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Submission on Litigation Funding and the Class Action Industry

Executive Summary

1. The submission addresses the Committee's Terms of Reference 5 and 6
2. The submission recommends against subjecting litigation funding to the managed investment scheme regulations comprised in Chapter 5C *Corporations Act 2001* (Cth) and the Australian Financial Services Licensing Requirements comprised in Chapter 7 *Corporations Act 2001* (Cth)

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Introduction

On May 22, 2020 the Federal Treasurer announced that regulations currently exempting litigation funders from holding a financial services license and exempting the litigation funding of class actions from the managed investment scheme regulations would be repealed, effective August 22, 2020.

The Federal Treasurer's announcement was driven by the view that Australian business was subject to too many class actions instigated by litigation funders. That view is open to question and, in that respect, I refer the Committee to Professor Vince Morabito, Morabito, Vince, Shareholder Class Actions in Australia – Myths v Facts (November 11, 2019). Available at SSRN: https://ssrn.com/abstract=3484660 or http://dx.doi.org/10.2139/ssrn.3484660. As the Australian Securities Investment Commission (ASIC) has previously submitted: 'An increase in the frequency of class actions is not of itself indicative of a problem with the regime.'[1]

Terms of Reference 5

Up until the Treasurer's announcement takes effect in August 2020, *Corporations Regulation* 7.6.01AB provides that Chapter 7 obligations do not apply to litigation funding schemes if adequate procedures are in place to manage conflicts of interest. The Australian Securities and Investment Commission (ASIC) has produced a Regulatory Guide (RG 248 *Litigation schemes and proof of debt schemes: Managing conflicts of interest*) setting out how litigation funders should comply with this obligation. Nonetheless, despite instances of potential conflicts of interests being raised in proceedings, there has been no regulatory action taken by ASIC against funders of class actions.

[1] Australian Securities and Investment Commission, Submission to the Australian Law Reform Commission Inquiry into class proceedings and third-party litigation funders (2018), [54].

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The Regulatory Guide is predicated on disclosure being an effective means to manage conflicts of interest. Yet merely requiring disclosure of a conflict and advising how it might be resolved in the event of a dispute is (arguably) insufficient. Studies have shown that disclosure may exacerbate conflicts of interest by effectively 'excusing' self-serving behaviours.[2] Likewise, recipients of disclosure are generally not able to calibrate the effect of bias that the disclosure might reveal.[3]

Nor is ASIC well placed to assess whether the complex conflict of duty issues that may arise in class proceedings are appropriately managed. Many of the conflicts are dependent upon how the class proceedings evolve and may not become evident until certain orders are sought[4] or settlement is imminent.[5] ASIC has previously submitted that '….the courts are better placed to regulate litigation funders, through court rules and procedure, oversight and security for costs.'[6]

Finally, the ASIC guidelines are inadequate because they do not address conflicts that may arise between the class law firm, litigation funder and class members who are not party to litigation funding agreements but whose interests may be affected by the size of class law firm fees and funding commissions as well as by orders that exclude them from participating in class settlement. Similar issues apply to limit the efficacy of Chapter 5C *Corporations Act 2001* (Cth) (discussed below).

Proposed regulation

(i) Australian Financial Services Licenses – *Corporations Act 2001* (Cth) Chapter 7

When the proposed repeal comes into force, litigation funders will be required to hold an Australian Financial Services License (AFSL).[7] Holders of financial services licenses are required to:

- Provide their services efficiently, honestly and fairly
- Have in place adequate arrangements for the management of conflicts of interest
- Comply with the terms of their license and with the financial services laws
- Have available adequate resources including financial, technological and human resources
- Maintain their competence in providing financial services
- If retail clients are involved have an authorized external dispute resolution scheme that meets the mandatory requirements set out in s 1051 *Corporations Act 2001* (Cth)
- Have adequate risk management systems[8]
- Appoint an auditor[9]

Additionally, insofar as retail clients are concerned, they must:

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2 Sunita Sah, Understanding the (perverse) effects of disclosing conflicts of interest: A direct replication study' (2019) 75 (Part A) *Journal of Economic Psychology* 102118; Daylian M Cain, George Loewenstein & Don A Moore 'The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest' (2005) 34 (1) *Journal of Legal Studies* 1.

3 Sunita Sah, George Loewenstein & Daylian M Cain, 'The burden of disclosure: Increased compliance with distrusted advice' (2013) 104 (2) *Journal of Personality and Social Psychology* 289.

4 See eg *Haselhurst v Toyota Motor Corporation Australia Ltd* [2020] NSWCA 66, [120 - 123] per Payne JA – identifying a conflict of interest when a class closure order was sought.

