RISK AND INSURANCE MANAGEMENT SOCIETY

Inquiry into Litigation Funders and the Regulation of the Class Action Industry
Outline of submission

1 Background and Executive Summary

This submission is prepared by the Australasian Chapter of the Risk and Insurance Management Society (**RIMS**) in relation to the Inquiry into litigation funding and the regulation of the class action industry (**Inquiry**) referred to the Parliamentary Joint Committee on Corporations and Financial Services (**the Committee**). RIMS is content for this submission to be published by the Committee. As a regional body focused on enhancing risk leadership across Australasia and as a chapter of the wider global network, RIMS considers the issues raised in the Inquiry's Terms of Reference to be of paramount importance for the global risk and insurance community. Our Australian membership is composed of representatives from major Australian corporates (many listed), international insurers and other risk professionals with first-hand experience of and exposure to the day-to-day realities of class actions.

RIMS recognises the need for appropriate regulation of Australian corporations, and the access to justice benefits which the class action regime can provide. However, consistent with RIMS' focus and membership, we are primarily concerned that Australia's current class action regime is failing to achieve an appropriate balance between these objectives and the increased and unwarranted burden upon Australian corporations' ability to conduct their businesses, as well as the financial burden on their insurers.

Accordingly, this submission puts forward proposals to reform several aspects of the class action regime and the laws which underpin the vast majority of class action activity in Australia, building on the Federal Government's recent announcements requiring litigation funders to hold Australian Financial Services Licenses (**AFSL**) and providing temporary relief to listed companies regarding continuous disclosure obligations during COVID-19.

2 Impactful reform is needed

In RIMS's view, the current system fails to achieve an appropriate and practical balance between access to justice and the ability of corporate Australia to function effectively.

From the perspective of corporate Australia:

- The commencement or threat of class actions has grown steadily in Australia. To date, there have been more than 630 class actions filed in Australia.[1] Of these, approximately three quarters have been filed in the Federal Court, which has seen significant growth in the last decade with the number of class actions tripling.[2] In the last financial year alone, more than $10bn in claims were lodged against businesses.[3] By far the largest proportion of those claims are securities class actions, commenced on behalf of securities holders in respect of alleged breaches of the continuous disclosure regime or disclosure obligations in specific capital raising documents such as prospectuses.
- The increasingly opportunistic nature of shareholder class actions is evident:
    - Nearly all shareholder class actions (and less than 10 per cent of class actions overall) result in settlement (even if they reach the trial stage). This is recognised as one of the key reasons for the growth in class actions;[4]
    - For the only shareholder class action which proceeded to judgment (Myer), the claim ultimately resolved with no return to group members, and the parties ordered to pay their own (no doubt substantial) legal costs;[5] and

    - Recently, a shareholder class action against IOOF was abandoned with no return to group members (although the position on the plaintiff firm's legal fees is not clear).[6]
- It is unsurprising that companies and their Boards, faced with the prospect of the inherent cost, drain on management time and uncertainty associated with litigation choose to resolve these claims – this is not a reflection on the merits of the claims.
- Historically, much of the direct financial burden of shareholder class actions has fallen onto directors' and officers' insurers who provide 'securities claim' cover (colloquially referred to as 'Side C' cover) to corporates. As indicated below, this position is not sustainable for the D&O insurance market. Going forward, corporations will likely have significant uninsured exposure to defence costs and settlements (or judgments) which will ultimately impact their returns to existing shareholders. Australian economics and business commentator, Michael Pascoe, has described this dynamic as shareholders being invited to "punch themselves in the head and pay the [law] firms for the privilege".[7]

Meanwhile, the access to justice benefits of class actions appear to be becoming increasingly diluted – the real winners are the plaintiff law firms and the funders. There are many examples of this – by way of overview:

