MENZIES

RESEARCH CENTRE

Submission to the Joint Committee on Corporations and Financial Services

Inquiry into Litigation Funding and the Regulation of the Class Action Industry

14 June 2020

Contents

Executive Summary

> *"The phrase 'access to justice' is often misused by litigation funders to justify what at bottom is a commercial endeavour to make money out of the conduct of litigation."*
>
> *Federal Court Justice Michael Lee, in approving the settlement of the PFAS class action, 5 June 2020*

> *"It is rightly a scandal for there to be situations where group members in proceedings where there has not been a massive change in prospects are recovering very small return for their claim in circumstances where legal costs have become extraordinarily large and funding commission taking on top of that means they are recovering very little..."*
>
> *Federal Court Justice Michael Lee, as the Keynote Speaker at Omni Bridgeway (IMF Bentham)'s 2017 Class Action Conference*

> *"Increased access to justice? Give me a break. This is all about increased access to the latest BMW. Everything else is just marketing."*
>
> *Chris Merritt, The Australian – 'Prejudice' Column, Friday 6 March 2020*

Civil law serves to quench the thirst for justice, not the thirst for profit. Its primary purpose is to compensate citizens whose rights have been infringed. Any remittances that lawyers and funders may make along the way should be merely incidental.

In the field of class actions, however, there is a risk that profit may become chief motivation for initiating proceedings if it is not already. Lawyers are shopping for aggrieved clients, not the other way round. Lawyers and third-party litigation funders are shaping proceedings. It is they who are deciding whether justice should be dispensed in the court or settled outside. The decisions frequently appear to be made in their own best interests, favouring the return on their own investment rather than what is best for the client.

In this, the first of our reports into representative proceedings and litigation funding, we present evidence of manifest injustice in civil proceedings. Justice has become subordinate to the profit motive. Lucrative commercial returns for legal firms and investors are driving a spiralling number of class actions in which compensation for plaintiffs is little more than a by-product.

The introduction of provisions allowing plaintiffs to litigate collectively in 1992 was well intentioned. It was designed to make justice more affordable by sharing risk and costs. That noble aim has been corrupted by predatory practices by legal companies backed by investors looking for a return on capital.

Forget the heroic narrative of the passionate lawyer acting pro-bono for the marginalised and vulnerable. Three quarters of these are so-called funded cases, investment vehicles for financiers, frequently from the US, who bet their money on a successful court finding or settlement and pocket the proceeds.

Awards for damages that are intended to redress the conditions a plaintiff enjoyed before the wrong was committed are being eaten up by the professionals commissioned to help.

Last year the average amount paid to plaintiffs in such cases was a mere 39 per cent of the settlement proceeds. The average commissions paid to litigation funders increased to 24 per cent and legal fees to 37 per cent. Nearly two thirds of the compensation intended for their clients is being taken by the promoters of class actions.

The damage suffered by injured parties is tangible. They cannot begin to replace a home or business lost in a fire or flood if they receive half or less than half of the replacement cost.

Our justice system has hurtled along the American path and then some. The returns available for investing in litigation in Australia exceed, by a considerable margin, the returns available in nearly every other alternative asset class in the world. Two of the largest litigation funders operating in Australia, Omni Bridgeway and Litigation Lending Services returned ROICs of 154% and 165% respectively. Their success rate is between 89 - 94 per cent.

The returns, in other words, are 17 times larger than those that might be achieved by investing in ASX 200 shares, and nearly 12 times the benchmark returns earned by US Hedge Funds.

The checks and balances that apply to other forms of consumer finance no longer apply. Indeed, since litigation funding was expressly exempted from investment regulation in 2013 by then Labor Minister Chris Bowen, the industry has flourished. The close ties between the Labor Party and Maurice Blackburn, the industry's largest class action player, should be noted.

The report highlights the misuse of common fund orders which allow litigation funders to charge commission on all members of the class whether or not they have consented to the action being undertaken on their behalf. It allows class actions to commence on behalf of hundreds of thousands of class members without their knowledge. All that is required is for one member of the class to consent to their involvement.

The advent of super profits by litigation funders has encouraged class action law firms to seek the ability to charge US- style contingency fees through a bill introduced into the Victorian parliament. This report notes that Maurice Blackburn has already commenced class actions in Victoria in anticipation of being able to charge their percentage of the settlement.

The development challenges their fiduciary duty to their clients giving them a direct financial stake in any settlement. No less challenging is the influence funders are able to exercise in shaping proceedings.

Unlike lawyers, litigations funders have no duty to act in the best interests of the plaintiff. Rather their duty is to maximise returns for investors, which may mean a premature out-of-court settlement that may not be in the best interests of the injured party.

The report also makes recommendations to address conflict of interest, the lack of appropriate disclosure and control of proceedings. It calls for the regulation of foreign funders, the proper application of character and qualification requirements and the same level of prudential supervision that applies to other investment vehicles.

Justice apart, there is a strong economic imperative to prioritise the reform this area of civil law. The escalating cost of proceedings is significantly adding to the cost of doing business at a time when the economy is entering recession. Much of the burden of these costs is ultimately carried by ordinary Australians through the loss of jobs, wages or reduced dividends towards their retirement savings.

COVID-19 has demonstrated the need to expand domestic manufacturing. Yet legal liabilities are becoming yet another disincentive for companies to operate here.

The impact on business, the broader economy and jobs will be more closely examined in a further report. It will examine how sensible adjustments to corporate laws will close some of the most egregious loopholes currently being exploited in class actions while strengthening corporate governance.

The series of external shocks we have experienced this year has highlighted the measures we must take to ensure we emerge stronger on the other side. Legal reform of the nature we describe must be high on the list.

There is nothing fair about the system as it currently stands. Its impact is steeply regressive, rewarding some of the richest professionals in the country at the expense of those who can least afford it.

Litigation that delivers private profits for a few at the expense of the many is an injustice that cannot be allowed to stand.

Factors driving the increasing prevalence of class action proceedings in Australia

Class actions were first introduced in Australia in 1992. The first court to adopt a class action procedure was the Federal Court of Australia. The Supreme Courts of Victoria, New South Wales and Queensland subsequently followed. The Parliament of Western Australia is currently considering a bill to allow class actions in the State's Supreme Court.

Initially, Australian plaintiffs and plaintiffs' lawyers were slow to take up the new procedure. However, that has now changed and the incidence of class actions in Australia has significantly increased. At the same time, litigation funders and plaintiffs' lawyers have endeavoured to deny that growth and its impact on the Australian economy. They argue that, since the early 1990s, the average numbers of class actions commenced each year is just 23. They also try to draw comparisons to the number of class actions occurring in some irrelevant foreign jurisdiction. These numbers are clearly misleading.

