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Access to Justice
Productivity Commission
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Dear Commissioners,

Access to Justice – Litigation Funding & Class Actions

The Australian Institute of Company Directors welcomes the opportunity to provide comments to the Productivity Commission's inquiry into Access to Justice. We confine our comments in this submission to the matters raised by section 13 of the Productivity Commission's Issues Paper which relate to litigation funding and class actions.

The Australian Institute of Company Directors is the second largest member-based director association worldwide, with individual members from a wide range of corporations; publicly-listed companies, private companies, not-for-profit organisations, charities and government and semi-government bodies. As the principal Australian professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

From the introduction of the class actions regime in the Federal Court of Australia until 2011, approximately 250 class actions were commenced in the Federal Court.[1] While the number of actions is a small percentage of the Federal Court's case load and not all of these actions have been funded, class actions brought against corporations are highly complex pieces of litigation and have the potential to impose significant burdens on the companies and directors involved. Increasingly, major litigation against corporations is being funded by professional litigation funders who commence litigation with a view to obtaining a profit. Given the costs and the extent of the disruption caused to companies facing prolonged, expensive and complex litigation, the director community is sufficiently concerned to provide comments to this inquiry.

1. Summary

In summary, the comments of the Australian Institute of Company Directors are as follows:

(a) Access to justice, including ensuring that the law is applied and enforced and that disputes are resolved fairly and effectively, is critical to ensuring the preservation of the rule of law in Australia.

(b) However, access to justice must be appropriately balanced against the economic and productivity consequences which flow from allowing third party

[1] Betts J, *Class Actions and Litigation Funding* Paper to the Law Council of Australia, Corporations Workshop, 31 July 2011.

funders to be involved in extensive, time consuming and costly litigation against corporations and directors for the purpose of obtaining a profit.

(c) The approach taken to the regulation of litigation funding in Australia to date, has been one that provides little or no regulation for litigation funders. In large part this approach has sought to be supported by access to justice arguments.

(d) The access to justice arguments which support minimal regulation for litigation funders fail to recognise that in recent class action litigation access to justice has been limited or undermined by:

(i) the use of closed classes in class actions which require group members to sign an agreement with a litigation funder to participate (and exclude those that do not);

(ii) the fact that many class actions are now promoted by plaintiff's lawyers and litigation funders, not by aggrieved persons seeking to commence a proceeding to quell a real controversy;

(iii) the high level of control exercised by the litigation funder over the proceedings; and

(iv) the lack of data available to determine the returns (if any) to group members who are successful, when at least 25-35% of the return is commonly taken by the funder and a percentage of the remaining amount is used to cover the costs of the legal representatives.

(e) We remain of the view that litigation funders should be subject to an appropriate regulatory regime that, at least:

(i) provides certainty for participants in litigation that involves litigation funding;

(ii) protects potential members of a group intending to enter into a litigation funding arrangement and prescribes specific common safeguards and procedures;

(iii) prevents law firms from establishing related litigation funding providers;

(iv) requires litigation funders to meet certain prudential requirements so that funders have sufficient assets to meet any relevant costs orders made against them or the members of the plaintiff group; and

(v) ensures that foreign litigation funders who finance actions in Australia have sufficient assets to satisfy costs orders and that those cost orders and the funding agreements entered into with persons located within Australia, can be enforced.

(f) Further, we are of the view that the Government should undertake a detailed analysis as to whether a regulatory regime which encourages the proliferation of funded class actions against corporations is in the best interests of the Australian economy.

2. Background to the regulation of litigation funding in Australia

In 2012 the Federal Government introduced Regulations[2] which exempted funded class actions from being 'managed investment schemes' under the Corporations Act and exempted litigation funders from being required to hold an Australian Financial Services License (AFSL).

Prior to the introduction of the Regulations, the Australian Institute of Company Directors stated that while some of the provisions of the AFSL regime may be appropriate for the regulation of litigation funding[3] we were of the view that not all of the provisions regulating AFSL holders were a good fit for litigation funding arrangements. We further stated that we did not believe that the Regulations put in place were the most effective way to regulate litigation funders, "given that only one aspect of an appropriate regulatory regime (being the regulation of conflicts of interest) is addressed by the Regulations."[4]

Despite the Australian Institute of Company Directors concerns about the Regulations, the Regulations were adopted and followed by ASIC Regulatory Guide 248 *Litigation schemes and proof of debt schemes: Managing Conflicts of Interest*. Regulatory Guide 248 sets out how, in ASIC's view, litigation funders should appropriately manage their conflicts of interest arrangements.

