Submission on Corporations Amendment (Improving Outcomes for Litigation Funding Participants) Bill 2021

Executive Summary

1. Clarity is required around the scope of 'funding agreements.'
2. Consistent with the Parliamentary Joint Committee on Corporations and Financial Services Report, *Litigation funding and the regulation of the class action industry* (2020) ('PJC Report'), the submission argues that courts should have an express power to make Common Fund Orders (CFOs).
3. The submission supports the introduction of a power to approve or vary litigation funding agreements (LFAs) but queries the exclusive factors to be applied in the exercise of the power.
4. The submission supports the use of litigation funding fee assessors but not contradictors unless a FEO/CFO is sought.
5. The submission queries the utility of a presumption in favour of a ≥ 70% return to class members.

The submission is made pursuant to the author's role as Professor of Law at the University of South Australia, Justice and Society. The author's contact details are:

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Introduction

The Bill proposes to introduce a specialist regime for class action litigation funding schemes as a sub-set of Managed Investment Schemes (MIS) under Chapter 5C *Corporations Act 2001* (Cth). This reflects: (1) An imminent challenge to the ruling in *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd* (2009) 260 ALR 643 which may result in litigation funding of class actions falling outside Ch 5C *Corporations Act 2001* (Cth); (2) The need to create a specialist set of rules to address litigation funding because Ch 5C is perceived as inadequate for its regulation; and (3) The view that litigation funders are making unjustified windfall profits at the expense of class member interests.

In relation to (2) above, the cumulative effect of parts of the Bill require consideration. As a result of regulatory changes introduced by the *Corporations Amendment (Litigation Funding) Regulations 2020* (Cth), litigation funding was made subject to the general provisions of Chapter 5C as well as Chapter 7 *Corporations Act 2001* (Cth). To date there has been little experience to determine the effectiveness of these 2020 changes in addressing funding costs and self-serving behaviour by funder-lawyer teams. The requirements imposed under Chapter 5C and Chapter 7 are comprehensive and onerous. They include the duty to: (1) act honestly, efficiently and fairly; (2) implement internal and external dispute resolution schemes; (3) have adequate risk management systems; (4) register the scheme with ASIC and appoint a responsible entity; and to (5) create and lodge a compliance plan. The main impact of these changes has

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been a substantial decrease in funded class actions.[1] Consequently, without an assessment of the efficacy of the 2020 regulatory changes, the evidence that the further constraints contained in the Bill are required to ensure fairness and reasonableness is weak.

In relation to (3) above, I refer to an earlier submission I made to the PJC regarding judicial oversight of litigation funding fees: '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 ('Money Max')* [2] 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.'[3] Empirical evidence collated by Professor Vince Morabito confirms that litigation funding fees have not been outlandishly high.[4] Between 2013 and 2018, 26.87% of all the settlement proceeds generated in all funded class actions ($582,953,453 out of $2,169,021,672) were applied towards funding fees. During that time the median funding rate was 25.5%. Professor Morabito also found that a funding rate of over 40% only applied in 4.7% of cases. A review of post *Money Max* case law undertaken by Professor Morabito found that in most instances funder commissions were even lower than the 2013 – 2018 average and median commission rates.[5]

Clarity around the scope of 'funding agreement'

Funding agreements are made unenforceable unless they are approved or varied under s 601LF. Consequently, clarity over what is meant by a 'funding agreement' is essential. Section 9AAA (1) (c) defines a funding agreement as an agreement by the funder to provide funds or indemnities. The other party to the agreement is not specified. The definition appears broad enough to include an agreement solely between a funder and a class law firm, where the funder is entitled to a share of the class law firm's fees generated by a class proceeding if it provides funding to the firm. If so, this does not align well with s 601LG.

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1 Cat Fredenburgh, 'Class Action Filings Plummet as Law Firms, Litigation Funders Regroup' *Lawyerly* 2021-09-03.

2 (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.

3 Vicki Waye, Submission on Litigation Funding and the Class Action Industry, Parliamentary Joint Committee on Corporations and Financial Services Inquiry (June 2020).

