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Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
CANBERRA ACT 2600

Attention: Committee Secretary

By email:

Dear Committee Members

Public Submission: Inquiry into litigation funding and the regulation of the class action industry

1 On 13 May 2020, the House of Representatives referred to the Parliamentary Joint Committee on Corporations and Financial Services ("**Committee**") an inquiry into litigation funding and the regulation of the class action industry. The Committee has invited individuals and organisations to make written submissions in relation to the inquiry. King & Wood Mallesons makes the following submissions.

Executive summary

2 Australia has one of the most facilitative class action procedures in the common law world and, following the decision of the High Court of Australia in *Campbells Cash and Carry Pty Limited v Fostif Pty Limited* (2006) 229 CLR 386 (*Fostif*) and the introduction late last decade of bespoke exemptions from the financial services licensing and conduct regimes that would otherwise apply, the regulatory approach to litigation funding has (until very recently) been light touch. In addition, the strictures of substantive Australian law concerning continuous disclosure and misleading conduct are, in important part, unique in not requiring a fault element to found liability.

3 The combination of these matters has created a commercial environment in which money is redistributed with increasing frequency from current to former securityholders of listed security issuers without the need to prove blameworthy intent, recklessness or negligence on the part of defendant issuers or their management – while plaintiff lawyers and class action funders (who are often based offshore) claim a sizeable proportion of such funds for themselves. If this trajectory continues, such inefficiency risks the competitiveness of Australian capital markets in providing public equity funding to enterprises.

4 In our submission, class action law (including, but not limited to, the law concerning class action litigation funding) – and, to a more limited extent, the law of continuous disclosure and misleading or deceptive conduct – should be reformed to address these deficiencies.

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Reform proposal: early scrutiny of the appropriateness of the class action mechanism for advancing a claim

5 In the federal jurisdiction, the procedural framework for class actions is provided for in Part IVA of the *Federal Court of Australia Act 1976* (Cth) ("**Federal Court Act**"). In short, an applicant may commence a class action if 7 or more persons have claims against the same person, the claims of all those persons are in respect of, or arise out of, the same, similar or related circumstances, and the claims of all those persons give rise to a substantial common issue of law or fact: Federal Court Act, s 33C. The concept of a "claim" in this context has a wide meaning[1] and may arise out of disparate transactions.[2] Section 33C has been held to mean that a class action can be commenced even in circumstances where there is only one substantial common issue of law or fact.[3] This is in marked contrast to other common law jurisdictions, such as the United States and Canada, which have certification requirements, calling for positive judicial determinations to allow collective claims to advance through an individual claimant.

6 The low hurdle in Australia has the potential to encourage speculative claims and undermines the efficacy of representative proceedings as an efficient mechanism for the substantial resolution of individual plaintiff claims. The latter practical consequence is driven by the legal reality that, in circumstances where the common issues of law or fact in a class action are limited in scope, individual trials will still be required to take place in order for individuals to demonstrate their personal entitlement to relief.

7 In some cases, such individual issues may be quite confined, being limited (for example) to matters that can be determined formulaically by reference to readily verifiable objective facts such as the quantum of relief. Class actions are appropriate for the efficient resolution of claims of this kind. However, where the individual issues pertaining to the class extend well beyond such limited questions (for example, in cases alleging unconscionable conduct which require a consideration of the totality of each individual claimant's circumstances in order to determine whether a respondent is *liable* before even reaching the question of quantum), this would be a time-consuming and costly exercise. Increasingly, class actions are being commenced which raise these types of issues.

8 This has brought into sharper focus significant doubts as to whether class actions are an appropriate vehicle for advancing claims of this kind. While there is little doubt that class actions bring efficiencies and are an appropriate vehicle for addressing certain types of grievances, the false promise of class actions as a panacea for advancing any and all claims, of tenuous commonality, which it would be uneconomical to bring on an individual basis, is one area which would benefit from practical reform.

9 At present, section 33N of the Federal Court Act provides that orders may be made on the application of the respondent (or of the Court's own motion), after a class action has been commenced, to the effect that a proceeding no longer continue as a class action. This may be because, for example, the class action will not provide an efficient and effective means of dealing with the claims of group members.

10 Rather than leaving the question whether a claim is suitable for prosecution as a class action in the hands of a respondent – who may or may not bring a (comparatively rare) de-classing application and would bear the onus of proof and exposure to an adverse costs order on that application – all class actions should be the subject of mandatory judicial scrutiny at an early stage. Part IVA of the

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1 *Allphones Retail Ltd v Weimann* [2009] FCAFC 135 at [80].