In summary, the approach taken to the regulation of litigation funding in Australia to date, has been one that provides little or no regulation for litigation funders. In large part this approach has sought to be supported by access to justice arguments. The Australian Institute of Company Directors is of the view that the approach to the regulation of litigation funders is flawed and that access to justice, while significant, is only one of a number of factors that needs to be considered when policy decisions related to funded class actions are made.

3. Access to justice is only one consideration

In *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* Justices Callinan and Heydon in a minority decision, stated "the purpose of court proceedings is not to provide a means for third parties to make money by creating, multiplying and stirring up disputes in which those third parties are not involved and which would not otherwise have flared into active controversy but for the efforts of third parties....and...with the motive not of resolving disputes justly but of making very large profits."[5]

The Australian Institute of Company Directors is concerned that access to justice arguments have overshadowed the commercial reality of how modern class actions (particularly shareholder class actions) originate and are conducted. For example, the access to justice arguments which support minimal regulation of litigation funders fail to recognise that in recent class action litigation access to justice has been limited or undermined by:

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[2] The *Corporations Amendment Regulation* 2012 (No 6)(C'th) as amended by the *Corporations Amendment Regulation* (2012)(No 6) *Amendment Regulation 2012* (No 1) commenced on 12 July 2013.

[3] For example, the need to have in place adequate arrangements for the management of conflicts of interest (s 912A(1)(aa) of the Corporations Act) and the need to have dispute resolution system in place (s 912A(1)(g) of the Corporations Act)

[4] Australian Institute of Company Directors' submission to Federal Treasury *Funded Class Actions, Corporations Amendment Regulations 2011* dated 17 August 2011, available at www.companydirectors.com.au.

[5] (2006) 229 CLR 386

(a) the use of closed classes in class actions which require group members to sign an agreement with a litigation funder to participate (and exclude those that do not);

(b) the fact that many class actions are now promoted by plaintiff's lawyers and litigation funders, not by aggrieved persons seeking to commence a proceeding to quell a real controversy;[6]

(c) the high level of control exercised by the litigation funder over the proceedings; and

(d) the lack of data available to determine the returns (if any) to group members who are successful, when at least 25-35% of the returns are commonly taken by the funder and a percentage of the remaining amount is used to cover the costs of the legal representatives.

In addition, little attention has been paid to the impact of these claims on Australian productivity and the economy as a whole.

The excessive cost of class action litigation to companies and the distraction it provides for boards, directors and management where those claims are unmeritorious should not be under-estimated. As noted by Justices Sundberg and Dowsett in *Brookfield Multiplex Limited v International Litigation Partners Pte Ltd* [2009] FCAFC 147: "it is not unknown for somebody without a cause of action to make an unmeritorious claim and enjoy a degree of success." It should therefore not be assumed that the prevalence of settlements in class action litigation has arisen because the funded plaintiffs have had strong claims.

The commercial reality is that directors may feel that it is prudent to settle this type of litigation because it distracts the board and employees from focusing on core business activities. The cost and time involved in defending these actions is extensive and there are still many unsettled areas of Australian class action law, particularly in relation to actions commenced by shareholders, which adds to the level of uncertainty for companies.[7] The commencement of a large scale shareholder class action can itself place pressure on the target entity's share price.

While access to justice is critical, the economic considerations of allowing litigation funders to initiate litigation with a view to forcing settlements for profit should not be ignored. Further, any recovery ordered against a company in a market based class action commenced by one group of shareholders is ultimately borne by another group of shareholders, being those holding the company's shares at the time of settlement. Consideration should be given as to whether this re-allocation of resources amongst shareholders through the class action mechanism (with lawyers and funders in between) represents sound economic policy.

Class action litigation due to its size and scale can impose costs on the public in the form of higher consumer prices, the diminution of share value (reflected in superannuation account balances) and decreased tax revenue (as corporate profits decline). While the focus has been on the access to justice arguments which support litigation funding for

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[6] For example in *Kirby v Centro Properties Limited*, Justice Finkelstein stated in relation to the three proceedings commenced "Each is an example of a relatively new phenomenon in Australia, namely lawyer-driven litigation. This is litigation where the lawyer investigates the potential for a claim and recruits the plaintiff and often the group on whose behalf a class action initiated. Sometimes the person who is named as the plaintiff is simply a figurehead, with little at stake, and who is usually not very well informed about the theories of their case. The most common recruiting method is direct advertisement, often through the lawyer's website or the internet." *Kirby v Centro Properties Limited* (2008) 253 ALR 65 at 67

[7] See for example, Grave, Watterson & Mould *Causation, Loss and Damage: Challenges for the New Shareholder Class Action* (2009) 27 C&SLJ 483

major class actions, little attention has been paid to the impact of such actions on Australian productivity and the economy as a whole.