4 Vince Morabito, An Evidence-Based Approach to Class Action Reform in Australia: Common Fund Orders, Funding Fees and Reimbursement Payments (January 31, 2019). Available at SSRN: https://ssrn.com/abstract=3326303 or http://dx.doi.org/10.2139/ssrn.3326303. These empirical findings are consistent with findings made by Cashman and Simpson who found that between 2001 and 2020 funding commissions in funded cases comprised on average approximately 26% of the settlement amount: Cashman, Peter Kenneth and Simpson, Amelia, Research Paper #5: Costs and Funding Commissions in Class Actions (December 11, 2020). UNSW Law Research Paper No. 20-87, Available at SSRN: https://ssrn.com/abstract=3765081 or http://dx.doi.org/10.2139/ssrn.3765081

5 Morabito n 4, 15 – 20.

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The power to make CFOs

Under a proposed amendment to s 9 a member of a class action litigation funding scheme must agree in writing to be a member of the scheme and be bound by the scheme's constitution. This proposed amendment reflects the existing law. Under the current law unless the court makes a CFO or Funding Equalisation Order ('FEO'), class members are not legally liable to contribute towards funding commissions without an agreement. What s 9 does, however, is ensure that such agreements can only be enforced if approved or varied by a court. Consequently, it remains possible for litigation funders to book build the scheme and for the lead plaintiff to constitute the class as an open class. This has occurred in the past on the understanding that funding commissions would be equitably exacted across the whole class via CFOs or FEOs.

However, contrary to the recommendation of the PJC's 2020 Report, under the Bill the existence of a judicial power to make a CFO at settlement remains uncertain. Although CFOs are carved out from court approval of the scheme's claims distribution, proposed s 601LF (7) states that nothing in s 601LF implies that the court has the power to make a CFO. Regulatory Impact Analysis accompanying the Explanatory Memorandum indicates that FEOs which provide no financial return to funders are the preferred means to ensure equitable spreading of funding costs between class members.

While it is true that FEOs will result in greater returns to class members, funders who cannot recover from non-scheme members will not be able to make underwriting class actions viable unless they are able to recruit a critical mass of class members to the class action litigation funding scheme. Under these conditions it is likely that the volume of funded class actions will fall further, and that funders will only support 'closed class proceedings.' Even where the proceedings are constituted as an open class proceeding, expensive book building will still be required. Imposing the cost of book building apropos scheme members will work against lowering funding costs and therefore act against the interests of class members as a whole.

The lack of certainty regarding CFOs is likely to lead to the proliferation of 'closed classes' in relation to the same matters. Open class proceedings with members who participate in various competing class action litigation funding schemes could proliferate too. Multiple class actions incorporating similar factual and legal issues are inefficient because they: undercut the purpose of the class action regime by diminishing the benefits of scale; drain precious court resources; unnecessarily increase transaction costs for scheme members; and pose significant problems for corporate defendants in terms of managing and defending multiple proceedings. These problems were recognised in the PJC Report which recommended the enactment of a power to decide that only one of competing or multiple class actions should continue. However, arguably, the Bill's framework throws the High Court's decision in *Wigmans v AMP Ltd* (2021) 95 ALJR 305 ('*Wigmans*') into doubt. This decision supported efficiency for both class members and defendants by clarifying the court's powers to stay competing class actions. In light of a legislative policy that favours multiple closed classes for funded proceedings, *Wigmans* may require review.

Significantly, reverting to closed classes for funded proceedings is likely to make the funding of certain types of proceeding less feasible and reinstate the skewing of litigation funding toward securities class actions. It is likely that classes with diffuse low value claims and difficult to identify class members such as classes formed for the purpose of pursuing consumer or competition law breaches will no longer be able to attract funding.[6] It will be too expensive for funders to 'sign-up' large numbers of unknown, low

[6] See eg *McKay Super Solutions Pty Ltd (Trustee) v Bellamy's Australia Ltd (No 3)* [2020] FCA 461, [16] Beach J.

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value claimants. Skewing of litigation funding towards certain high value claims like securities matters is therefore likely to decrease access to justice for other types of claim.

The power to approve or vary litigation funding agreements

In a liberal market-oriented economy like Australia's, the overriding of freely agreed contractual terms is exceptional and only justified on the basis of egregious unfairness or significant market failure. Market failure can be caused by information asymmetry and significant imbalance in bargaining power. Both of these were cited in *Money Max* as justification for the Court's decision that it could determine funding rates.[7] Since then, however, there have been varying views as to whether such a power exists beyond the ability to make a CFO.[8]

Both the Australian Law Reform Commission ('ALRC') and the PJC Report recommend the enactment of an express statutory power to approve or vary litigation funding fees. Given the preference for FEOs in the Regulatory Analysis Statement which would require non-scheme members to contribute to the funding costs of scheme members in an open class proceeding, implementation of an express power to approve or vary a litigation funding rate and then apply that pro rata between class members is supported.

However, it is more difficult to support intervention where parties freely enter such agreements in a closed class where all class members have voluntarily entered the class litigation funding scheme. In that regard, it is important to note that s601LG (1) only applies to scheme member agreements. The only matter relevant to non-scheme members is the rebuttable presumption in favour of a ≥ 70% return set out in s 601LG (5). As a result of the legislation, we may therefore end up with a situation where the court approves a claims distribution method for scheme members and another claims distribution method for non-scheme members.

