendment) (No. 2) Rules 2002.¹⁶ The amended rule only applies to companies that go into liquidation after January 1, 2003.¹⁷ The effect of the amendment is to broaden the scope of the rule with the result that expenses or costs “relating to the conduct of any legal proceedings which [the liquidator] has power to bring or defend whether in his own name or the name of the company” are recoverable as liquidation expenses as well as expenses or costs “properly chargeable or incurred ... in preserving, realising or getting in any of the assets of the company”. This means that costs incurred

by a liquidator in bringing statutory clawback¹⁸ or wrongful trading proceedings¹⁹ now fall within r. 4.218 whereas before the amendment the courts had held consistently that even the costs of successful litigation of this nature fell outside the scope of the rule and could not be treated as a liquidation expense.²⁰ However, the liquidator will still have to demonstrate that the costs were “properly chargeable or incurred” and, so to cover herself, she may wish to apply for a declaration that prospective costs will be treated as a liquidation expense once they have been incurred. It will be interesting to see if a pre-emptive costs jurisdiction along the lines contemplated by the deputy judge in *Demaglass* takes root.

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1. [2001] 3 All E.R. 499; [2002] B.C.C. 198; [2001] 2 B.C.L.C. 392 and see (2001) 22 *Company Lawyer* 215.
2. [2002] All E.R. (D) 155 (July).
3. S.I. 2002 No. 2712.
4. [2002] E.W.C.A. Civ. 228, [2002] 1 B.C.L.C. 571. The decision in *Leyland Daf* is currently under appeal to the House of Lords.
5. [2002] U.K.H.L. 6; [2002] 1 W.L.R. 671.
6. S.I. 1986 No. 1925.
7. [2002] U.K.H.L. 6; [2002] 1 W.L.R. 671 at para. 15.
8. [1991] Ch. 127; [1990] 3 W.L.R. 646; [1990] B.C.C. 430; [1990] B.C.L.C. 607.
9. [2001] 3 All E.R. 499; [2002] B.C.C. 198; [2001] 2 B.C.L.C. 392.
10. [2002] U.K.H.L. 6; [2002] 1 W.L.R. 671 at paras 15-16. See also M. Briggs in (2002) 23 *Company Lawyer* 230.
11. [1895] 1 Ch. 758.
12. See paras 30-32 of the judgment. See also *Re Romar Engineering Co Ltd* [2002] B.P.I.R. 409.
13. See *Re Beddoe, Downes v Cottam* [1893] 1 Ch. 547; *Re Buckton, Buckton v Buckton* [1907] 2 Ch. 406.
14. See, by close analogy, *Re Ciro Citterio Menswear Plc* [2002] E.W.H.C. 897. The question here was whether the prospective costs of an appeal brought on the company's behalf by its administrators could be treated as “expenses properly incurred” payable out of the assets in priority to the holder of a floating charge by virtue of the Insolvency Act 1986, s. 19(4). It was held following *Re MC Bacon Ltd (No. 2)* [1991] Ch. 127; [1990] 3 W.L.R. 646; [1990] B.C.C. 430; [1990] B.C.L.C. 607 and *Mond v Hammond Suddards (No. 2)* [2000] Ch. 40; [1999] 3 W.L.R. 697; [2000] B.C.C. 445; [1999] 2 B.C.L.C. 485; [1999] B.P.I.R. 975 that an administrator does not have an unqualified right to recoup his costs “by virtue of an order made *a priori* upon a partial assessment of the merits of the proposed litigation”. The decision is probably explicable on policy grounds as if the court had ruled in their favour, the administrators would have been entitled to subordinate a secured creditor to the costs of unsuccessful proceedings against him.
15. [1893] 1 Ch. 547.
16. S.I. 2002 No. 2712.
17. In the case of compulsory winding up, the petition must have been presented after January 1 for the amended rule to apply.
18. For example, under the Insolvency Act 1986, ss.238-241.
- 19.

ibid., s.214.

[20.](#)

The amendment effectively reverses *Re MC Bacon (No. 2)* [1991] Ch. 127; [1990] 3 W.L.R. 646; [1990] B.C.C. 430; [1990] B.C.L.C. 607; *Mond v Hammond Suddards (No. 2)* [2000] Ch. 40 and *Re Floor Fourteen Ltd, Lewis v Inland Revenue Commissioners* [2001] 3 All E.R. 499; [2002] B.C.C. 198; [2001] 2 B.C.L.C. 392 on the point.

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