2 *Dillon v RBS Group (Australia) Pty Ltd* [2017] FCA 896 at [43].

3 *Dillon v RBS Group (Australia) Pty Ltd* [2017] FCA 896 at [53] ("…and give rise to *at least one* substantial common legal or factual question", emphasis added)

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Federal Court Act should be amended to provide for a mandatory procedure in every class action whereby:

(a) a representative applicant must serve outlines of anticipated lay and expert evidence and submissions shortly after the close of pleadings and before a respondent incurs the costs of extensive discovery. Those outlines and submissions would describe, so far as the applicant is best able (noting that the applicant was required to have a basis to advance its claim in the first place), the evidence it anticipates leading at an initial trial of the proceedings and the questions of law and fact common to both its and other group members' claims that it seeks to have determined following an initial trial on the basis of that evidence; and

(b) then, following the filing of any responsive evidence and submissions and a hearing, the Court must determine:

(i) whether the proceeding should continue as a class action in light of the pleadings and the outlines of anticipated evidence served by the representative applicant, with mandatory factors for consideration by the Court; and

(ii) if so, a determination of the common questions of law and fact to be determined at an initial trial.

11 The benefits of such a procedure would be:

(a) to deter speculative claims being commenced in the hope of fishing by way of discovery;

(b) to prevent proceedings being continued in the form of expensive "mega-litigation" where it is apparent at an early stage that the class action structure is not appropriate or the scope of the class action element of the proceedings can be sensibly adapted; and

(c) to confine, in an unambiguous way, the scope of discovery required to be given, and responsive evidence prepared, for the purpose of an initial trial.

Reform proposal: clear legislation prohibiting common fund orders

12 There is a role for well-regulated litigation funding in Australia. For example, litigation funders play an important role in funding insolvency practitioners who wish to bring proceedings with a view to obtaining recoveries for creditors in circumstances where they would otherwise have no funds to do so. In that area, judicial scrutiny of funding arrangements entered into by insolvency practitioners has a clear basis and scope, through the prism of the legal duties owed by such practitioners and the Courts' well-defined jurisdiction.

13 The position is different as regards litigation funding for class actions. Since the decision of the High Court in *Fostif*, holding that litigation funding does not offend public policy or constitute an abuse of process (at least where the common law rules of maintenance and champerty have been abolished), there has been a steady growth in the funding of class actions in Australia – often by funders headquartered offshore. At first, in order to make litigation funding an attractive commercial proposition, funders were required to book-build, i.e., persuade a sufficient number of individual group members to sign litigation funding agreements with them, providing for them to take a portion of recoveries by way of commission.

14 Later, the Courts held that they had power to make common fund orders under section 33ZF of the Federal Court Act (and state equivalents), in many cases at an early stage of a proceeding. A

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common fund order obliges all group members – whether they have entered into agreements with a litigation funder or not – to pay all of their class action recoveries into a "common fund", which is to be applied not only to legal costs but also to a commission for the funder, before being distributed (in diminished amount) back to group members. This was said to address what would otherwise have been a disparity of outcomes between funded and unfunded group members. In doing so, it imposed upon group members, who had either not been willing or were not even asked, to enter into an agreement with a well-resourced and well-advised litigation funder, the economic consequences they would have borne if they had done so. In some instances, common fund orders were to deliver commissions to litigation funders of up to 30% of group member recoveries.

15 In December 2019, the High Court held that the Federal Court did not have power to make such orders under section 33ZF of the Federal Court Act. Subsequent judicial consideration has differed as to whether common fund orders continue to be permitted at the end of a proceeding under the Federal Court's power to approve class action settlements.

16 Part IVA of the Federal Court Act should be amended to make clear that common fund orders are not to be made in proceedings brought under those provisions. This should not stymie litigation funding, nor stifle current or future class actions, if litigation funders revive their former practice of book-building and undertaking their own detailed risk and cost/benefit analyses with a view to earning their returns. It is appropriate that funders – which are profit-driven commercial enterprises – be required to work for their returns.

17 A legislative prohibition on making common fund orders in class action proceedings would also:

(a) preserve the freedom of contract and the equally important right *not* to contract; and

(b) acknowledge that it is not appropriate to expect Courts to act, in practical terms, as price regulators by being called upon to determine an appropriate level of funding commission based predominantly on evidence put forward by a funded representative applicant.