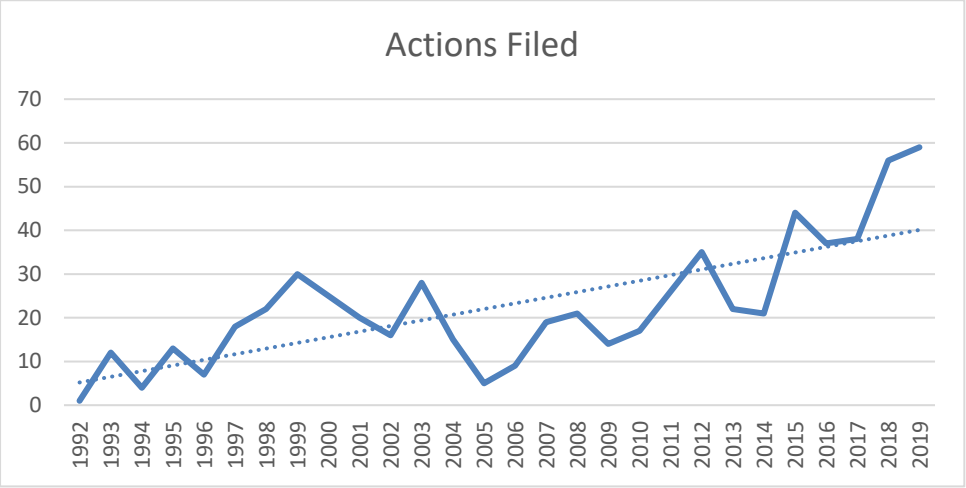
Over the last ten years alone, 355 class actions were filed in Australia. These represent 56 per cent of the total number of class actions filed in the regime's 28-year history.[1]

In FY 2019, some 59 class actions were commenced.[2] In the period from 1 July 2019 to 31 January 2020, at least 30 class actions have been filed. This filing rate indicates that the likely total number of actions for FY 2020 will be similar to or will exceed the number filed in FY 2019.[3]

[1] Prof. Vince Morabito, An Evidence-Based Approach to Class Action Reform in Australia, Monash University, November 2019.
[2] Ibid.
[3] Peta Stevenson, Justin McDonnell and Moria Saville, Class Action Update, King & Wood Mallesons, February 2020.

The growth of class actions in Australia can be clearly seen in Figure 1.

Figure 1: The number of Class Actions filed 1992 to 2019



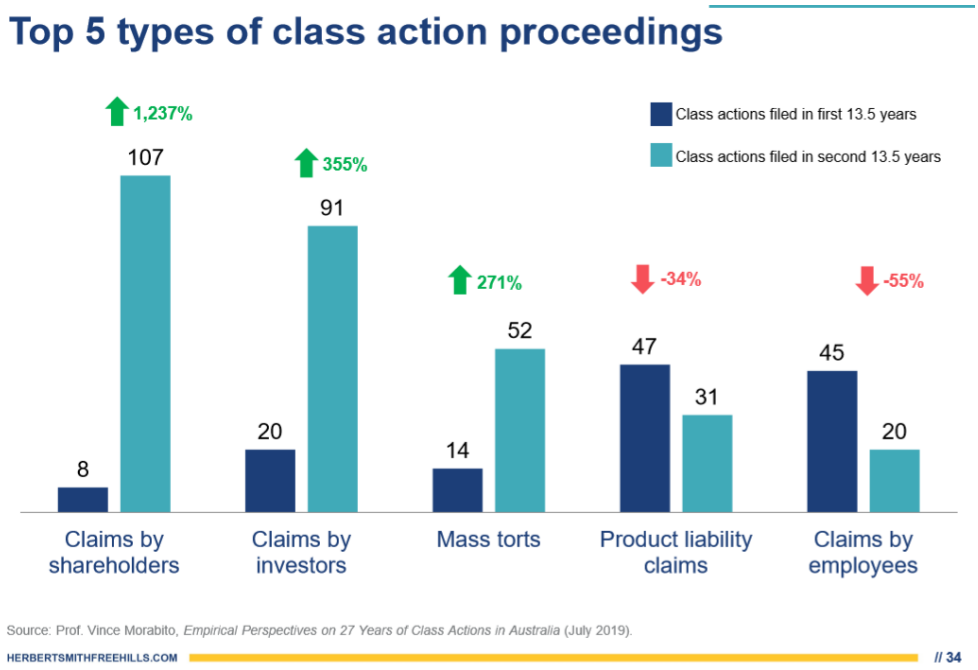
At the same time, the subject matter of class actions has changed with significant consequences for the Australian economy.

Initially, class actions focused on product liability and industrial relations related claims with 47 and 45 actions respectively launched in the period to 2005. More recently, both categories have seen a significant decrease. Product liability claims have fallen by 34 per cent while industrial relations related claims have fallen by 55 per cent since 2005.[4]

Data released by law firm Herbert Smith Freehills reveals that while there has been a significant decrease in the number of product liability and industrial relations class actions, there has been an explosion in class actions brought on behalf of investors and shareholders. This is set out in Figure 2. Over the past 13.5 years, the number of class actions commenced by investors has increased by 355 per cent to 91. Astonishingly, the number of class actions brought on behalf of shareholders has surged by 1,237 per cent.[5] According to the Australian Institute of Company Directors, just under half of the total number of shareholder actions ever initiated in Australia are only now in the moving through the courts.[6]

[4] Herbert Smith Freehills, Class Actions – Myths v Facts CPD Series 2020 -Prof. Vince Morabito, Empirical Perspectives on 27 Years of Class Actions in Australia, July 2019.
[5] Ibid.
[6] www.afr.com/companies/professional-services/business-needs-reprieve-from-covid-19-class-actions-20200507-p54quq

Figure 2: Increase in Shareholder and Investor Claims – Herbert Smith Freehills



Present and potential future impact of class actions on the Australian economy

The significant growth in the number of class actions has been accompanied by an extraordinary increase in the size of the claims being litigated. In November 2009, it was estimated that there were $2.6 billion worth of claims through class actions against Australian businesses[7]. Just 10 years later that figure had almost quadrupled to over $10 billion.[8]

The explanation for the growth in the Australian class action industry is clear - as law firm Allens Linklaters has observed:

> *The primary driver for this trend is more and more plaintiff lawyers and third-party funders bringing class actions in the hopes of sharing in the spoils of a substantial settlement (or, very occasionally, a judgement).*[9]

[7] Chris Bowen, Address to Shareholder Class Action Conference, May 2010.
[8] Ai Group, Class Action claims total over $10 billion – Government needs to act quickly to protect economy, 30 October 2019.
[9] Allens Linklaters, Class Action Risk, 2018, (Page 1).

The role of litigation funders

Much of the growth of the Australian class action industry has been made possible by the emergence of the third-party litigation funding industry. This is clearly demonstrated by the increase in numbers of class actions that have been filed after two key events involving litigation funders.

- Court approval of litigation funding – the decision of the High Court in *Fostif* which effectively legitimised the industry.[10]
- Removal of regulatory oversight for litigation funders – the decision by then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen, to exempt litigation funders from the requirement to hold an Australian Financial Services Licence (AFSL) – something required of all other providers of financial products and services.[11] This was an extraordinary decision given that the courts have held that litigation funding should be regulated variously as a managed investment scheme or financial product.

In the year following the granting of the exemption for litigation funders, class action filings more than doubled. These historically high levels have been maintained ever since.

At the same time, the percentage of class actions backed by litigation funders has steadily increased to the point where nearly three quarters of all class actions are now promoted by a litigation funder.

Figure 3: Percentage of Class Actions backed by Litigation Funding[12]

FINANCIAL YEAR	2014	2015	2016	2017	2018	2019
PERCENTAGE FUNDED	33%	50%	43%	64%	74%	72%

These developments have effectively converted what was intended to be a mechanism to allow groups of people to resolve their legal claims efficiently and cost effectively into an industry which is focused on delivering financial returns to investors in litigation.

[10] Campbells Cash and Carry Pty Limited v Fostif Pty Limited [2006] HCA 41
[11] The Hon Chris Bowen, Address to shareholder Class Action Conference, 4 May 2010.
[12] King & Wood Mallesons, Class Action Report, September 2019.

As demonstrated in this report, the returns delivered to those investors exceed the returns available in nearly every other investment asset class in the world. This both undermines the credibility of the legal system and comes at the expense of the very people the class action procedure was intended to assist.

