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9 June 2020

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

By email:

Dear Secretary

Inquiry into Litigation funding and the regulation of the class action industry

We are experienced academics with a keen research interest in insolvent litigation funding. Aspects of our research will be relevant to Terms of Reference (6) the regulation and oversight of the litigation funding industry and litigation funding agreements; (10) the effect of unilateral legislative and regulatory changes to class action procedure and litigation funding; and (14) any matters relevant to these terms of reference.

We note the emphasis of the inquiry on litigation funding in a class action context. However, commercial litigation funding is also being used regularly and with much success in the context of insolvent winding-up. We recognise that any regulatory reform in respect of litigation funding, driven by perceived issues in respect of litigation-funded class actions, could also have an impact on the availability and operation of litigation funding in insolvency. We therefore suggest that it is important to separate 'class action' concerns from 'litigation funding' concerns, to ensure that any potential regulatory reform will offer a balanced response targeted at specific issues as they arise in a certain context. As such, our submission is confined to and supportive of aspects in regard to potential regulation of litigation funding, rather than regulation of the class action industry.

Context

It is a well-known fact that the law provides insolvency practitioners acting as liquidators with certain 'mechanisms' to enable them to increase the pool of assets available for general distribution among unsecured creditors. These include, for example, actions against directors for breaches of duties,[1] or a range of voidable transactions.[2] However, it is also a well-known fact that a lack of funds in an insolvent company could potentially restrict the ability of the insolvency practitioner to utilise these measures. A liquidator is not obliged to litigate where there are no funds available to meet expenses under s 545(1) of the *Corporations Act 2001* (Cth).

Commercial litigation funding became available in the insolvency context as a result of the judicial interpretation in *Re Movitor Pty Ltd*[3] of the liquidator's statutory power of sale or disposition of company property under s 477(2)(c) of the *Corporations Act 2001* (Cth). This development has proven particularly useful in overcoming the funding obstacle mentioned above. In the insolvency context, it is therefore clear that the involvement of a litigation funder could provide enhanced opportunity to increase the assets available for distribution among the pool of unsecured creditors, by removing the cost bar that could have hindered a liquidator to institute proceedings against directors for breach of duties owed to the company, or to recover assets through the voidable transaction regime.

However, concerns that have been raised generally also exist in the insolvency context about the use of litigation funding. These are often in relation to the size of the premium negotiated with the litigation funder; control over the litigation; conflicts of interest; and the availability of litigation funding leading to a proliferation of vexatious proceedings. Despite this, the third-party litigation funding industry has been growing very rapidly and continues to do so. In fact, it appears that commercial development in this context is happening at a much faster pace than formal regulatory attempts to address some of the concerns that have been raised, causing a clear 'regulatory gap'. This rapid growth encompasses litigation funding involving insolvency administrations.

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[1] In the Australian context, these could include actions against directors on the basis of a breach of general law fiduciary type duties or duty of care, skill and diligence, as well as statutory directors' duties to act in good faith in the best interests of the company (*Corporations Act 2001* (Cth), s 181(1)), to act with care and diligence (*Corporations Act 2001* (Cth), s 180(2)), to prevent insolvent trading (*Corporations Act 2001* (Cth), s 588G), etc.
2 For example, unfair preferences (*Corporations Act 2001* (Cth), s 588FA), uncommercial transactions (*Corporations Act 2001* (Cth), s 588FB), unreasonable director-related transactions (*Corporations Act 2001* (Cth), s 588FD), etc.
[3] (1996) 14 ACLC 587.

Judicial oversight as a means to fill the regulatory gap

In the Australian context, statutory requirements in the *Corporations Act 2001* (Cth) that agreements made by a liquidator require Court approval, where the term of the agreement is more than three months,[4] has created an opportunity for the Court to become involved in 'approving' litigation-funding agreements. As a result, a system of 'judicial oversight' in respect of insolvent litigation funding agreements has developed. This development has succeeded, to some extent, in filling the existing 'regulatory gap', due to the Court having developed a set of Common law guidelines or principles that will be taken into consideration when approving insolvent litigation funding agreements. The Court indicated that it will not merely 'rubber-stamp' whatever is put before it by the liquidator and that it will carefully scrutinise the proposed agreement.[5] Furthermore, the Court has developed certain principles that it will consider when sanctioning a funding agreement. These are typically related to matters such as the prospects of success of the proposed litigation; possible oppression; the nature and complexity of the cause of action; the extent to which the liquidator has canvassed other funding options; the level of the funder's premium; consultations with creditors; and the risks involved in the claim.[6] An analysis of the Court's application of these principles in cases involving an application for approval of an insolvent litigation funding agreement, appears to indicate a willingness to engage meaningfully with the concerns about litigation funding highlighted in the previous paragraph and may allay some concerns in respect of the regulatory gap. The Court is clear, however, that the standard required for approval under s 477(2B) of the *Corporations Act 2001* (Cth) does not involve exercise of a commercial judgment in respect of the terms of the agreement, but only requires an assessment of whether the entry into the litigation funding agreement is a proper exercise of the liquidator's power, and not ill-advised or improper.[7]

Judicial scrutiny of litigation funding of class actions is similarly required.[8] There are conflicting views about the extent of the Court's inherent discretion in this regard. In some instances, the Court indicates its preparedness to use this opportunity to intervene where it is of the view that the funding premium is excessive, to the extent that it would vary, of its own motion, the terms of the litigation funding agreement.[9] This view is not shared by all,[10] and in other cases, the Court has indicated that an excessive premium could cause it to refuse to approve the settlement,[11] rather than considering the possibility of varying the terms of the agreement.

