COMMERCIAL LITIGATION FUNDING: THE NEED TO IMPOSE REGULATIONS TO IMPROVE THE OUTCOME OF THE SHAREHOLDER CLASS ACTIONS

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In the past few years, commercial litigation funders have been celebrating their successes in various shareholder class actions. The fact that litigation funders are not regulated by any specific law creates a minefield of problems, not only for plaintiffs in class actions, but also for defendants and the courts. The aim of this article is to explain why government intervention is necessary to regulate the litigation funding industry and litigation funders, in order to improve the outcome of class actions for shareholders. The article identifies some current problems associated with litigation funding and, in doing so, makes some suggestions for reform.

I. Introduction

The aim of this article is to call for government intervention to regulate the litigation funding industry and litigation funders. The central reason for this discussion is to improve the outcome of shareholder class actions.

A litigation funder is usually a corporate entity which agrees to assist a plaintiff to commence a court action by providing funds. In return, the funder expects to retain an agreed percentage of any compensation awarded by way of settlement or court order. Since 2006, it has been possible for plaintiffs to engage a commercial litigation funder to help fund their court actions.[1] The High Court has even acknowledged that, in some cases, where plaintiffs have a legitimate claim but are unable to pursue a court action because of their impecunious position, they may call upon a litigation funder to assist.[2] This may be the only way to ensure that their case would go to trial and that justice is served. However, the problem with litigation funding in Australia stems from the fact that the industry is largely unregulated and that funders are free to set their own terms and conditions in the funding agreement.

Class action procedure in Australia is also problematic. There are two main difficulties. The first is that Part IVA of the *Federal Court of Australia Act 1976* (Cth) (FCAA) provides for a so-called 'opt out' class action procedure, without making clear what 'opt out' actually means. Section 33J provides a mechanism for members who are already in a class action to 'opt out' of the class action at a later stage if they so wish, by simply filing a notice to court of their intention, without needing to provide a reason for opting out. This is of concern, particularly since members who are already in the class action are free to come and go as they please and so the defendant has no way of estimating the size of liability it may incur. The second difficulty is when a class action is commercially funded by a litigation funder, which has been common practice since 2006. A funder generally requires the funded party to sign a litigation funding agreement (that is, to 'opt in' to the funding agreement). When this occurs, the 'opt out' mechanism referred to in s 33J has, arguably, become unworkable and ineffective.

The fact that a litigation funder is not regulated by any specific law creates a minefield of problems, not only for plaintiffs, but also for defendants and the courts. The aim of this article

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1 In *Campbells Cash and Carry v Fostif* (2006) 229 CLR 386 ('*Campbells Cash and Carry*'), for the first time in history, the High Court of Australia permitted a class action to be commercially funded by a litigation funder.

2 See *Jeffery & Katauskas Pty Ltd v Rickard Constructions Pty Ltd* (2009) 239 CLR 75 ('*Jeffery & Katauskas*').

is to explain why government intervention in the litigation funding industry is necessary to improve the outcome of the class actions *for shareholders*, The key point is to ensure there is a fairer outcome for shareholders. The article is divided into five parts. Part II provides an overview of how litigation funding works in Australia. Part III compares the two most recent appeal cases to understand why and how the courts have insisted that litigation funders must hold an Australian Financial Services Licence, and considers ASIC's temporary exemption from requiring a licence and the government's proposal on this. Part IV outlines Australia's class action procedure, with discussion on why the procedure is unworkable when commercial litigation funding is involved. Part V highlights some of the current problems associated with litigation funding arrangements, and provides some suggestions for reform. Part VI concludes with a note that a whole new Act is necessary, rather than adding provisions into the current *Corporations Act 2001* (Cth), for the regulation of litigation funders.