As law firm Allens Linklaters observed –

> *More than ever before, class actions are being seen as lucrative profit-making enterprises for plaintiff lawyers and litigation funders. Indeed, we do not see it as an exaggeration to say that justice for class members is often nothing more than a convenient by-product of many class actions.*[13]

How litigation finance works

Litigation finance operates in a manner very similar to private equity. Litigation funders raise capital from third party investors. That capital is then deployed to fund legal fees to pursue class actions run by plaintiffs' lawyers. In exchange, the litigation funders are entitled to a 'commission' or share of the proceeds that the class recovers, whether by way of settlement or final judgement.

Funding is usually provided on the basis that if the case is lost the funder will be liable to pay the defendant's costs.

Plaintiffs' lawyers are attracted to litigation funding because their fees are effectively underwritten or paid by the litigation funder.

Litigation finance is not limited to multiparty class actions. It extends to all disputes and modes of resolution including arbitration, traditional corporate litigation, and insolvency matters.[14] In Australia, it appears to be used predominantly in class actions. An investor presentation by Omni Bridgeway (IMF Bentham) from May 2020 reveals that, as of 30 April 2020, 'multi party' matters (i.e. class actions) comprise 27% of its global litigation funding portfolio. However, the same presentation also reveals that 'multi party' matters comprise 70% of its Australian investment portfolio.[15]

[13] Allens Linklaters, Class Action Risk, 2018 (Page 2).
[14] Omni Bridgeway, Investor Presentation, May 2020 (Page 20).
[15] Ibid (Page 20).

Litigation funders investing foreign capital

> *"Litigation financing was 'invented' in Australia [and] Litigation Capital Management, along with IMF Bentham (ASX listed) and Litigation Lending Services (private) were the pioneers."*
>
> *LCM Management Presentation 'LCM IPO on the ASK, November 2016*

There are at least 33 litigation funders operating in Australia.[16] Most of these are foreign entities, or locally created companies investing on behalf of offshore funds.

Similar to private equity funds, these offshore funds are often structured as investment fund vehicles and raise money from external investors – usually sophisticated investors and pension funds. Some funders invest through advantageous tax jurisdictions, including Jersey, the United Kingdom and the Cayman Islands.

Even funders that reside in Australia have restructured their operations to act more like international fund managers to access foreign capital. For example, Omni Bridgeway (formerly known as IMF Bentham)'s most recently completed fund, Fund 5, is run through a Cayman Island based entity. It has raised investments of up to US$1 billion from foreign investors to deploy into Australia and the region.

ASX disclosures indicate that major investors in this fund include investment firms in Singapore, Europe and North America, including a cornerstone investment from endowment funds associated with Harvard University.[17]

The global litigation fund market is currently valued at US$10.916 billion and is expected to grow to US$22.373 billion by 2027 at a compound annual rate of 8.3 per cent.[18] Some US commentators suggest that the market is potentially as large as US$50 billion - $100 billion. [19] A significant amount of these funds are earmarked for deployment in Australia.

[16] Australian Law Reform Commission, An Inquiry into Class Action Proceedings and Third-Party Litigation Funders, January 2019 (appendix G).
[17] IMF Bentham, ASX Disclosure, 20 June 2019.
[18] Absolute Market Insights, global litigation funding investment market, yahoo finance, 18 February. 2020.
[19] https://www.marketwatch.com/story/in-low-yield-environment-litigation-finance-booms-2018-08-17

The impact of litigation funding on the damages and other compensation received by class members in class actions funded by litigation funders

The litigation funding industry is generating extraordinary profits for its investors – profits that are paid out of the compensation awarded to their clients, the class members.

Indeed, the point has been reached where even some litigation funders are acknowledging that the returns being generated by the industry are excessive and regulation to protect consumers and class members is required.[20]

In examining this issue two questions must be considered. First, the percentage of the compensation awarded to class members that is taken by the litigation funders and plaintiffs' lawyers. Second, the returns being generated by the funders through their involvement in the proceedings.

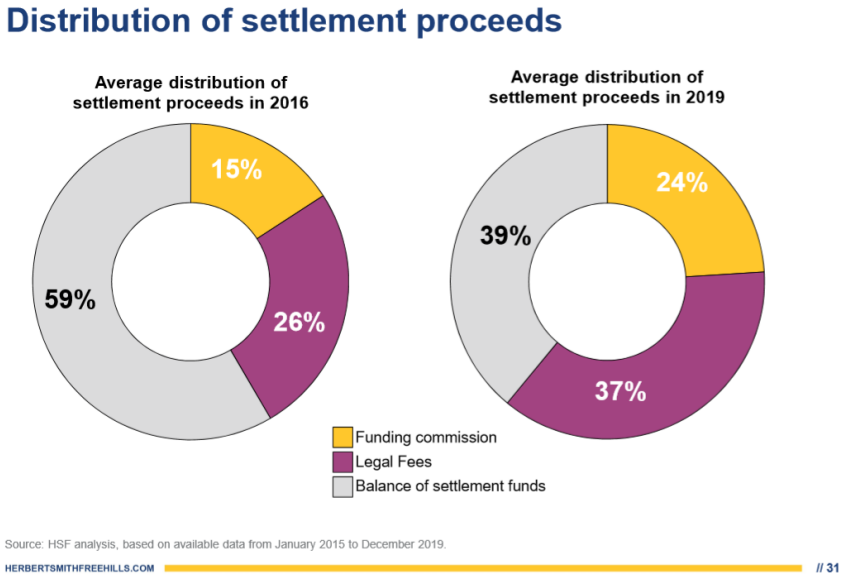
Returns to class members

In 2016, on average 59 per cent of settlement[21] proceeds went to class members whilst the average percentage paid out of these damages as a funding commission was just 15 per cent. The balance went to the plaintiffs' lawyers.[22]

By 2019, the average amount paid to plaintiffs had fallen to just 39 per cent of the settlement proceeds, whilst commissions paid to litigation funders increased to 24 per cent and legal fees to 37 per cent.[23] Nearly two thirds of the compensation intended for their clients is being taken by the promoters of class actions.

[20] Omni Bridgeway (IMF Bentham) ASX release – 14 May 2020
[21] While class members may receive compensation following a judgement or the settlement of their claim, most class actions settle before judgement. Accordingly, we have used the term 'settlement' to refer to both modes of resolution.
[22] HSF Analysis, Based on available data from January 2015 to December 2019.
[23] Ibid.

Figure 4: Decreasing Returns to Class Members



The Australian Law Reform Commission (ALRC) reached a similar conclusion. It reported that in actions settled between 2013 and 2018 class members in actions without a third-party litigation funder received a median return of 85 per cent. When a funder was involved that amount fell to just 51 per cent.[24]

Figure 5: Median Return to Class Members

Median funder commission rate	**30%**
Median return to class member (funded)	**51%**
Median return to class member (un-funded)	**85%**

Clearly this is both unacceptable and unsustainable.

In many cases class actions are commenced seeking compensation for significant losses. The class actions commenced following the major Victorian bushfires or the Brisbane floods are good examples. If class members are forced to surrender fifty per cent or more of the compensation they receive to litigation funders and lawyers, any success they may achieve is illusory. Class members cannot begin to replace a home or business lost in a fire or flood if they receive half or less than half of the replacement cost.

[24] Australian Law Reform Commission, *An Inquiry into Class Action Proceedings and Third-Party Litigation Funders*, January 2019, (Page 83).

If nothing else, the returns being delivered to class members starkly demonstrates how the class action system has been corrupted for the benefit of the promoters of class actions, the litigation funders and plaintiffs' lawyers, at the expense of class members themselves.