5 *Botsman v Bolitho* above n (2).

6 ASIC above n (1), [76].

7 *Corporations Act 2001* (Cth), s911A

8 *Corporations Act 2001* (Cth), s 912A (1)

9 *Corporations Act 2001* (Cth) s 990B

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- Have arrangements for compensating clients for loss or damage suffered because of breach of obligations
- Provide clients with a Product Disclosure Statement (PDS)[10]

Effective from April 5, 2021, AFSL holders will also need to comply with Part 7.8A *Corporations Act 2001* (Cth), which lays down design and distribution (DDO) requirements relating for retail clients. These provisions aim to ensure that retail clients are not marketed with unsuitable financial products. For instance, it would be irresponsible to market financial products to retirees whose main asset is their home where those financial products put that asset at risk. Under the provisions, reasonable steps must be taken to ensure that the financial product is marketed in a manner consistent with a target market determination.

It is unclear whether litigation funders will be required to comply with all or just some of the requirements applicable to AFSL holders. For example, it is unclear what benefit might apply if litigation funding agreements were subject to the DDO requirements or why a compensation scheme might be warranted if funders only provide non-recourse financing to class members. The utility of a PDS over and above the receipt of the terms and conditions set out in a litigation funding agreement is also open to question. When some litigation funders voluntarily held AFSL previously, they were exempt from many of the conditions set out in Chapter 7. In his announcement, the Treasurer focused on honesty, fairness and efficiency; competency; and adequate resourcing. Dealing with each of these in turn:

Honesty, fairness and efficiency
Requiring that funders act honestly, fairly and efficiently adds little to existing obligations imposed under ss 12BF, 12CB and 12DA *Australian Securities and Investment Commission Act 2001* (Cth). Nonetheless, there is a case for arguing that coupling existing requirements to a licensing regime reinforces those obligations and provides ASIC with a stronger deterrent against bad behavior.

Competency
There is no evidence that litigation funders operating in Australia lack competency in assessing the value of claims and the costs and risks associated with litigating them.

Adequate resourcing
Security for costs will generally be applied to class proceedings where a litigation funder is involved. An order for security for costs will be more fine-grained that a general resourcing requirement insofar as class member and respondent interests are concerned because it is fitted to the context of the actual litigation, whereas financial adequacy is likely to be fluid across a funder's portfolio. Moreover, prudential requirements generally only amount to a small percentage of liabilities.

In 2015, Treasury identified the cost of AFSL regime compliance at $600,000 per annum with an additional $1.4 million per annum in PDS costs.[11] That substantial cost is likely to have increased over the past 5 years. Costs of provisioning for compensation may also need to be considered. Given these costs and given ASIC's view that litigation funding should be regulated as a legal service and not a financial service, the 'value add' of a licensing regime over and above that provided by existing judicial oversight (including

10 *Corporations Act 2001* (Cth) s 1012A. The main requirements of PDSs are set out in *Corporations Act 2001* (Cth) s 1013D.

11 Australia, Treasury, *Post Implementation Review: Litigation Funding Corporations Amendment Regulation 2012 (No 6)* (2015).

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the requirement of security for costs) has not been adequately articulated. Further as noted above, it is ASIC is not equipped to regulate the conduct of class actions.

(ii) Managed Investment Schemes (MIS) – *Corporations Act 2001* (Cth) Chapter 5C

There are many reasons why the MIS provisions are not a suitable for litigation funding. Primarily, the provisions are directed toward funds management and are unsuitable for non-recourse lending. That is reflected in the requirement that consumers contribute money or money's worth and fits with the statutory exclusions for MIS set out in s 9 *Corporations Act 2001* (Cth) and exemptions such as the *ASIC Corporations (Managed Investment Schemes: Interests Not For Money) Instrument 2016/1107*. By contrast where litigation financing involves fundraising, for example, if the public is asked to invest in law claims via crowdfunding platforms[12] strong policy grounds exist for the application of the MIS provisions. Other matters:

a. Appointment of a responsible entity

Under Ch 5C *Corporations Act 2001* (Cth) the responsible entity operates the scheme, holds the scheme property on trust for the scheme members and is required to act in the interests of members rather than its own interests if a conflict of interest arises. However, I argue that the imposition of fiduciary like duties is inappropriate given that it is the litigation funder who is underwriting the cost of proceedings and putting its assets at risk. Rather, the best placed party to act in the interests of class members is the class law firm not the funder. Imposing a stronger than currently articulated burden on class law firms to ensure that funding arrangements are in class members' best interests and made on the best possible terms would be a more apposite and effective means of protecting class member interests.