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[4] *Corporations Act 2001* (Cth), s 477(2B).
[5] *Stewart re Newtronics Pty Ltd* [2007] FCA 1375, at [26].
[6] See eg *Re ACN 076 673 875 Ltd (rec'r & mgr apptd) (in liq)* [2002] NSWSC 578, at [17]-[34]; *Leigh, re AP & PJ King Pty (in liq)* [2006] NSWSC 315, at [25], (per Austin J), and endorsed by the Full Court in *Fortress Credit Corporation (Australia) II Pty Ltd v Fletcher* [2011] FCAFC 89.
[7] *Re Gerard Gassegrain & Co Pty Ltd (in liq)* [2013] NSWSC 257, at [11].
[8] Federal Court of Australia, *Class Actions Practice Note (GPN-CA)* (2019) cl 6.
[9] See eg *Earglow Pty Ltd v Newcrest Mining Ltd* [2016] FCA 1433, at [7]; [157].
[10] See eg *Liverpool City Council v McGraw-Hill Financial Inc* [2018] FCA 1289, at [51].
[11] See eg *City of Swan v McGraw-Hill Companies Inc* [2016] FCA 343, at [30].

In the absence of a formal regulatory framework, judicial scrutiny of litigation funding agreements appears to have functioned reasonably effective as a regulatory 'gap-filler'. However, on its own, it is possible that judicial oversight will not achieve optimum regulatory impact, due to factors such as uncertainty created as a result of inconsistent statements from judges about the Court's inherent discretion in relation to altering the terms of the litigation funding agreement.

Legislation or Codes of Conduct as a means to fill the regulatory gap

Legislation or a Code of Conduct could potentially fulfil a useful complementary function to judicial scrutiny insofar as regulation of litigation funders is concerned. An example of such a code is the Code of Conduct for Litigation Funders (January 2018) that exists in England and Wales. The Code sets out standards of practice and behaviour and contains a number of rules that apply to litigation funders, in relation to aspects such as capital adequacy requirements; behaviour of litigation funders; setting out the roles of litigation funders, litigants and lawyers; and who is ultimately in control of the litigation.

In Australia, the exemption to operate subject to the managed investment scheme regime and to hold an Australian Financial Services Licences that applied to litigation funders, has very recently been revoked by Treasury.[12] This obviously brings increased regulatory oversight in relation to aspects that are regulated under the managed investment scheme fund legislative regime. However, this regulatory regime has not been developed with litigation funding in mind, and some of the concerns around litigation funding mentioned previously, are not addressed by this regulation. It also raises concerns about stifling competition in this market, and the potential implications of this type of regulation for litigation that is funded by creditors in the context of insolvencies.[13] The English Code of Conduct is not ideal in the sense that it is voluntary, but is preferable for having a more targeted approach, directly aimed at regulating litigation funding practices, behaviour and legal relationships.

Conclusion

We suggest that that any regulatory measures aimed at litigation funding should be targeted at specific concerns that have been identified. A careful balance should be maintained between protecting consumers against unscrupulous funders and allowing competition in the market to develop. Increased competition could have the benefit of downward pressure on funders' fees, thus addressing the concern around the premium charged by funders. Judicial oversight of litigation funding agreements has largely proven to function successfully. An Australian industry Code of Conduct, clarifying some of the parameters within which litigation funding operates, could fulfil a useful complementary regulatory function. Such an approach would allow for the benefit of flexibility, recognising that not all litigation will be identical, and that

[12] https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/litigation-funders-be-regulated-under-corporations

[13] *Corporations Act 2001* (Cth), s 564; and equivalent provision in terms of the *Bankruptcy Act 1966* (Cth), s 109(10).

the risk taken, and role assumed by the litigation funder could vary significantly. The appropriateness of a particular litigation funding agreement remains ultimately to be considered by the Court.

In conclusion, we submit that some of the concerns that exist in respect of litigation-funded class actions are not necessarily present in the insolvency context and suggest that wider implications of potential law reform in respect of litigation funding should be given careful consideration. A targeted approach, with reforms aimed at issues that have been identified in respect of litigation funding generally, irrespective of context, is preferable. Concerns that exist exclusively in relation to litigation funding in a class-action context, whether they are of a regulatory or economic nature, are better dealt with by targeted reform in that arena.

We would be happy to answer any questions you may have in relation to our submission.

Yours sincerely

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Professor Christopher Symes (University of Adelaide)