As law firm Allens Linklaters observed:

> *There is […] growing evidence that recent experience has us fast approaching a 'tail wagging the dog' scenario – by which we mean that the promoters' pursuit of profits has become an end in itself and is no longer supporting the objectives of the class action regime.*[25]

Quantum of fees, costs and commissions earned by litigation funders and the treatment of that income

Litigation funders earn commissions which are generally expressed as a simple percentage of the compensation awarded to class members. However, like private equity and hedge funds, funders measure their profit using the metric of 'Return on Invested Capital' (**ROIC**). This is a measure of the profit that a funder has made from its investments after the return of the funds it has deployed to run a case.

The returns available to investors in funded litigation are, quite frankly, astonishing. When benchmarked against other asset classes, litigation funders in Australia are generating ROIC returns around seventeen (17) times more than investors in ASX 200 stocks and more than ten (10) times the average global hedge fund and private equity performance.

Even when benchmarked against exceptionally high risk / high return investments such as biotech, the returns of funds are still nearly six (6) times higher.

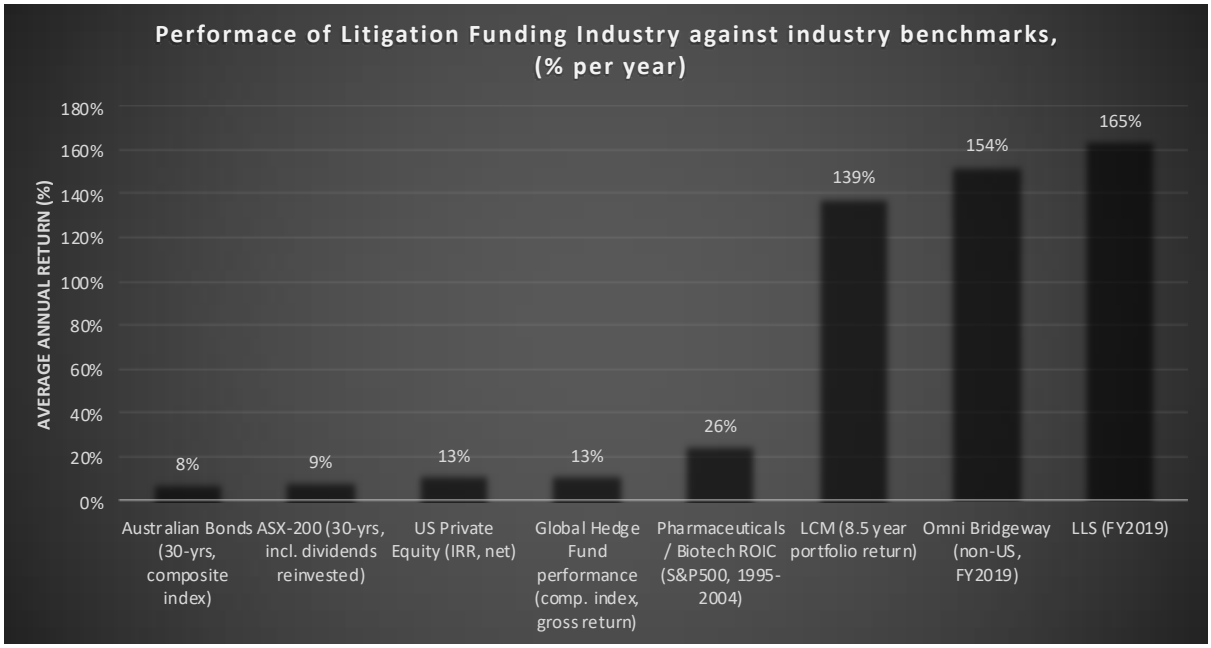
Consider the returns generated by three Australian funders which have disclosed their results:

- LCM disclosed a return of 139% based on an 8.5-year portfolio return.
- Omni Bridgeway's non-US (predominately Australian) return in FY 2019 was 154%.
- Litigation Lending Services returned 165% in 2019.

[25] Allens Linklaters, Class Action Risk, 2018, (Page 6) – emphasis added.

These returns are benchmarked against other asset classes in Figure 6.

Figure 6: Benchmarked Performance of Australian Litigation Funds



The high returns and low risk of litigation funding make this a tantalising investment class for investors in the current climate of low returns on more traditional forms of investment.

The litigation funding industry seeks to justify these returns by arguing that they are necessary given the risks associated with funding class actions in the event of losing a case and the funder becoming liable for adverse cost orders. However, as demonstrated in Figure 7, the success rate for third-party funded class actions in Australia is between 87 and 94 per cent.

The low risk associated with these investments does not justify the returns generated by Australian litigation funders on any sensible interpretation of corporate finance principles.

Figure 7: Disclosed Success Rate for Litigation Funders

Funder	Investment Duration	Success Rate
Omni Bridgeway (ASX Investor Presentation - Sep 2019)	2.6 Years	89%
Litigation Capital Management (AIM Presentation - Sep 2019)	2.1 Years	87%
Litigation Lending Services (ASIC Annual Report 2018)	2.5 years	94%

The returns in Australia significantly exceed those generated by litigation funders in other jurisdictions, including the United States. Globally, it is estimated that the litigation funding industry generates annual returns between 29.4 and 43.2 per cent, with average annual returns of about 36 per cent.[26]

Omni Bridgeway (IMF Bentham) has confirmed the lucrative nature of the Australian market as compared to the US in a recent investor presentation. It revealed that its ROIC for non-US, predominately Australian ligation investments are currently 3.7 times more profitable than the ROIC for its US litigation operations.[27]

Furthermore, the performance of litigation funding investments are not corelated to other investment classes. Even during times of pandemics such as COVID-19, there is no expectation that stock prices for listed litigation funders should fall. In a recent briefing to investors, Omni Bridgeway (IMF Bentham) has disclosed expert analysis that revealed that its share price is not correlated to the ASX 300 Diversified Financials Index, and that history has shown "Omni Bridgeway's share price has not suffered in the longer term".[28] The analysis also revealed that in times of crisis, rather than its share price dropping Omni has seen its share price increase, first during SARS by 164 per cent and second during the Swine flu outbreak by 26 per cent.[29]

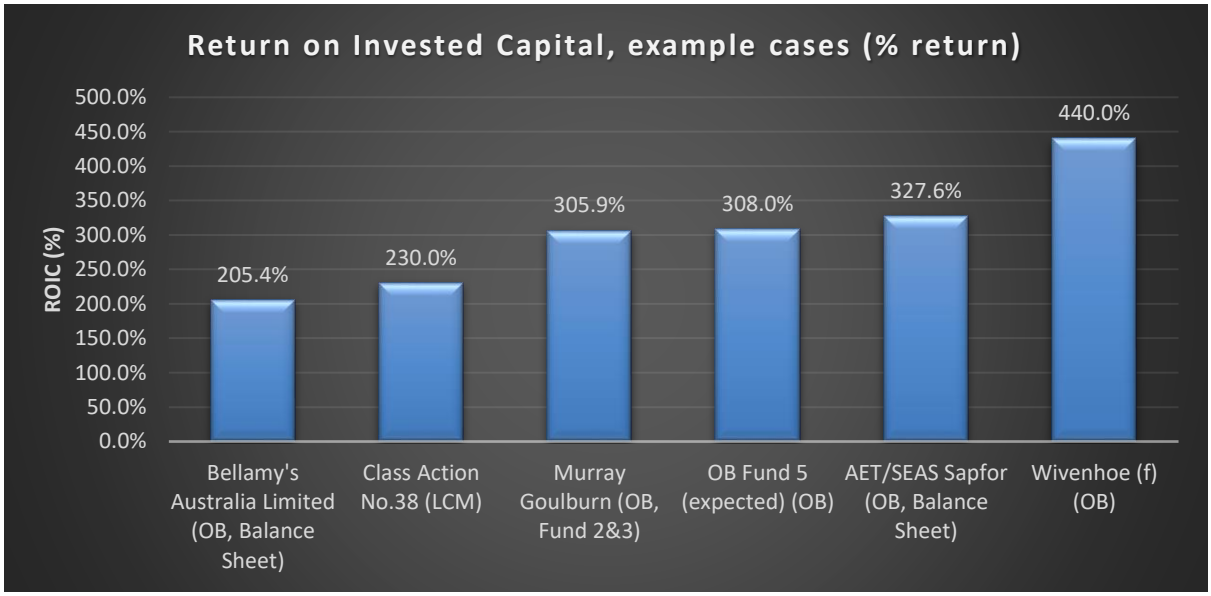
Given these returns, coupled with the fact that the barriers to commencing a class action in Australia are lower than those in the United States[30], it is not surprising that Australia is now the second most attractive class action jurisdiction globally.[31]