- On average the litigation funders take about 30 per cent of the payout, the plaintiff lawyers recoup all costs plus a handy margin, while the "class" members receive "compensation". In many cases, the money available to claimants is little more than half of that awarded in the settlement.[8]
- When litigation funders take on a class action, the median return to plaintiffs is just 51 per cent, compared with 85 per cent when no litigation funder is involved, according to the Australian Law Reform Commission.[9]
- A class action for the 380 clients of jailed financial planner Bradley Sherwin that resulted in a payout only for 53 group members. This payout was almost the same as the fees for the lawyers, funders and administrators, leaving the group members feeling like they had been 'screwed over once again'.[10]
- Criticisms of Maurice Blackburn by the Australian Tax Office and victims of the Black Saturday Bushfires for delayed payouts to group members, resulting in a significant tax bill. Maurice Blackburn was charging about $1 million a month for administrative costs relating to the payout.[11]

The impact of shareholder class actions on the Australian (and global) D&O market is stark:

- The Australian Institute of Company Directors believes total historical settlements for shareholder class actions against Australian companies now total more than $1.8bn, with D&O insurers estimated to have contributed more than $1.1bn to the settlements, including defence costs.[12]
- Australian insurance premiums rose faster than anywhere else in the world last year, the Marsh's Global Insurance Market report reveals, as the cost of taking out directors' and officers' liability insurance (D&O) or financial services professional indemnity insurance (PI) doubled in 2019.[13]
- According to Marsh's latest D&O market data, over the first three quarters of 2019 D&O premiums rose on average 75 per cent, on top of an 88 per cent average increase in 2018. Over the last seven years, premiums for D&O insurance have risen on average by 250 per cent.[14]
- Major players, including Allianz and Lloyd's of London syndicates Neon, Pioneer and Acapella, have withdrawn from the market altogether. Chubb, Zurich and Vero have introduced restrictions so strict they amounted to a de facto withdrawal.[15]

3 Amendments to continuous disclosure regime

On 25 May 2020, the Federal Government announced that it will temporarily amend the *Corporations Act* 2001 so that companies and officers' will only be liable if there has been

"knowledge, recklessness or negligence" with respect to updates on price sensitive information to the market. RIMS welcomes this announcement. We hope that this temporary amendment is the first step towards greater, permanent reform of continuous disclosure obligations - the existing strict legal requirements upon listed entities to make continuous disclosure of material information are a catalyst for the significant growth in Australian class actions.

There is minimal empirical evidence as to the true impact of the current continuous disclosure and misleading and deceptive conduct regimes on the Australian class actions market. What is clear is that Australia appears to be the only jurisdiction in the world to have the unique combination of the following features:

- a strict liability continuous disclosure obligation for listed entities;
- a strict liability prohibition on misleading and deceptive conduct for Australian corporations; and
- minimal threshold requirements for the commencement of class action claims, and no American-style certification procedures.

RIMS considers the current market disclosure requirements impose a substantial, and potentially unreasonable, burden upon directors and corporations. RIMS agrees it is necessary for companies, particularly publicly listed entities, to give adequate disclosure to markets to facilitate a fair exchange of information and capital, and reduce asymmetries of information. However, RIMS disagrees that this safeguard should take strict liability form, which is a legal standard removed from the practical and commercial realities of good business and disclosure practice.

Possible solutions

Matters which the Committee should consider in relation to this issue are:[16]

- Adopting American-style "periodic disclosure" obligations. While Australian corporations are already under periodic obligations (e.g. reporting half-year and full-year results), that burden is significantly more realistic than continuous disclosure.
- Alternatively, the meaning of "immediately disclose" could be amended to more clearly set out expectations consistent with the reality of the Australian business decision-making process, for example, by enshrining concepts of disclosure "as soon as practicable" taking into account a range of factors referable to the nature of the disclosure contemplated, including the need for proper internal reviews and processes to occur before the company is required to make disclosure to the market.[17]
- Further, additional consideration might be given to the protections which exist in the UK (and the US and Canada) for directors for forward looking statements. A director is protected from liability where a third party relies on future-looking statements contained in an annual report, unless the director knew them to be misleading or was reckless to the possibility that they could be misleading (*Companies Act 2006* (UK) s 463).
- A particular challenge with the current regime is that the provisions "focus on consequences so that there is no need to provide a particular state of mind".[18] This has led to class action 'promoters' treating any significant price drop in a corporation's share price, as indicative of, at least the possibility of, an omission or non-disclosure of price-sensitive information.[19] The Committee should consider whether defences to class action litigation should be made available for companies that can demonstrate good faith and/or reasonable inquiries have been made in respect of disclosure decisions.