II. Litigation Funding in Australia

A. *What is a Litigation Funding Agreement?*

A litigation funding agreement is an agreement entered into between a litigation funder and a plaintiff or plaintiffs whereby the funder agrees to assist the plaintiff(s) to conduct a court action by providing funds. In return, the funder expects to retain an agreed percentage of any compensation awarded by way of settlement or court order. Generally, a funder would want to get involved in a court action only if the plaintiff has a legitimate claim against the defendant and there is a high probability of success — or a high probability that the defendant is likely to negotiate for a settlement at the earliest opportune time. Thus, the funder will normally and independently conduct its own investigation into the issue before making an offer to the plaintiffs to assist with funding their court action.

Depending on the terms of the funding agreement, as this can vary from case to case, litigation funding includes lawyers' fees, disbursements, court fees, project management fees, investigation fees and may include security for costs.[3] The funder's sole purpose is to make a commercial gain from the litigation of others. Depending on how the funding agreement is phrased, the funder may or may not have any direct control over the court action.

It is not uncommon for a litigation funder to approach potential plaintiffs to make an offer to assist with funding litigation.[4] Funders are unlikely to approach just one plaintiff; instead, funders tends to approach a large pool of plaintiffs to form a class action, since this will enable the funder to justify a larger claim against the defendant when there is a larger pool of persons with the same or related circumstances. This approach is also taken because the size of the compensation earned by the funder is likely to be proportional to the size of the pool of plaintiffs. Also, the funder is able to save time and money by acting for several plaintiffs who have similar interests.

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3 IMF (Australia) Ltd, a litigation funder, may have published on its website that it would also provide security to meet a security for costs order in addition to the other associated costs, such as lawyers' fees and project management and investigation fees. However, there are other litigation funders who have been reluctant to provide any security for costs and instead have agreed to provide finance up to a certain limit: see, eg, *Jeffery & Katauskas* (2009) 239 CLR 75.

4 Examples of cases where litigation funders have approached plaintiffs to fund their class actions are *Campbells Cash and Carry v. Fostif Pty Ltd* (2006) 229 CLR 386 ('*Campbells Cash and Carry')*; *P Dawson Nominees Pty Ltd v. Multiplex Limited and Multiplex Funds Management Limited* [2007] FCA 1061 ('*Dawson Nominees')*; *Dorajay Pty Ltd v. Aristocrat Leisure Ltd* (2005) 147 FCR 394 ('*Dorajay'). Dorajay* started in 2003 and settled in January 2009 after the 2006 High Court case in *Campbells Cash and Carry*. See also the most recent Centro Properties shareholder class action case, *Australian Securities and Investments Commission v. Healey (No.1)* [2011] FCA 717, handed down by the Federal Court of Australia on 28 June 2011.

B. *High Court Cases Approving Litigation Funding*

There are two cases in which the High Court of Australia has approved funding by an external non-party funder, which are described briefly below. The approval was given for the same reason in both cases.

1. *Campbells Cash and Carry v Fostif Pty Ltd*[5]

This was the first case where the High Court approved a commercially-funded class action. The case dealt with two central issues: (1) whether the class action procedures under part 8 of the *Supreme Court Rules 1970* (NSW) (NSWSCR) had been followed correctly; and (2) whether the plaintiffs were permitted to engage a litigation funder to finance their class action for commercial gain.

A litigation funder, Firmstone Pty Ltd, independently conducted an investigation into a matter which related to the possible return of tobacco licence fees to retailers, which the retailers had paid but which the wholesalers had not passed on to the taxation office (because of certain overriding rules). The funder formed a view that the prospect of success in a class action would be high. It approached the tobacco retailers and offered to fund their class action, on the condition that they sign an agreement to allow the funder to brief and instruct a law firm and that the funder would be entitled to keep one third of any recovery earned from a successful outcome, whether such recovery was by way of settlement or court order.

The litigation funder signed up 2100 retailers, but only seven of these were chosen and named as plaintiffs in the summons to represent all other retailers in that class. Rule 13(1) under part 8 of the NSWSCR required 'numerous persons' to have the same interests before a class action could be brought; however, the rule did not specify the actual number of persons required.[6] The litigation funder and the law firm believed that seven retailers would be sufficient to form a class action under the rule. They were of the view that the class action procedure under r 13(1) was the same as the class action procedure under the federal legislation which specifies 'seven persons' as the minimum number for bringing a class action.[7] The class action commenced in 2003.