[26] Michael McDonald, Finance and Law: Returns to Litigation Finance Investments, above the law.com, July 2016.
[27] Omni Bridgeway, Investor Presentation, March 2020 (Page 13).
[28] Omni Bridgeway, Euroz Conference, March 2020 (page 2)
[29] Ibid.
[30] Samuel Issaharoff and Thad Eagles, *The Australian Alternative: A view from abroad of Recent Developments in Securities Class Actions*, UNSW Law Journal 179, 2015
[31] Herbert Smith Freehills, Litigation Funding on the Rise, 23 May 2018.

Recent Case-by-case Returns of Litigation Funders

Several recent cases funded by Omni Bridgeway (IMF Bentham) correlate to an increasing ROIC well beyond its historic average listed in Figure 6.

Figure 7: ROIC - recent case examples



The current legislative regime for class actions does not contemplate the role of litigation funders. Indeed, litigation funding in its current form didn't exist at the time the relevant legislation was enacted. As the Australian Law Reform Commission observed in its report in 2018 -

> "*It is unlikely that in 1988 the Australian Law Reform Commission could have foreseen the developments in the law relating to class actions that have occurred since then. It certainly would not have foreseen the growth in the involvement of litigation funders".*[32]

It is even less likely that the ALRC would have foreseen the extent to which the litigation funders have become the beneficiaries of the compensation awarded to class members.

[32] *ALRC Report – An inquiry into Class Action Proceedings and Third-Party Litigation Funders, January 2019.*

Judges Focus on Percentage Commissions, Not Funder Returns

The litigation funding industry is unregulated and there are no statutory or other criteria for determining how litigation funding agreements operate or a funders remuneration should be determined. As a general rule, a litigation funding agreement will provide for the funder to receive a commission determined by reference to a percentage of the compensation the class members receive from the defendant. The litigation funding agreement may also provide for the funder to charge a range of other fees and charges in addition to the commission. In some cases, the percentage payable to the funder may increase the longer the case runs.

Similarly, the legislation governing class actions in Australia makes no provision for dealing with the role of litigation funders in class action proceedings. Rather, the courts have been forced to try and develop an appropriate response with very limited assistance.

When a court is hearing an application for the approval of a class action settlement the judge considers a range of issues to determine whether it is 'fair and reasonable'. As part of that process, the court will review the commission and charges sought by the funder and the legal fees charged by the plaintiffs' lawyer. However, instead of considering the profit measures used by funders, such as ROIC, judges instead focus on the commission as a percentage of the compensation awarded to class members. As a result, the approach taken by the court in relation to the funders remuneration is haphazard and undertaken without regard to principles of corporate finance or benchmarks for risk adjusted rates of return.

The task is made more difficult by the fact that, once a settlement has been reached, the defendant has no interest in delaying approval and thus the final resolution of the matter. For their part, both the litigation funder and the plaintiffs' lawyer representing the class are hopelessly conflicted and unlikely to do anything to jeopardise the approval or delay receiving their often significant remuneration. Unless a class member is willing to appear at the approval hearing with independent lawyers at their own expense to oppose or question the settlement costs or remuneration, nobody will be independently representing the class members.

In most cases, the judge will take a fairly arbitrary view as to an appropriate percentage which is at least in part informed by the overall quantum of the settlement. In other words, the larger the settlement the more likely the court will balk at approving a high percentage. But in each of these approaches, the courts focus entirely on the commission measured as a percentage of the class members' compensation and has no regard to the ROIC profitability measure used by litigation funders.

Consequently, the commission paid to the litigation funder, expressed as a percentage of the compensation awarded to class members, can be reduced by the court while still delivering extraordinary levels of returns when benchmarked against alternative investments.

Two recent approval decisions illustrate these issues.

Murray Goulburn

Omni Bridgeway (IMF Bentham) and Slater & Gordon commenced a class action against Murray Goulburn. The case related to a profit forecast revision which saw a decline in the value of the dairy cooperative.

The case was ultimately settled for $42 million. Omni Bridgeway disclosed that it expected to generate profit of $13.5 million under its funding agreement, equivalent to a 32 per cent of the compensation awarded to class members.[33] Approximately $2.6 million of legal fees were to be paid to Slater and Gordan.

The judge hearing the approval application, Justice Murphy, refused to approve the settlement with a commission of 32 per cent, saying, “my present view, which I have reached without the benefit of further submissions, is that the more appropriate rate is something in the line of 25 per cent [of the settlement sum]”.[34]

In light of these comments, Omni Bridgeway (IMF Bentham) sought to revise its claim for commission to 28 percent. However, Justice Murphy would not move from his view that 25 per cent commission was the appropriate figure. Ultimately, Omni Bridgeway (IMF Bentham) accepted that position.

Despite the reduction, Omni Bridgeway disclosed a ROIC of 3.1 times its initial investment (i.e. a 310% return on top of its investment), and an internal rate of return (IRR)[35] of a staggering 624 per cent.[36]

Despite being reduced, the final commission which was approved as ‘fair and reasonable’ by the Court resulted in a return which was nearly twenty-four (24) times the benchmark for ROIC returns for hedge funds and nearly forty two (42) times the benchmark IRR for private equity and hedge funds.

[33] IMF Bentham, Conditional Settlement – Australian Securities Class Action, ASX, 24 June 2019.
[34] Lawyerly, judge rejects $42M Murray Goulburn class action settlement, says funder’s cut too high, 16 October 2019
[35] IRR is an internal measure of profitability which takes into account the time for realising an investment
[36] Omni Bridgeway, Investor Presentation, Individual case Performance to 13 March 2020, March 2020

Per-and-Poly-Fluoroalkyl Substances (PFAS)

Omni Bridgeway (IMF Bentham) and Shine Lawyers brought three separate class actions against the Australian Government in relation to PFAS contamination around defence bases in Williamtown, Katherine and Oakey. The contamination was alleged to affect the value of properties in the area.

The parties agreed to settle the three matters for a total amount of $212.5 million. Justice Michael Lee approved the $212.5 million settlement on 5 June 2020 notwithstanding a "large number" of objections.[37] These included objections to the 25 per cent commission awarded to funder Omni Bridgeway.

Omni Bridgeway subsequently disclosed that the settlement generated income for it of $76.9 million. It also disclosed the profit, ROIC and IRR amounts set out below in Figure 8.[38]

Figure 8: Omni Bridgeway (IMF Bentham) PFAS Settlement Disclosure

PFAS Actions	Gross Income	Profit	ROIC	IRR%
Williamtown investment (balance sheet investment)	$31.1m	$18.8m	1.53x	51%
Oakey investment (balance sheet investment)	$15.8m	$7.2m	0.84x	44%
Katherine investment (funds 2 & 3 portfolio)	$30.0m	$21.7m	2.62x	179%

When benchmarked against comparable IRR metrics, the amounts approved are, respectively, 3.4, 2.9 and 11.9 times more than benchmark returns for private equity and hedge funds.