The requirement of identifying scheme property and holding it separately from the other property of the responsible entity is also challenging because of the contingent nature of the class members' claims, and difficult to comply with because any compensation paid on behalf of the class members is paid to the class law firm's trust account rather than to the litigation funder directly.

b. Scheme Constitution

A MIS must have a constitution outlining the consideration to be paid to acquire an interest in the scheme, the powers of the responsible entity in relation to making investments, complaints, and winding up. But given that funders make no investments on behalf of class members this requirement appears to lack utility. As there is no scheme property held by the funder, winding up is also otiose. Similarly, it is not possible for the funder to ensure that payments from scheme property are made in accordance with the scheme's constitution. Class member entitlements are subject to approval by the Court and the Court may make orders at settlement contrary to the terms of any constitution formed at the outset of the MIS.

c. Valuation of scheme property

The responsible entity must ensure that the scheme property is valued regularly. This can be problematic given that class claims are contingent, subject to variable interpretation as to their strengths and weaknesses, and subject to unpredictable levels of legal costs (as legal costs are often driven by respondents). It also does not take account of the fact that each members' interest will be dependent upon administration formulas approved by a court.

d. Exit

The constitution of the scheme must make provision for member withdrawal while the scheme is liquid.

[12] Eg Lawfunder at https://www.f6s.com/lawfunder and Lexshares at https://www.lexshares.com

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A scheme is liquid if 80% of the scheme's property are liquid assets. Non-assignable claims are not liquid assets. Therefore, all litigation funding schemes will be illiquid schemes and subject to the provisions in s 601KB - KD which are ill fitting when applied to opt out class actions.

e. Conflict with the Uniform Legal Professional law

Lastly problems may arise with respect to s 258 *Legal Profession Uniform Law* which prohibits law firms from promoting or operating a MIS.

Terms of Reference 6

Currently, the major form of oversight for litigation funding of class actions and litigation funding agreements is provided by the Courts pursuant to legislation regulating representative proceedings. Historically, Australian courts took a laissez-faire approach to litigation funding agreements and rarely limited funding fees. However, as a result of the Full Court's decision in *Money Max Int Pty Ltd v QBE Insurance Group Ltd*[13] and growth in funder numbers, competition among class law firm and funder teams has intensified placing downward pressure on funding fees. At the same time the courts have been more willing to discount funding commissions at settlement. Thus, while in the early stages of the Australian litigation funding industry when there were few litigation funders commissions may have been very high, more recently the courts have been active in constraining class action transaction costs and more active in acknowledging the potential conflicts of interest between funders and class members at settlement.

The Australian Law Reform Commission (ALRC) has recommended that a statutory power to approve litigation funding agreements and common fund fees be enacted.[14] This submission supports that proposal as well as proposals requiring funders to provide a complete indemnity for adverse costs and to irrevocably submit to the jurisdiction of Australian courts.

Courts have also been active in dealing with relationships between class law firms and funders that may compromise the interests of class members and in some cases have stayed proceedings perceived as a potential abuse of process. To reinforce that power, the ALRC has recommended the enactment of a prohibition of cross-interests (both direct and indirect) between funders and class law firms. This submission supports that proposal and argues that it should go further and incorporate other forms of commercial relationship such as common directorships, family ties and ongoing commercial relations.

Imposing another regulatory regime on top of the current regime of judicial oversight of class actions poses several problems. For example: It is unclear how dispute resolution at the Australian Financial Complaints Authority (AFCA) will interact with court supervision of class settlements and supervision of the administration of class settlements. The AFCA is not currently equipped for dealing with collective disputes and any dispute raised by an individual class member will naturally have implications for other class members. It is also uncertain how complaints regarding litigation financing arrangements in the AFCA might intersect with the work of legal disciplinary bodies addressing any failure of a law firm to adequately address conflicts of interest arising between it and a litigation financier and class members.

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13 (2016) 245 FCR 191; [2016] FCAFC 148. This decision determined that the Federal Court had the power to make a common fund order regarding litigation funding commissions in class actions irrespective of whether class members had entered into funding agreements. The decision also determined that the Court had the power to fix the litigation funder commission referring to a range of factors incorporating funder risk and reward. Subsequently, however, the High Court has overruled this decision in *BMW Australia Ltd v Brewster* (2019) 94 ALJR 51.

14 Australian Law Reform Commission, Report No. 134*, Integrity, Fairness and Efficiency—An Inquiry into Class Action Proceedings and Third-Party Litigation Funders* (2018), Recommendation 14, p. 169