



U.S. CHAMBER
Institute for Legal Reform

An Oversight Regime for Litigation Funding in Australia

Options Paper

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Introduction

- 1.1 This paper discusses the issues associated with third party litigation financing (TPLF) and explains why Commonwealth oversight of the industry is required. It proposes that a licencing regime applicable to TPLF funders (“litigation funders”) be introduced to ensure adequate regulation of the industry.

Background

- 2.1 Third party litigation financing (TPLF) provides financing to claimants or their lawyers for litigation costs in exchange for a portion of any recovery from the dispute.
- 2.2 The TPLF industry has its origins in financing insolvency proceedings. Following the High Court’s endorsement of third party investment in and control over litigation in *Campbell’s Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 CLR 386, there has been a growth in the number of legal proceedings financed by litigation funders. The principal area of growth has been the prosecution of complex torts or business disputes and class actions.
- 2.3 Despite this shift in the litigation landscape, the Australian government has taken a largely hands-off approach to the regulation of the TPLF industry. Under the Corporations Regulations 2001 (Cth) (Corporations Regulations), litigation funders are exempt from the Australian Financial Services Licence (AFSL) requirements as provided for in Chapter 7 of the *Corporations Act 2001* (Cth) (Corporations Act). Additionally, they are not bound by the professional rules that govern lawyers in their dealings with the Court.¹
- 2.4 As a result, litigation funders operate with minimal regulatory oversight.

Consequences of the Lack of an Oversight Scheme for TPLF

- 3.1 The involvement of litigation funders in Australian litigation in the absence of any regulatory framework has a number of consequences, including:
- (a) An increase in the number of filed and threatened claims, as there is a larger resource pool available to potential claimants and their lawyers.² The availability of TPLF can also prompt an increase in meritless and opportunistic claims, as a litigation funder's decision to invest is based upon an assessment of the prospects of a financial recovery in the lawsuit of which legal merit is only one component.³ In addition, litigation funders can spread the risk of failure in any particular case over their portfolio and among their investors;⁴
 - (b) Conflicts of interest arising between the litigation funders, the lawyer and the claimant, as a consequence of the fact that litigation funders exert a significant degree of control over strategic decisions concerning the litigation process and any settlement.⁵ This results in the claimant's interests being relegated to secondary status behind the litigation funder's profit objective, weakens the role of legal counsel and calls into question who the lawyer's "client" is. As the claimant's lawyer accedes to the control asserted by litigation funders, no one remains to protect the claimant's interests;
 - (c) A potential increase in prolonged litigation, as the typical structure of TPLF agreements deters claimants from accepting settlement offers, encourages litigation funders to draw out the litigation process, and thereby increase costs. On the one hand, a claimant is obliged to pay a portion of the proceeds of recovery to the litigation funders, and would therefore be expected to reject what would ordinarily be a fair settlement offer. Litigation funders on the other hand are often entitled to recover a greater percentage of any financial outcome the longer the dispute is pending. While this ostensibly is compensation for a longer term of investment, in reality it incentivises litigation funders to hold out for more attractive settlement offers regardless of whether the claimant's interest would be better served by early settlement.⁶ Indeed, in the first empirical study of the effects of TPLF, researchers found that increased litigation funding in Australia was "associated with slower case processing, larger backlogs, and increased spending by the courts."⁷
 - (d) Conflicts of interests arising between funded group members and non-funded group members with the increasing use of funded open class actions,

often at the expense of the non-funded group members.⁸ The funded group controls the litigation and any settlement. The non-funded group has less power and ability to challenge any decisions made by the funded group in Court proceedings or to challenge any settlements;