When considering the suitability of the factors for determining whether the claims distribution method in a funding agreement is fair and reasonable, the court is mandated to exclusively consider factors set out in s 601LG (3). The factors listed reflect much of the existing case law determining the fairness and reasonableness of legal costs, funder renumeration and other costs associated with running the class action. However, neither the scheme members' initial agreed rate nor the volume of scheme members as a proportion of the total class are listed as factors to be considered by the court in s 601LG (3). Ideally, some deference should be given to what scheme members' have themselves agreed, particularly where they form a large majority of the affected class.

There may be a query raised regarding the scope of s 601LG (3) (a) (ii) and how it is different from s 601LG (3) (a) (iv) and (v). For example, how is the reasonableness of legal costs to be assessed without reference to whether the proceedings have been managed efficiently in the members' best interests?

Finally, it does not seem necessary to make the factors that the court should consider under s 601LG (3) exclusive rather than inclusive. Unnecessarily limiting court discretion may lead to unintended consequences such as not being able to take account of the majority of class member wishes.

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7 Nonetheless it is important to be aware that almost all consumer/small business contracts involve information asymmetry and imbalance in bargaining power but that price and term setting by the legislature is the exception rather than the rule except in the case of high vulnerability (eg the regulation of maximum interest rates under the *National Consumer Credit Code*).

8 Eg compare *Earglow Pty Ltd v Newcrest Mining Ltd* [2016] FCA 1433 [115 – 120] with *Liverpool City Council v McGraw-Hill Financial, Inc* [2018] FCA 1289, [42, 52]

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The use of litigation funding fee assessors and contradictors

There are inevitable conflicts of interest that arise between funders, class members and the class law firm at settlement/judgment regarding reimbursement of legal costs and the payment of funder fees and commissions. The oversight of the court is meant to mitigate these conflicts by ensuring rigorous scrutiny of legal costs and funder fees. However, because the funder, class law firm and defendant are all seeking to have their case finalised, there may be a lack of adversarial interrogation regarding fees and charges. Relationships between funders and class law firms including repeat financial arrangements between them exacerbate the conflicts. Concerns regarding the independence of costs assessors appointed by class law firms have also been raised.[9]

Bolitho v Banksia Securities Ltd (No. 18) [10] exemplifies the problems that arise when these conflicts of interest are not adequately managed. Using an independent litigation funding fee assessor to evaluate the reasonableness of funder commissions is therefore supported. An independent costs assessor appointed by the court rather than the class law firm to evaluate the reasonableness of legal costs is also recommended.

However, appointment of a contradictor unless the interests of justice dictate otherwise is not supported. Contradictors are very expensive and will inevitably push up the cost of funding that class members will have to bear albeit indirectly as part of the funder's commission. If a fees assessor is available to the court outlining the risks and appropriate return for funders and the court carefully scrutinises the reasonableness of legal costs it seems that fairness and reasonableness can be ascertained without the necessity of a contradictor as a matter of course. Accordingly, contradictors should only be appointed vis-à-vis funder commissions where warranted. The interests of justice may best be served where the funding costs are to be spread to class members who have not freely entered the scheme, that is, where a FEO/CFO is sought or where scheme members raise concerns.

The presumption in favour of a ≥ 70% return to class members

The establishment of a benchmark minimum 70% return to class members emphasises the compensation rationale of representative proceedings but significantly downplays their capacity to deter harmful conduct. In modelling conducted by PWC on behalf of Omni Bridgeway, it was estimated that 'in 36% of reported class actions supported by litigation funders, a 30% cap on gross returns would not have covered the litigation costs (even before consideration of any return to funders).[11] Such modelling indicates that a significant proportion of meritorious class proceedings might not proceed.

While cast as a rebuttable presumption allowing a court to approve a smaller return to class members, s 601LG (5) operates as a strong signal to funders that unless the total compensation pool is very large and litigation risk small (making legal and funding costs proportionately lower) that funding is not viable. This benchmark is therefore also likely to skew litigation funding away from certain types of small-scale claims or claims concerning ambiguous areas of law. Given that funding costs have fallen post *Money Max* and the proposed introduction of a funding fee assessor, a benchmark that will only facilitate very large-scale funded claims is not supported.

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9 Michael Legg, 'Class Action Settlements in Australia – The Need for Greater Scrutiny' (2014) 38 (2) *Melbourne University Law Rev*iew 590.

10 [2021] VSC 666.

11 PWC, Models for the Regulation of Returns to Litigation Funders (2021), 15.