Seemingly unaware of these returns, the Court approved the funding commission as 'fair and reasonable' and observed that the amounts received by the class members "can fairly be described as excellent."[39] This was despite the fact that many class members would receive much less than the loss of the value of their properties as a consequence of the contamination.

In its subsequent ASX release, Omni Bridgeway asserted that it had 'voluntarily' reduced its contractual fee entitlements across the three class actions by approximately 30%.

[37] Alison Eveleigh, judge approves $212.5M toxic foam class action settlement, Lawyerly, June 5 2020.
[38] Omni Bridgeway ASX Release 9 June 2020
[39] Omni Bridgeway ASX Release 9 June 2020

However, what the release does not disclose is that in April 2019 Omni Bridgeway sought to have a common fund order applied to the Katherine proceeding which would likely have significantly increased its commission.

Justice Lee refused to approve Omni's fee proposal without the fee structure being disclosed to him. He requested more information and suggested the appointment of an independent contradictor[40] to assess the reasonableness of the fees proposed. According to the legal periodical *Lawyerly*, the proposal Omni Bridgeway withdrew its initial proposal to avoid the involvement of a contradictor. A subsequent article in *Lawyerly* revealed that the increased commission proposed was 15% of any gross recovery in the case plus up to three and a half times the funder's costs.[41] Given the legal fees for the Katherine matter appear to be $8.3 million and the current profit level for that case was $21.7 million, the inital commission structure would possibly have increased the funder's profit by tens of millions.

The application of common fund orders and similar arrangements in class actions

A common fund order is an order made by the court on the application of a litigation funder to require all class members to pay the funder a commission in the absence of any agreement on their part to make such a payment. Common fund orders enable litigation funders to take a percentage of every class member's compensation regardless of whether the class members has signed a funding agreement, agrees to the payment or is even aware that such an application has been made by the funder.

This is particularly egregious in the context of the Australian opt-out class action system where a funder can commence a class action on behalf of hundreds of thousands of class members in circumstances where no more than one member of the class need consent to their involvement or even be aware that the proceedings have been commenced.

This has huge advantages for litigation funders. They no longer need to go to the trouble of identifying clients and seeking their agreement to join the action and pay the funder a fee or commission. It makes it much easier and quicker to commence a class action and describe a class that is really only limited by the imagination of the person drafting the class description.

40 A contradictor is an independent lawyer appointed by the Court to assist it in determining the issues in circumstances where the parties are conflicted or the Court otherwise believes that it will assist the Court.
41 Lawyerly, 23 April 2019.

This mechanism, first approved by the Federal Court in the 2016 'Money Max' decision[42], has enabled funders and plaintiff lawyers to bring larger claims for larger classes without the additional work required to sign up individual class members – the so called 'bookbuild'.

The mechanism has allowed funders to both expand the damages pool, and, by extension, exponentially increase the commissions they can make from a class action.

The class action involving Takata airbags in BMWs is a prime example. In this case only 33 of the potential 200,000 class members had entered into a litigation funding agreement and agreed to the funder's terms. Despite this, the funder sought to have the entire class pay it a commission. In this instance, when the application finally came before the High Court it held that the provision under which the application had been made did not extend to the making of the order.

How Common Fund Orders magnify claim sizes

The use of the common fund mechanism has increased both the number and size of class actions in Australia and the ease with which they are commenced.

Given the lack of regulatory oversight, it is difficult to determine the exact size of the litigation funding market in Australia and the impact that the advent of common fund orders has had on the sector. However, some insight is provided into claim sizes through portfolio updates filed by Omni Bridgeway (IMF Bentham) with the ASX.

Omni Bridgeway (IMF Bentham) measures the size of its pipeline of active funded litigation by 'EPV', which it defines as follows:

> "*EPV for an investment where the IMF funding entity earns a percentage of the resolution proceeds as a funding commission is* ***IMF's current estimate of the claim's recoverable amount after considering the perceived capacity of the defendant to meet the claim.***"[43] (our emphasis)

It is from this amount, once recovered, that Omni Bridgeway (IMF Bentham) derive its commissions. It discloses that:

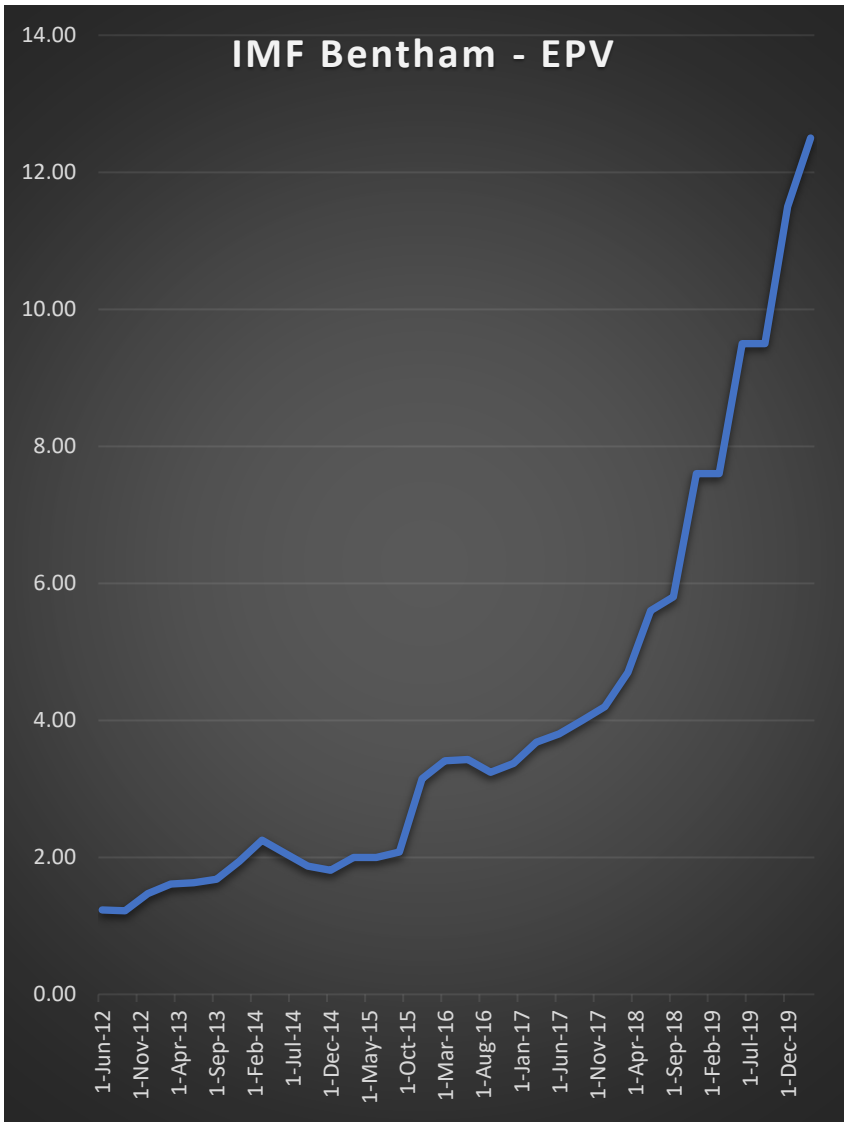
> *"Past performance indicates that OBL's litigation funding investments (excluding OBE investments) have generated average gross income of approximately 15% of the EPV of an investment at the time it is completed (****Long Term Conversion Rate****)."*[44]

42 Money Max Int Pty Ltd (Trustee) v QBE Insurance Group Limited [2016] FCAFC 148.
[43] Omni Bridgeway (IMF Bentham) Investor Portfolio Report at 30 September 2019.
[44] Omni Bridgeway (IMF Bentham) Investor Portfolio Report at 31 March 2020.