The wholesalers sought to have the class action terminated on the ground that the class action procedure contained in part 8 of the NSWSCR had not been followed, in that the requirement of 'numerous persons' under r 13(1) had not been fulfilled. The wholesalers also argued that the litigation funder was 'trafficking in litigation'[8] when it approached the retailers for their authority to take control of the proceedings through the funding arrangement and this, they argued, constituted an abuse of process.

The trial court dismissed the retailers' class action on the ground that the action was an abuse of the court's process. The New South Wales Court of Appeal reversed this decision and allowed the class action to continue.

On appeal by the wholesalers, the High Court, by a majority of 5:2, held that the class action procedure under part 8 of the NSWSCR had not been fulfilled. Only seven retailers had opted into the class action and this did not constitute 'numerous persons' under r 13(1), even though 2100 retailers had agreed to the litigation funding agreement.[9] The High Court noted that the

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5 *Campbells Cash and Carry* (2006) 229 CLR 386.

6 Rule 13(1) under part 8 of the *Supreme Court Rules 1970* (NSW) states:

> 'Where numerous persons have the same interest in any proceedings the proceedings may be commenced, and unless the Court otherwise orders, continued, by or against any one or more of them as representing all except one or more of them'.

7 *Federal Court of Australia Act 1976* (Cth) s 33C.

8 *Campbells Cash & Carry* (2006) 229 CLR 386, 393.

9 *Campbells Cash & Carry* (2006) 229 CLR 386, 421, 422 (Gummow, Hayne and Crennan JJ provided the joint judgment, with Callinan and Heydon JJ concurring; both Gleeson CJ and Kirby J provided dissenting views).

class action procedure in NSW had an 'opt in' mechanism and that this procedure was different to that set out in part IVA of the FCAA, which provides an 'opt out' approach.[10] The High Court declined to say how many persons would be sufficient to pass the 'numerous persons' test for the purpose of bringing a class action under r 13(1) of the NSWSCR. In conclusion, the High Court dismissed the class action on the ground that there were insufficient retailers to form a class action under the NSW legislation.

On the issue of litigation funding, however, the majority of the High Court permitted the commercially-funded class action.[11] The Court stated that the involvement of a litigation funder had provided the plaintiffs, who believed they had a legitimate claim against the defendants but who could not pursue their claims individually because of the high costs of doing so, an opportunity to get access to justice. A class action funded by a non-party funder had not contravened any public policy and the action did not constitute an abuse of the court's process.[12] In support of litigation funding, Kirby J went further and said:

> The individual claim may (as in the case of many tobacco retailers in these proceedings) be comparatively small and hardly worth the expense and trouble of suing. But the aggregate of the claims of those willing to proceed together, as proposed by a funder and organiser such as Firmstones, might be very large indeed. What is a theoretical possibility, as an individual action or series of actions, needs therefore to be converted into a practical case by the intervention of someone willing to undertake a test case, followed by others willing to organise litigants in a similar position, and under appropriate conditions, to recover their legal rights by helping them to act together.[13]

Kirby J went on to explain how a litigation funder could help to 'organise' the plaintiffs into a court action:

> By 'organising' persons into a legal action for the vindication of their legal rights, representative proceedings are not creating controversies that did not exist. Controversies pre-existed the proceedings, even if all those involved in them were unaware of, or unwilling earlier to pursue, their rights. A litigation funder, such as Firmstones, does not invent the rights. It merely organises those asserting such rights so that they can secure access to a court of justice that will rule on their entitlements one way or the other, according to law.[14]