- (e) A conflict of interest arising in circumstances where the instructing law firm has a financial interest in the funding vehicle, and the lawyer's duties to their clients are undermined.⁹ In those circumstances there is no incentive on the part of the funding entity to minimize the legal fees. Litigation funders may accept excessive charge out rates from the lawyer, knowing ultimately that cost will be borne by the members and/or defendant in the litigation;
- (f) Lawyers may side-step the prohibition on charging contingency fees¹⁰ by creating litigation funding vehicles and/or acting in matters funded by entities in which they have a financial interest;¹¹
- (g) There is scope for "fly by nighters" to operate in the Australian market, meaning claimants and defendants cannot be confident that a litigation funder will remain solvent, or have sufficient financial resources to pay legal fees, disbursements and any adverse costs order in the event the litigation is unsuccessful.¹² Presently, there are overseas-based litigation funders operating in Australia that remain unregulated and offer no cost protection to companies that are defending claims they are funding;¹³ and
- (h) There is presently no adequate requirement of disclosure to claimants who avail themselves of a litigation funder's service.¹⁴

Licencing Regime Applicable to Litigation Funders

- 4.1 A regulatory framework applicable to litigation funders must be implemented so as to protect the interests of claimants, defendants and the Courts.
 - 4.2 Claimants must be confident that the litigation funder has the means to pursue claims appropriately, and that their rights are protected during the course of litigation. The Courts and defendants on the other hand must be assured that litigation funders provide their services ethically, are capable of meeting any adverse costs orders, and are not encouraged to pursue unmeritorious claims or unreasonably increase the duration, and therefore cost, of proceedings.
 - 4.3 In view of these objectives, a licencing regime applicable to litigation funders should be introduced. A licencing regime specific to litigation funders is warranted
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because of the distinctive nature of the financial product offered (funding in return for a portion of an amount paid to a claimant) and the forum in which the investment is utilized (in adversarial proceedings in the courts and other tribunals in which the rights of the parties must be protected and ethical issues properly addressed).

OVERVIEW OF PROPOSED LICENCING REGIME

- 4.4 A litigation funder should be required to hold a licence of a specific class. Entry into the Australian market should be limited to those funders that meet the licence requirements.
- 4.5 A licensing regime could be implemented by way of introduction of a new category of licence into Chapter 7 of the *Corporations Act*.
- 4.6 ASIC should be the designated regulatory body responsible for the administration and enforcement of this licensing regime. ASIC should be empowered to exercise the powers and discretions it presently exercises over the AFSL regime. This should include the authority to:
 - (a) licence litigation funders;
 - (b) enforce any applicable rules and regulations governing TPLF investments as required by the relevant licensing regime;
 - (c) commence enforcement proceedings and take action for non-compliance with the relevant licensing regime;
 - (d) issue both public and private instruments of relief regarding compliance with licence conditions.

CONDITIONS IMPOSED ON A LICENCED LITIGATION FUNDER

- 4.7 As a licence holder, a litigation funder should be required to comply with the specific conditions of its licence.
- 4.8 The conditions should, at a minimum, address the eight matters set out below.
 - (a) *Capital Adequacy Requirements*
 - A licenced litigation funder should be subject to prudential supervision to ensure the funding vehicle has sufficient capital in Australia to satisfy its financial obligations.
 - It is proposed that the applicable prudential requirements include those that already exist under the AFSL regime in addition to further obligations set out below:
 - satisfy the “Base Level Financial Requirements” set out in ASIC Regulatory Guide 166;

- comply with the surplus liquid fund (SLF) requirements that presently apply to specific classes of AFSL holders. This would oblige a licenced litigation funder to hold at least \$50,000 in SLF in circumstances where it holds client money or property to the value of \$100,000 or more. This may apply to litigation funders in circumstances where the funder holds in trust for the claimant any money or property received from successful litigation or any settlement offer;
- comply with the adjusted surplus liquid fund (ASLF) requirements that presently apply to specific classes of AFSL holders who are (or may become) liable for more than \$100,000 in aggregate to clients from transactions the licensee entered into with those clients. The ASLF requirement, if triggered, would require a licenced litigation funder to hold at least the sum of the following (with a maximum cap of \$100 million):
 - \$50,000; plus
 - 5% of adjusted liabilities between \$1 million and \$100 million; plus
 - 0.5% adjusted liabilities for any amount of adjusted liabilities exceeding \$100 million;
- satisfy ASIC that it has sufficient assets to cover the potential liabilities associated with an unsuccessful case; and
- maintain liquid capital reserves equal to at least twice the amount of its investments in litigation. ASIC should conduct an annual audit of the funder to ensure its financial soundness. This would ensure that a litigation funder is capable of paying legal fees, disbursements and any adverse costs order.