For these reasons, the Australian Institute of Company Directors has long called for a detailed analysis to be undertaken as to whether a policy setting which encourages an increase in, or a proliferation of, funded class actions is in the best interests of the Australian economy.

4. Preferred approach to regulation of litigation funders

The Australian Institute of Company Directors continues to be of the view that litigation funders should be expressly regulated. We are of the view that this regulation could be most effectively achieved by the creation of a separate category of license in Chapter 7 of the Corporations Act which addresses at a minimum, the aspects of an appropriate regulatory regime for litigation funders referred to in section 5 below. Alternatively, litigation funders could be required to obtain an AFSL under the current regime which prescribes certain conditions relevant to litigation funding arrangements.

We are of the view that a *tailored licensing regime* would be more effective than:

- regulating funded class actions and litigation funders under a regulatory regime designed for managed investment schemes and other more traditional financial products and services; or

- exempting litigation funders, as is the case under the current regime, from holding a license with a requirement to merely have adequate conflict of interest arrangements in place.

Tailored and specific licensing regimes are not uncommon under the Corporations Act. For example, market operators and operators of clearing and settlement facilities, as examples, are all subject to specific licensing requirements. We therefore see no reason why litigation funders could not be specifically regulated under the Act. A small number of provisions would be sufficient to address the specific characteristics of an appropriate regulatory regime as identified in section 5 below.

Similarly, if our preferred approach of adopting a new category of licence under Chapter 7 is not envisaged, it would not be difficult for litigation funders to obtain an AFSL and have ASIC prescribe specific litigation funding license conditions which address the requirements identified in section 2 above.

We are of the view that a tailored licensing regime would provide certainty for plaintiffs, defendants and funders, would assist to reduce the ancillary litigation relating to the conduct of litigation funders and the nature of litigation funding agreements, and would save the public from "obscure legislation"[8] and regulation.

The Australian Institute of Company Directors continues to be of the view that it is more effective to directly regulate funders rather than to indirectly regulate funders by

[8] In *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50 Young JA at [152] –[153] stated: "Chapter 7 of the Corporations Act 2001 (C'th) is drafted in the most obscure and convoluted manner....I know our job is to make plain what is obscure and I know commercial lawyers are thought by the legislature to be so able to find loopholes that every possible eventuality must be thought of and covered. However, the main aim is to protect the investing public and the investing public gain little comfort from obscure legislation."

way of exemptions and the requirement to have a conflicts of interest arrangement in place.

5. Characteristics of an appropriate regulatory regime for litigation funding

The Australian Institute of Company Directors is of the view that litigation funders should be subject to an appropriate regulatory regime which goes beyond the need to simply have adequate conflicts of interest arrangements in place as required by the Regulations introduced by the previous Federal Government.

We are of the view that an appropriate regulatory regime for litigation funding should include a number of characteristics which are discussed below. As the litigation funding industry grows, there may be a need for further regulation going forward.

5.1 *Certainty*

We continue to be of the view that the Regulations leave a number of concerns and uncertainties related to litigation funding unaddressed (or addressed only by ASIC Guidance) and that this will continue to impose a burden on participants in class action proceedings. This is because ancillary or satellite litigation, which seeks clarification from courts as to the nature of litigation funding agreements and the conduct of litigation funders is likely to continue.

The implementation of a licensing regime which is specifically tailored to address the key areas of concern relating to litigation funding would assist to prevent further ancillary or satellite litigation and reduce the costs of all the parties involved. Unfortunately, we are of the view that the Regulations in place do not provide sufficient certainty for participants involved in funded litigation.

5.2 *Protection of Group Members*

Litigation funding schemes are based on allowing persons with no direct or subject matter interest in the outcome of the proceeding to pay the costs of the litigation in return for a share of the proceeds if the litigation is successful. If the predominant reason for allowing these types of arrangements is to provide access to justice, then the protection of group members by the introduction of a common set of procedural safeguards should also be considered.

We are of the view that at a national level some basic specific safeguards should be included in a licensing regime for litigation funders.

Given that it is often prior to the commencement of proceedings when the protection of group members is most warranted, we are of the view that an appropriate regulatory regime would:

(a) ensure that potential group members are not misled or deceived by litigation funders who are promoting a litigation funding arrangement;

(b) require the disclosure of any potential conflicts of interests involving the funder, to the potential group members;

(c) require the funder to have in place appropriate procedures for managing conflicts of interest and to disclose those policies and procedures to group members prior to entering into a litigation funding agreement;

(d) require an appropriate dispute resolution procedure to be put in place and disclosed to group members prior to entering into a litigation funding agreement; and

(e) require funders to encourage potential group members to seek their own independent legal advice prior to entering into a litigation funding agreement.