The total amount of Omni Bridgeway (IMF Bentham)'s EPV[45], expected funded litigation recoveries, increased by 600% from the date Common Fund Orders were first proposed in the Federal Court's 'Money Max' case in September, and increased by 385% since the date that Common Fund Orders were approved by the Federal Court in October 2016 to March 2020.[46]

Omni Bridgeway discloses that its total EPV as of 31 March 2020 is $12.5 billion.[47] Assuming that its Long-Term Conversion Rate holds, it would potentially recognise average gross income of $1.87 billion on this portfolio.

Figure 9: Omni Bridgeway (IMF Bentham) EPV 2012 to 2020



[45] It is noted that the EPV figures disclosed in portfolio reports include global returns. However, regional based breakdowns of the data are not disclosed.
[46] Omni Bridgeway (IMF Bentham) Investor Portfolio Report at 30 September 2019.
[47] Omni Bridgeway (IMF Bentham) Investor Portfolio Report at 31 March 2020.

Claim sizes for Omni Bridgeway (IMF Bentham)

The funds raised by litigation funders produce enormous leverage in terms of the size of the claims they can bring with these funds. For example, Omni Bridgeway (IMF Bentham)'s Funds 2 & 3, which invest into Australia and the region, have just $180 million of committed capital. According to a portfolio report released by Omni Bridgeway (IMF Bentham) as of March 2020, Funds 2 & 3 are currently funding litigation where the total expected recovery measured by 'EPV' is $3.2 billion.[48] That means the fund can bring claims where expected recoveries are nearly eighteen (18) times larger than the fund value itself.

Uncertainty around the continued use of common fund orders

The High Court decisions involving BMW and Westpac (the *Brewster* case) held that courts may not have the power to make common fund orders at the outset of class action proceedings. However, the Federal Court quickly issued a practice note stating that the Court would make alternative orders at the end of proceedings providing the same economic benefits to litigation funders, and imposing obligations to pay the funder's commission on class members regardless of whether or not they consent to, or are even aware of, class action proceedings being run in their name.

The position on common fund orders is currently a point of contention between judges in the Federal Court. Several judges have approved common fund orders following the *Brewster* decision. However, Justice Foster delivered a powerful condemnation of the concept in his decision in the Volkswagen Diesel Emissions Class action. He said:

> *"Unfunded group members have no contractual or other relationship with the litigation funder. Nor have they any liability to the funder. The funder has no right to the proceeds of a settlement or judgment under contractual or equitable principles… [It] is clear that the [High Court] rejected the idea that, upon some free-standing independent basis, equitable principles could support the [CFO] under consideration in Brewster," Justice Foster wrote.*

[48] Omni Bridgeway (IMF Bentham) Investor Portfolio Report at 31 March 2020.

> *"In my judgment, the making of a CFO, whether at an early stage of a group proceeding or at the conclusion of such a proceeding, cannot be supported by the equitable principles … which addressed the sharing of reasonable legal costs expended in the creation of a court ordered trust fund and did not concern spreading the burden of a litigation funder's profits amongst all the beneficiaries of the trust fund thereby created, or by notions of unjust enrichment."*
>
> *"It is apparent [that Justices Murphy, Beach and Lee] are of the opinion that this court has power to make a CFO at the conclusion of a representative proceeding and should ordinarily do so, keeping a close eye, of course, upon the approved rate of commission and overall quantum of the particular funder's remuneration. Their Honours are of the opinion that the judgments of the majority in Brewster did not go so far as to decide that this court has no power to make a CFO at any time. With great respect to my colleagues, I do not think that the position is so clear."*[49]

The legal position on common fund orders remains unclear. But what is crystal clear is that common fund orders have played a large part in allowing offshore litigation funders and plaintiffs' lawyers to bring claims where very few claimants are actively engaged and bring class actions on behalf of large groups, for large amounts of money, potentially without the group members' knowledge or consent.

Somewhat surprisingly Omni Bridgeway (IMF Bentham) signalled its support for the abolition of common fund orders stating:

> *"The company advocates for a number of measures… including… introducing legislation to end the use of common fund orders and prevent the introduction of contingency fees for lawyers, as proposed by the Victorian government. <u>This would ensure that only claims which are genuinely supported by enough engaged claimants, rather than funders or lawyers alone, are commenced</u>."*[50]

Omni Bridgeway (IMF Bentham) is of course already well placed in terms of its infrastructure to bookbuild for major class actions. Perhaps it perceives a strategic commercial advantage?

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[49] Dalton & Anor v Volkswagen AG & Anor (No.2) [2020] FCA 661.
50 Omni Bridgeway (IMF Bentham) ASX Announcement, 14 May 2020.

No-win-no-fee actions delivers huge fees to plaintiffs' lawyers

As noted earlier in this report, plaintiffs' lawyers involved in funded litigation can have their fees paid by a funder for several years. This is obviously desirable from a plaintiffs' lawyers cashflow and profitability perspective. But it is not just funded litigation that is lucrative for plaintiffs' lawyers.

Matters run on a 'no-win-no-fee' basis have also proven to be incredibly lucrative for plaintiffs' lawyers. For example, Maurice Blackburn is reported to have received more than $100 million in fees for running and subsequently administering the distribution of funds for the Black Saturday bushfires class action.[51] More recently, they received $43 million from the Volkswagen diesel emissions class action – something the judge approving the settlement described as "very substantial".[52]

In cases where the likelihood of a successful outcome is high, the no-win-no-fee model carries little risk coupled with the prospect of an enormous return. This can be seen in the extraordinary efforts of the five separate teams of plaintiffs' lawyers and funders in their attempts to win the right to run the class action against AMP. Ultimately, Maurice Blackburn was successful because it agreed to run the class action on a no-win-no-fee basis.[53]

When a settlement or successful judgment is all but assured, given discovery has, in effect, already occurred through the Royal Commission, a firm that has the resources or cashflow to run the matter stands to profit handsomely. Significantly, the decision to allow Maurice Blackburn to run the class action is being currently challenged by one of the losing teams, a US based law firm backed by a US litigation funder, in the High Court. The motivation for running a challenge all the way to the High Court was reportedly questioned by Maurice Blackburn's counsel, who said:

"[The outcome is of] great interest to [their client's] lawyers, Quinn Emmanuel, and [funder] Burford Capital, and neutral to Wigmans [their client],".[54]

[51] www.theaustralian.com.au/nation/nation/angry-survivor-returns-black-saturday-payout-to-only-winner-maurice-blackburn/news-story/ea9fe705b2616852235851e62424adea.
[52] www.lawyerly.com.au/judge-greenlights-law-firms-43m-payday-in-vw-class-actions
[53] https://www.lawyerly.com.au/law-firm-maurice-blackburn-wins-amp-class-action-beauty-contest
[54] https://www.lawyerly.com.au/amp-class-action-should-be-put-on-ice-until-high-court-decision-court-hears.