(b) *Disclosure Rules*

A licenced litigation funder should be required to disclose certain information to consumers and the market. This would ensure that potential claimants are not misled as to who is promoting the funding arrangement, and that any potential conflicts of interest are disclosed.

On this basis, it is proposed that a licenced litigation funder should be required to issue a Product Disclosure Statement (PDS) containing similar requirements to the current obligations applicable to AFSL holders. That PDS must, at a minimum:

- (i) set out the following matters:
 - dispute resolution procedures that would apply in the event of a dispute or disagreement between a claimant and the litigation funder;

- how a claimant may raise concerns in relation to the funding arrangement; and
- how a claimant may obtain independent legal advice.

(ii) disclose the following information:

- the identity and relevant interests of all members of the litigation funder's Board of Directors, senior executive Officers and funders;
- how costs will be calculated, including the litigation funder's fees; and
- in the event that the proceedings are concluded by way of settlement, the settlement amount, the way in which the proceeds of settlement are distributed as between the claimants, the instructing lawyers and the litigation funder (including amount distributed to members and median distribution to funders).

These disclosure requirements should be included as a condition of a litigation funder's obtaining (and maintaining) the licence.

(c) *Breach Reporting*

A licenced litigation funder should be subject to the existing breach reporting requirements that apply to AFSL holders under the *Corporations Act* and ASIC Regulatory Guide 78.

On this basis, it is proposed that a licenced litigation funder should be required to:

- notify ASIC in writing within 10 business days about any significant breach (or likely breach) of its obligations as a licence holder. This notification obligation should apply to all licence conditions, disclosure obligations and capital adequacy requirements; and
- maintain appropriate breach registers and compliance reporting.

(d) *Minimum Content of TPLF Agreements*

A licenced litigation funder that purports to enter into a funding arrangement, must ensure that the arrangement is covered by an agreement in writing that addresses the following matters:

- an indemnity in favour of the claimant to pay any adverse cost orders;
- disclosure of the fees payable to the funder, including an estimate of costs;

- identification of the obligations and rights of the litigation funder, in particular, the level of control over decision making in the litigation and termination rights;
- identification of the obligations and rights of the instructing lawyers;
- disclosure of any contractual or other relationship between the funder and the lawyer; and
- identification of the obligations and rights of the potential claimant. The ability to control significant decisions relating to the proceedings, such as those that may settle the proceedings or that increase the cost or duration of the proceedings must be reserved to the claimant.

(e) *Compliance Obligations*

A licenced litigation funder should be required to implement policies and procedures that ensure licensees comply with the licence conditions. This should include an obligation on licenced litigation funders to train their employees on compliance practices and procedures.

(f) *Best Interest Obligation*

A licenced litigation funder who enters into a funding arrangement should be under a non-derogable duty to:

- act in the best interest of its clients, and to place the best interests of its clients ahead of their own; and
- in circumstances where a conflict arises, prioritise the interests of their clients over their own.

(g) *Obligation in Relation to Conflicts of Interest*

A licenced litigation funder who enters into a funding arrangement should be under a duty in relation to conflicts of interest that might arise in the course of that arrangement. That duty should have two arms:

- first, a general duty to maintain adequate practices for managing any conflict of interest (as presently applies to funder vehicles that hold an AFSL); and
- second, a specific duty to avoid conflicts of interest with the claimant in the following two circumstances:
 - where the litigation funder and the instructing law firm share a common financial interest through ownership (of the funder by the law firm or of the law firm by the funder) or other joint economic interest in the outcome of the litigation; and

- where the litigation funder purports to issue instructions to the lawyers on the scheme they are funding over decisions relevant to the claim.