4 Substantive reform: regulation of litigation funders

On 22 May 2020, the Federal Government announced that it will require litigation funders to hold an AFSL from the Australian Securities and Investments Commission (**ASIC**), categorising funders as responsible for a managed investment scheme.[20]

RIMS urges caution in adopting a managed investment scheme approach to litigation funders. This has the potential to increase the likelihood of 'closed' class actions with the prospect that defendants are unable to achieve finality from any settlement or judgment.

RIMS preference is for there to be bespoke regulation of litigation funders, consistent with Recommendation 16 of the Australian Law Reform Commission. In RIMS' view, such regulation should address at least the matters raised below to reflect a reality in which funders are vehicles responsible for the transfer of substantial amounts of capital and wealth in the Australian economy, and should justifiably attract careful scrutiny necessitating a licencing regime regulated by ASIC. Funders operate under a clear commercial and entrepreneurial incentive to participate in and benefit from class actions. In particular, the financial incentives for funders are clearly significant in the context of shareholder and investor claims, with 100% of shareholder claims, and 65% of investor claims brought in the period between 2013 and 2018 being supported by litigation funders.[21] Funders have benefited from a large proportion of the $3.5 billion that has been paid out in Court-approved class action settlements up to 2017.[22]

Prudential requirements

Having regard to this amount of capital and wealth, as well as the widely observed[23] likelihood of a conflict between the interests of justice and the funder, RIMS believes that litigation funders should be subject to further regulatory requirements, including prudential requirements. These would impose capital adequacy requirements upon litigation funders and also requirements relating to the character and suitability of litigation funders.

RIMS considers it essential for capital adequacy requirements to apply to an assessment of Australian assets or capital. Further, RIMS considers that this prudential standard should be regulated by a body with extensive and pre-existing experience in this area, such as ASIC or the Australian Prudential Regulatory Authority (**APRA**).

RIMS considers a possible model for litigation funders would mirror the characteristics of the APRA capital adequacy standards,[24] and/or the ASIC Regulatory Guide regarding financial requirements for an AFSL.[25] RIMS supports the types of measures set out in APS 110, including the requirement for strategies and policies to identify and mitigate financial risk, minimum capital requirements, and breach reporting and notification requirements. In adopting a similar regime, RIMS notes that APS 110 excludes foreign entities subject to similar overseas requirements, and considers that this should be rejected in favour of a single common approach to all funders wherever domiciled.

Conflicts of interest

RIMS considers the current obligation for funders to 'manage conflicts of interest' to be an absolute minimum standard which imposes little regulatory oversight or restricts upon funders. A preferred approach would be for the introduction of an additional requirement for funders to be under a duty of 'good faith', analogous to the current duty insurers are under.

A duty of good faith

Defendants often obtain financial support during a class action from insurers, through the provision of a range of products, most commonly Side C insurance. RIMS observes that these products are not only carefully monitored by regulatory bodies, but the insurers who provide them are under significant obligations to protect the interests of policyholder companies.

The role performed by litigation funders for the plaintiff is analogous to that of insurers for the defendants in a class action.[26] Most pertinently, insurers are under a duty of good faith to the insureds, requiring them to have regard for, and act in the interests of policyholders. RIMS considers it logical that there should be an equivalent duty for funders towards class members and that the most practical mechanism for ensuring litigation funders abide by a duty of good faith is for that duty to operate as a licence condition.