The distinction between plaintiffs' lawyers and funders is also beginning to blur. Maurice Blackburn already owns its own litigation funding firm, Claims Funding Australia[55] and Claims Funding Europe, which is based in Ireland.[56] These entities claim to "provide access to justice through our financial support of claimant litigation".[57]

Maurice Blackburn have also commenced class actions in the Supreme Court of Victoria in anticipation of being able to charge US-style 'contingency fee' commissions from the proceeds of class actions. One action against NAB was reportedly filed before the legislation enabling the charging of such fees had even passed through the Victorian Legislative Assembly.[58] Litigation funders have also considered becoming law firms. The legal periodical *Lawyerly* reported that Omni Bridgeway has contemplated establishing its own law firm if the contingency fee bill passes in Victoria.[59]

Litigation funders are already providing 'financial cashflow solutions' to law firms that are running class action matters on a 'no-win-no-fee'. This approach is something which Omni Bridgeway (IMF Bentham) has openly contemplated, revealing in an investor presentation from March 2020 that it has considered "funding law firms on a portfolio basis, as it does in the US".[60]

A number of plaintiffs' firms are routinely charging hourly fees in 'no-win-no-fee' class actions approaching $1,000 per hour. When the fee arrangements also include 25% fee uplifts for success, this rate would be approaching $1,250 per hour. The ability to quickly generate large fees at these rates is significant. These rates are well in excess of those charged by the firms engaged in the defence of class actions.

The same opt-out systems which enables litigation funders to easily commence litigation on behalf of large groups of people without their knowledge or consent also benefits plaintiffs' lawyers running 'no-win-no-fee' matters also.

[55] https://claimsfundingaus.com.au
[56] https://claimsfundingeurope.eu/
[57] https://claimsfundingaus.com.au
[58] https://www.theage.com.au/national/victoria/class-action-law-reform-could-see-big-firms-cash-in-20200226-p544kw.html
[59] https://www.lawyerly.com.au/litigation-funding-giant-considers-launching-own-law-firm-in-response-to-class-action-reforms
[60] Omni Bridgeway (IMF Bentham) Investor Presentation March 2020

Oversight of litigation funding agreements

Litigation funders and their supporters point to the fact that the commissions they receive are 'approved' by the court as part of the settlement process. This is intended to leave class members and the public with the impression that the approval process has involved a careful assessment of the commission and other fees and charges claimed by the funder by an independent entity seized with all of the relevant facts. On this basis they argue that regulation and independent oversight is unnecessary.

As demonstrated above, this belief is simply not true.

The judges do not have the experience and training in corporate finance to properly assess the risks and returns. Nor does the legislation require them to. They are not provided with the data required to undertake the exercise and receive no assistance from the parties. Even the appointment of an independent contradictor is a laboured exercise. The idea that a lawyer is the best person to appoint to explain, using principles of corporate finance, why a fee structure is reasonable is baffling. Consequently, courts are left as unwitting accomplices in what is unconscionable conduct on the part of the litigation funding industry. The litigation funding industry operates without any true 'market'. The returns are only possible because they are approved and enabled by a judge. Most concerningly, the levels of these returns defy all understood corporate finance principles of risk-adjusted return and escape all meaningful scrutiny.

Regulating the Industry

There have been repeated calls for the regulation of the litigation funding industry.

They have come from groups as diverse as the Productivity Commission, law reform commissions, trade unions, consumers caught up in class actions and even litigation funders themselves.

The vices that attend the litigation funding industry, the lack of oversight and the failure of the few mechanisms for consumer protection that may apply to the industry are well documented. See for example the report of the Victorian Law Reform Commission published in 2018 and the Australian Law Reform Commission's Discussion Paper of the same year.

Rather than repeat that material again here in detail the following is a summary of the key issues that must be addressed in addition to the question of the returns to class members and funders.

Conflict of Interest

Litigation funders face fundamental conflicts of interest in terms of their dealings with their clients. Those clients are often amongst the most vulnerable members of the community. They do not have the benefit of independent legal or financial advice – indeed, the lawyers who purport to represent them are themselves hopelessly conflicted.

This problem is exacerbated by the fact that litigation funders take the view that they do not owe a fiduciary duty to their clients – indeed, some even seek to contractually extinguish such a duty should it exist. Unlike other participants in the Australian financial services industry they do not have a statutory obligation to act in the best interests of their clients.

Meaningful disclosure

The level of disclosure to the clients and potential clients of litigation funders varies wildly. Given the potential for a class member to sign away fifty per cent or more of the compensation it is imperative that there be full and meaningful disclosure to those clients and the court.

The terms of the funding agreement

The terms offered by different funders and the way in which those terms are described lack any consistency. The are no minimum requirements in terms of what is offered or the way in which key obligations, including the funders remuneration, is described.

Control of the proceedings

While litigation funders are like to portray themselves as simple financiers of litigation which is then left to the client and 'their' lawyer to run the case this is clearly untrue. The litigation funder controls the proceedings, makes the key strategic decisions and will ultimately determine when and what terms the proceedings will be settled. While class members, or some of them, may be 'consulted', the final decision will rest with funder as has been demonstrated in a number of recently, well published, disputes between funder and client.

Foreign funders

Many litigation funders in Australia are foreign entities with little or no local presence. Enforcement of their clients' rights will be difficult if not impossible unless the funding agreements are governed by Australian law

For example, while the industry makes much of the obligation of funders to meet any adverse costs order some ligation funders do not indemnify their clients. Rather, they force the client to take out an after the event insurance policy – at the ultimate cost to the client – to meet that obligation.

Character and qualification requirements

Litigation funders promote and have effective control of significant litigation against corporations, financial institutions and governments. They have the ability to affect share prices and both corporate and government policy. There are however no character qualifications or tests required of those that control and mange funders that operate outside a corporate structure. Similarly, there are no minimum qualification standards notwithstanding funders are providing both legal and financial services and advice.

Prudential supervision

Notwithstanding the role funders are providing in financing litigation they are not subject to any minimum prudential requirements let alone prudential supervision or oversight.

While a funder will sometimes be obliged to provide security for a potential adverse costs order no such protection is offered to the funded clients to ensure that the funder has the resources to complete its obligations to fund a trial to its conclusion.

Recommendations

Our suggested approach to reforming and restoring integrity into our legal system centres around three key recommendations.

1. **Class members must consent to join a class action and incur a liability to a funder**

Cases should only be run on behalf class members who have given their express, informed consent to participate in the class action. Class actions should be run on an 'opt in' basis to ensure that only those who wish to participate in a class action are joined. This would dissuade the commencement of speculative actions on behalf of large classes where only a limited number of members are sufficiently motivated to participate but would not extinguish the claims of those that did not participate.

2. **Regulate litigation funders**

Litigation funding is a financial product. Funding is provided to class members in exchange for a commission which is taken from the class member's compensation.

At present, any company or individual, domestic or foreign, can provide litigation funding with no meaningful regulation or oversight. There is no legitimate reason why these arrangements should not be subject to regulation like every other financial product.

The following key changes should be made:

- Licensing: Require litigation funders, and any law firms seeking contingency fee commissions (should that be allowed), to hold an AFSL and regulate their practices through ASIC. This would cover both state and federal funded class actions.
- Consumer protection for financing - disclosure and consent: As with any other financial product, consumers should be provided with clear disclosure statements before entering into the funding agreement and must agree in writing to the terms of commission arrangements.
- Limit excessive returns on investment: As part of any licensing regime, incorporate limits on the commissions and returns that litigation funders can charge. These could be benchmarked against private equity returns and should be measured using the same profit measures funders themselves use.
- Jurisdiction: Require foreign funders to adopt Australian law for their contracts and submit to the jurisdiction of the Australian Courts.

- Control of proceedings: Prohibit litigation funders exerting control over proceedings.
- Best interests: Require litigation funders to act in the best interests of class members, as is the case for other financial advisers.
- Prudential & other requirements: Ensure that litigation funders satisfy capital adequacy requirements.

3. Stop forum shopping

Ensure that class actions based on federal law, e.g. *Corporations Act, Fair Work Act* and securities law, remain the sole jurisdiction of the Federal Court of Australia.