It is submitted that in those prescribed circumstances, the conflict of interest cannot be managed, and for this reason, a duty to avoid the conflict (i.e., a prohibition on the prescribed conduct) should operate.

In addition, a licensed litigation funder that has opted to bring an open class action proceeding should be required to take measures to ensure that the interests of class members that have not entered into a funding agreement are still adequately protected. The litigation funder should be required to propose and pay for a representative for non-funded claimants, approved by the court, to advise the court in relation to any proposed arrangements in a settlement or other resolution of the proceeding.

(h) *Appointment of Claimants Representative*

A licenced litigation funder who enters into a funding arrangement should be required to propose a claimant from the class to serve as the claimants' representative, subject to approval by the court. This would help prevent litigation funders from indirectly controlling the instructions given by claimants to lawyers about the conduct of the case.

Alternative Approach: Extension of AFSL Regime

- 5.1 As an alternative to the separate licencing regime proposed above, regulation of the industry could be achieved by requiring litigation funders that operate in Australia (and any person involved in providing services to TPLF schemes) to hold an AFSL. That change could be achieved by amending the definition of "financial product" in the Corporations Act to include "TPLF investment schemes" so that litigation funders (and any person involved in providing services to TPLF schemes) would be required to hold an AFSL to operate in Australia. In addition, r 7.6.01(1) (x) and (y) of the *Corporations Regulations* should be repealed to remove the AFSL exemption applicable to litigation funders.
- 5.2 If this approach is preferred, the obligations imposed on ordinary AFSL holders would automatically apply to licenced litigation funders. To the extent that the eight matters prescribed above are not reflected in the existing AFSL regime, these could be introduced as conditions of a litigation funder's obtaining and maintaining a licence.

Endnotes

- 1 The sole measures currently in place relate to conflicts of interest. *Corporations Amendment Regulation 2012 (No. 6)* provides that regulations may require a TPLF funder to “have arrangements, and follow certain procedures for managing conflicts of interest in relation to the scheme.” In April 2013, the Australian Securities and Investments Commission (“ASIC”) released its Regulatory Guide 248 “Litigations schemes and proof of debt schemes: Managing conflicts of interest” designed to supplement *Corporations Amendment Regulation 2013 (No. 6)* and articulate ASIC’s expectations about maintaining adequate conflict management procedures. These measures are insufficient safeguards, allowing TPLF investors to mirror the role of lawyers without the constraints applicable to the legal profession while encouraging speculation on litigation from investors around the world with a near total lack of accountability.
- 2 See King & Wood Mallesons, *The Review: Class Actions in Australia 2013/2014* at p 6: “In the 18 months to June 2014, 27 new class actions were filed in the Federal Court and the Supreme Courts of Victoria and New South Wales.”
- 3 *Campbells Cash and Carry Pty Limited v Fostif Pty Limited* (2006) 229 CLR 386 at 488 per Callinan and Heydon JJ (in dissent): “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 the third parties, by instituting proceedings purportedly to resolve those disputes, by assuming near total control of their conduct, and by manipulating the procedures and orders of the court with the motive, not of resolving the disputes justly, but of making very large profits.”
- 4 See generally, Paul H. Rubin, *On the Efficiency of Increasing Litigation*, paper presented to the Public Policy Roundtable on Third Party Financing of Litigation, Northwestern University Searle Center on Law, Regulation, and Economic Growth (Sept. 24, 2009); and Productivity Commission’s Draft Report on the Inquiry into Access to Justice, p 25.
- 5 This is the concern sought to be addressed by ASIC Regulatory Guide 248: Litigation schemes and proof of debt schemes: Managing conflicts of interest. Similar concerns were also expressed in *Kirby v Centro Properties Limited* (2008) 253 ALR 65. See further Anne Urda, *Legal Funding Gains Steam But Doubts Linger*, Law360 (Aug. 27, 2008) (quoting a Huron Consulting Group Vice President as saying, “clients may have to relinquish some decision-making authority to the funder” and “the client’s interests may diverge from the funder”).
- 6 See *Rancman v Interim Settlement Funding Corp.*, 789 N.E.2d 217, 220-21 (Ohio 2003) (noting that the amount the plaintiff-appellant owed to litigation financiers was an “absolute disincentive” to settle at a lesser amount).
- 7 Daniel Chen, *A Market for Justice: A First Empirical Look at Third Party Litigation Funding* (January 2012), at 27, available at www.law.upenn.edu/cf/faculty/dabrams/workingpapers/MarketforJustice.pdf.
- 8 See, for example, *ASIC v Richards* [2013] FCAFC 89, in which the Full Federal Court overturned a settlement approval on the basis that the settlement imposed a “funders premium”: unfairly differentiating between represented and unrepresented group members.