18 The recent announcement by the Government, that it will require litigation funders to be subject to the regulatory regimes in Chapter 5C and 7 of the *Corporations Act 2001* (Cth), is a welcome step toward restoring regulatory balance and should be maintained. Such regulation will impose on litigation funders the same burden of compliance and regulatory scrutiny to which other financial services providers are subject. This is appropriate, given that:

(a) litigation funders interact with class action claimants (who, generally being unsophisticated, are akin to retail investors); and

(b) the litigation funding industry appears, at times, opaque (particularly where funders are based offshore and/or are unlisted and therefore not bound by Australian market disclosure rules).

Reform proposal: prohibit contingency fee arrangements in class actions advancing federal causes of action

19 A more recent development in class action funding is the Victorian proposal to permit lawyers to charge contingency fees in class actions. This innovation has attracted both favourable and unfavourable commentary, reflecting the strongly held policy positions of its proponents and opponents. To the extent that this development is premised on the current state of the law and practice regarding class action funding, it should not be assumed that that position represents an unambiguous good in all circumstances.

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20 In any event, the proposed reform in Victoria would see a situation where different Courts which have power to exercise federal jurisdiction operate under different approaches to contingency fees. There should be a uniform approach until such time as the Commonwealth Parliament determines that it would be appropriate to permit lawyers to charge contingency fees in respect of actions arising under Federal law. Until then, the Federal Court Act, and legislation conferring jurisdiction in respect of causes of action arising under Federal legislation (thereby permitting class actions advancing federal causes of action to be brought in state courts) should be amended to require that contingency fees form no part of the arrangements between plaintiffs and their lawyers in such proceedings.

Reform proposal: require a blameworthy mental element to be proved in civil compensation claims

21 In its report on class action proceedings and third-party litigation funders, the Australian Law Reform Commission recommended that the Government should commission a review of the legal and economic impact of the operation, enforcement, and effects of continuous disclosure obligations and those relating to misleading and deceptive conduct contained in the Corporations Act and the *Australian Securities and Investments Commission Act 2001* (Cth) ("**ASIC Act**"). We agree.

22 In recording the history of the current continuous disclosure provisions, the Commission noted that, prior to the *Financial Services Reform Act 2001* (Cth) ("**FSRA**"), a failure to comply with the listing rules attracted criminal liability and did so only where the conduct was intentional, reckless or negligent. The FSRA removed any requirement to prove an element of mental fault – without much, if any, debate. This position is in contrast to other major common law jurisdictions. For example, in Britain, a claimant must prove knowledge or recklessness as to whether published information was untrue or misleading, or that an omission was a dishonest concealment of a material fact. In the United States, to be successful in a securities fraud claim, a claimant needs to demonstrate that a defendant acted *scienter*: that is, knowingly.

23 Australian law, however, is blind to honest and diligent conduct that nevertheless makes mistakes. Although directors and officers can personally rely on a due diligence defence to continuous disclosure claims, that defence is not available to the company itself. Nor is there a requirement to prove mental fault in primary misleading or deceptive conduct claims against companies (noting that, where accessorial liability is alleged against an officer, a mental element is rightly required to be proven). There seems to be no logical basis for this differential treatment, which sees current shareholders exposed to a liability to former shareholders in circumstances where the legislature has rightly determined directors and officers should not be liable. In short, there is a problem of circularity (and leakage, with a substantial portion of funds in circular motion being redirected to lawyers and funders).

24 The economic climate of the past decade was marked by historically low interest rates, a prolonged period of prosperity and a preference for debt funding. This has not been the ideal laboratory for testing the impact of such circularity on the competitiveness of Australian firms and equity markets in the global market for capital. This year, however, will see a marked economic downturn with closer consideration being given to funding sources (on the part of issuers) and the quality of investments (on the part of investors). The risks associated with continuous disclosure and misleading conduct claims are ultimately factored into the cost of equity capital and the current position may prove damaging to Australian companies and the economy. In short, equity investors may well ask whether Australian capital markets are worth investing in, having regard to the risks of exposure for honest mistakes. Similarly, enterprises may be driven to private equity and debt in preference to equity financing.

25 The Corporations Act and ASIC Act should be amended to provide for a defence on the part of issuers from civil compensation liability where the conduct (i.e., disclosure or omission to disclose, or

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misleading conduct) is not intentional, reckless or negligent. Such a defence could be limited to claims for civil compensation on the part of private claimants only. The current strict position on continuous disclosure could, if thought consistent with appropriate public policy aims, be maintained so as to allow regulators to bring enforcement action for civil penalties if they consider it necessary to do so to achieve their regulatory objectives.

Conclusion

26 We thank the Committee for the opportunity to make these submissions. Please contact Alexander Morris, Partner, if we can be of further assistance.

Yours faithfully