A duty of utmost good faith imposes higher standards on litigation funders than the current requirement to 'manage conflicts of interest' between funders and representative plaintiffs. Under the insurers' current duty of good faith, which involves a duty to act with 'due regard' to the insured's interests,[27] the market (particularly vulnerable and less sophisticated clients) can take comfort that insurers are required to meet an objective

standard of fairness and honesty.[28] RIMS considers it imperative that an analogous objective standard be introduced for litigation funders, particularly given the potential vulnerability of class members. A collateral advantage of this approach is that the Courts' resources and time would not be expended on closely monitoring the behaviour of funders, as this role could be taken up by a well-resourced regulatory body.

Breach reporting guidelines

Consistent enforcement of licencing regimes can be difficult to ensure and costly to maintain. One solution often introduced under Australian law is for there to be a positive obligation to report suspected breaches of law or licencing conditions (see for example, the continuous disclosure obligations imposed on corporations – as discussed above). RIMS considers the introduction of an obligation to notify ASIC, or the relevant licencing body if not ASIC, of a possible breach of a funders' licence would be an effective step to ensuring compliance with licencing regimes and assist in policing these conditions. The existence of further penalties for failure to report should create a positive culture of transparency, self-reporting and compliance amongst litigation funders in Australia.

Risk management systems

Adequate risk management systems are an essential component of suitable financial practice in Australia. Entities operating in the legal and financial services environment should be subject to requirements to have suitable mechanisms by which to identify and manage financial and legal risks.

In particular, RIMS supports a risk management system requirement to reduce the likelihood that funders suddenly abandon a claim owing to legal or financial challenges, resulting in all parties suffering significant prejudice.

Independent audits

Transparency and accountability are cornerstones of Australia's financial services industry. It seems striking that litigation funders would not be required to be subject to the same annual, independent audit requirements of other financial service providers. Such primary concerns are exacerbated in relation to litigation funders when regard is had to the uncertainty of their financial position. Accordingly, RIMS not only agrees with the requirement for an annual audit, it submits that this should be conducted by an independent, ASIC-appointed, auditor. The results of that audit should be required to be disclosed to the licencing body to ensure that the overarching goal of transparency and accountability are achieved. As part of this, the licencing body should be granted sufficient power to demand documents and information from the funders, and associated auditors.

Guidance and caps in relation to commissions

One of the major concerns arising from the involvement of litigation funders in class action proceedings is the amount of the commission which funders earn, with some commissions comprising about half of the settlement sum.[29]

Guidance from the regulator, focussed on the discharge of funders' duties to act honestly, fairly and efficiently, or in utmost good faith, could include indicative ranges for fair commissions, and the factors which could justify commissions in the higher end of that range (for example the nature of the claim, or the time at which it resolves).

Litigation Funding Agreements

In practice, litigation funding agreements are regulated through the application of ASIC Regulatory Guide 248 to litigation funders, which sets out ASIC's approach as to how a funder can maintain adequate practices and follow certain procedures for managing potential and actual conflicts of interest in relation to a litigation scheme.

Funding agreements are also subject to some regulation by the Courts. For example, in the Federal Court, litigation funding arrangements in class actions must be disclosed to the Court, along with the solicitors' costs agreement, at the commencement of proceedings. The Federal Court also has a practice note requiring litigation funding agreements to include provisions for managing conflicts of interest between funded class members, the solicitor and litigation funder.[30]

The regulator should consider the introduction of more comprehensive and specific regulation of funding arrangements, including a model funding agreement against which individual litigation funders' agreements can be measured, or alternatively guidance on obligations which can be imposed on the lead plaintiff and group members (and the rights which litigation funders are entitled to obtain) under litigation funding agreements.

5 Procedural reform

Procedural reform in relation to class actions is required to reduce the opportunism and inefficiencies now typified by the current system. RIMS anticipates that others will make detailed submissions on these issues. RIMS generally endorses the approaches to procedural reform recommended by the Australian Law Reform Commission.

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