- 9 The conflict of interest raised by this type of arrangement has been specifically recognized. A class action brought in 2013 by Maurice Blackburn on behalf of more than 500 horse owners for damages from a breakout of equine influenza was initially to be co-funded through Claims Funding Australia, a company set up by the law firm's principals. Claims Funding reportedly withdrew in late December 2013, "after drawing the ire of Attorney-General George Brandis, who said the involvement of law firms with litigation funders caused 'conflicts of interest and moral hazards.'" *The Age*, 22 February, 2014. Another dramatic example of this conflict is that of Melbourne City Investments Pty Ltd, a Victorian investment company managed and controlled by Mark Elliott, a Melbourne-based solicitor. He has been the sole director and shareholder since the company was incorporated in late 2012. MCI holds shares to the value of around \$700 to \$800 in over 150 publicly listed companies. In late 2013, MCI commenced three separate class actions as the lead plaintiff, with Mr Elliot acting for MCI. In *Melbourne City Investments Pty Ltd v Treasury Wine Estates Limited (No 3)* [2014] VSC 340, the Victorian Supreme Court held that the reason for MCI's existence was to launch proceedings to enable its sole director and shareholder to earn legal fees from acting for MCI and that that was MCI's predominant purpose in commencing proceedings. See also *Melbourne City Investments Pty Ltd v WorleyParsons Ltd* [2014] VSC 303.
- 10 For example, *Legal Profession Act 2004* (NSW), section 325.
- 11 See the example of MCI described above, in which the Victorian Supreme Court held that MCI was created in order to launch proceedings to enable its sole director and shareholder to earn legal fees.
- 12 A review of the ASIC records relating to a range of entities offering litigation funding services in Australia reveals that many are poorly capitalised, often having paid up capital of less than \$1,000, and operating as adjuncts to other businesses.
- 13 See King & Wood Mallesons, *The Review: Class Actions in Australia*, supra note 1 at p 13-15, in particular Figure 2. "Two things are apparent from this list. First, most funders operating in Australia are privately held, and do not make their financial information publicly available – Bentham IMF being the obvious exception as an ASX-listed company. Second, several of the largest funders operating in Australia are incorporated overseas." One overseas funding company that has operated in Australia is Argentum Capital, registered and listed in the Channel Islands. In early 2014, issues arose over the funding sources of this investment company. Finance news website Offshore Alert reported that Argentum Capital is owned and funded by a Cayman Islands-registered company Centaur Litigation which was allegedly a "Ponzi Scheme." See *The Age*, 26 July 2014. Argentum Capital reportedly had its CISX cancelled in late February 2014 as a result of this information. Id.
- 14 Currently, *Corporations Amendment Regulation 2012 (No. 6)* exempts litigation funders from the disclosure obligations applicable to AFSL licensees.



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