The insertion of such protections into a tailored licensing regime for litigation funders would ensure that a common approach to basic safeguards is observed prior to group members entering into funding agreements and regardless of the Court in which the proceeding is commenced. It is anticipated that such an approach would increase certainty and further reduce the prevalence of satellite litigation.

5.3 *Prevent law firms from establishing related litigation funding providers*

The Australian Institute of Company Directors is of the view that law firms should be prohibited from establishing related litigation funding businesses. Aside from the obvious conflicts of interest this would create and the potential for breaches of legal profession legislation, we are of the view that allowing affiliated businesses would provide a mechanism for law firms to circumvent the current prohibitions on lawyers charging contingency fees. If a specific regulatory regime for litigation funding was implemented, we are of the view that it should expressly prohibit the granting of a litigation funding license to funders that are affiliated with law firms or legal services providers.

5.4 *Prudential regulation of litigation funders*

In considering an appropriate regulatory regime for litigation funders, it is important to recognise the significant cost burden imposed on the corporations and directors involved in such actions. Even where companies and directors are successful in defending the claims brought against them, defendants will not recoup all of the costs spent to defend the claim.

The issue of cost recovery becomes particularly critical if a third party funder does not have sufficient assets to meet any adverse cost orders made against them. While it may be argued that this issue is adequately dealt with by the defendant making a security for costs application, it is important to note that:

(a) a defendant may not be successful in obtaining security for costs;

(b) traditionally security for cost orders are limited to parties in the proceeding (rather than third parties)[9];

(c) a security for costs order is generally made at the early stages of the proceedings where the length, complexity and likely cost of the proceeding is unknown and the strength of the defendants case may not be fully appreciated; and

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9 However, note that in *Knight v FP Special Assets Ltd* (1992) 174 CLR 178, the High Court held that it was a matter for the Court's discretion to make a costs order against a non-party. See also *Caboolture Park Shopping Centre Pty Ltd (In Liq) v White Industries (Qld) Pty Ltd* (1993) 45 FCR 224.

(d) if a security for costs order is made, courts commonly take a conservative approach to the amount awarded and the security will rarely cover all of the defendants costs in the proceeding.

The comments of Justice Heydon in *Jeffery & Katauskas v SST Consulting* are particularly relevant here:

> "Defendants are frequently in a dilemma. If they seek security speedily they are accused of applying too early. If they do not seek it speedily they may obtain security only for the future, not the past, and may not even obtain security for the future. Judges are reluctant to order security for costs in large amounts perhaps fearing that this will simply prolong the litigation in an ill- disciplined way. 'The amount awarded as security is no more than an estimate of future costs and it is not reasonable to expect a defendant to make further applications to the court at every stage when it appears that costs are escalating so as to render the amount of security previously awarded insufficient.'[10] The lack of judicial generosity is one of several signs that applications seeking security for costs have little attraction for judges."[11]

The Australian Institute of Company Directors is firmly of the view that if third party funders are allowed to be involved in extensive, time-consuming and costly litigation against corporations and directors for the purpose of obtaining a profit, funders should be subject to prudential requirements to ensure that they have sufficient assets to meet any costs orders made against them. Unfortunately the Regulations in place do not include requirements for litigation funders to be prudentially regulated.

5.5 *Ensure that foreign litigation funders can satisfy cost orders*

If the current lack of regulation of litigation funding has the effect of increasing the number of new entrants to the Australian funding market, the practical implications of further foreign litigation funders operating in Australia needs to be considered.

As far as we are aware, there are currently two foreign litigation funders operating in Australia.[12] It is important that if foreign funders are allowed to operate in Australia that they also have sufficient assets in the jurisdiction to satisfy any costs orders made against them. If a foreign funder only holds assets outside of Australia it may be difficult for parties to enforce orders and if the funder refuses to pay, the assistance of foreign courts may be required. It is important that group members can enforce the terms of litigation funding agreements against foreign litigation funders. If this is not possible, successful corporate defendants may be unable to effectively retrieve the costs of defending the proceeding causing detriment to the corporation involved, its shareholders, employees, creditors and government tax revenue.

We are therefore of the view that an appropriate regulatory regime for litigation funders would ensure that foreign litigation funders maintain sufficient assets in Australia to meet prudential requirements and to satisfy any costs orders made

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[10] Heydon J citing *Knight v FP Special Assets Ltd* (1992) 174 CLR 178 at 190 -191 per Mason CJ and Deane J.

[11] *Jeffery & Katauskas v SST Consulting* (2009) 239 CLR 75 per Heydon J (dissenting), at 118 – 119.

[12] These funders are Comprehensive Legal Funding LLC and International Litigation Funding Partners Pte Limited.

against them. Cost orders and the terms of litigation funding agreements must be capable of enforcement.

We hope that our comments will be of assistance to you

Yours sincerely

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