Callinan and Heydon JJ jointly provided a strong dissent. Their Honours focussed on the litigation funder having abused the process of the court. By having a funder funding the class action, the plaintiffs had in fact *assigned* their class action over to the funder and this was contrary to public policy.[15] They noted that an abuse of the court's process could come from 'very diverse circumstances' and contravention of public policy was just one example.[16] New South Wales Parliament had abolished the law of maintenance and champerty under the *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW), but there was still an exception in that Act under s 6 on public policy grounds. Their Honours highlighted the key facts that constituted an abuse of process on the part of the funder:[17]

- the litigation funder approached the retailers and encouraged them to sue, where they would not otherwise have done so;
- the litigation funder's motive was to make a profit from the litigation of others;

10 The 'opt opt' class action under part IVA of the *Federal Court of Australia Act 1974* (Cth) will be discussed later in this article.

11 *Campbells Cash & Carry* (2006) 229 CLR 386 (Gleeson CJ, Gummow, Kirby, Hayne and Crennan JJ; with Callinan and Heydon JJ dissenting).

12 Ibid 434 (Gummow, Hayne and Crennan JJ, with whom Gleeson CJ agreed at 407).

13 Ibid 449 (Kirby J).

14 Ibid 468 (Kirby J).

15 Ibid 484–5.

16 Ibid 486.

17 Ibid 488–95.

- the commercial gains hoped for by the litigation funder were potentially enormous, since the funder had signed up 2100 retailers which meant that these retailers had to each give up an agreed portion of their compensation to the funder if the case was successful; and
- the litigation funder had control over the litigation when the retailers signed an authority to permit the funder to brief and instruct the lawyers.

2. *Jeffery & Katauskas Pty Ltd v SST Consulting Pty Ltd*[18]

In this High Court case, a successful defendant sought to recover its costs awarded against the impecunious plaintiff by claiming them from the litigation funder who had initially helped the plaintiff to start the court action. The majority of the High Court again ruled that funding litigation for commercial gain by a non-party, regardless of whether the non-party funder had agreed to indemnify the impecunious plaintiff against adverse costs, did not amount to an abuse of process and did not warrant a costs order against the funder.[19] This is not a class action case, but it goes to show the High Court's continued support for commercially-funded court actions.

In this case, Rickard Construction Pty Ltd (Rickard Construction) needed finance to commence a court action against Jeffery & Katauskas Pty Ltd (Jeffery & Katauskas) in relation to a failed pavement construction. Both SST Consulting Pty Ltd and Charles Rickard (collectively, 'the litigation funder') agreed to fund the court action up to a limit of $150 000, but no security for the costs was required in the funding agreement.

The case commenced in September 2000. When Rickard Construction had used up the litigation funding limit, the funder continued to provide funding until Rickard Construction lost the case and an adverse costs order was awarded against it. Rickard Construction became insolvent and was unable to pay the costs order.

Jeffery & Katauskas sought to recover the shortfall of $450 000 from the adverse costs order by seeking an order for costs against the litigation funder on the ground that the funder had committed an abuse of process under r 42.3(2) of the *Uniform Civil Procedure Rules 2005* (NSW) (UCPR).

Rule 42.3(1) of the UCPR prohibits the court from making any order for costs against a person who is not a party to the litigation. This prohibition is qualified by r 42.3(2)(c), which provides that r 42.3(1) does not limit the power of the court to make an order for payment by a person who has committed contempt of court or an abuse of process of the court.

The trial judge refused to make a costs order against the litigation funder. The NSW Court of Appeal dismissed the appeal by Jeffery & Katauskas. On appeal to the High Court, the majority held that the litigation funder, who funded the court action for a commercial gain but who did not provide an indemnity for an adverse costs order made against the plaintiff, had *not* committed an abuse of process. Therefore, an order for costs could not be made against the litigation funder under r 42.3(2) of the UCPR.

(a) Majority Judgment by French CJ, Gummow, Hayne and Crennan JJ

The majority set out a general list of categories of abuse of process that would warrant a costs order against a funder under r 42.3(2) of the UCPR, but stated that the list was not exhaustive.[20] The present case did not fall squarely into any of the listed categories or into any general public policy category of abuse of process. Rickard Construction's court action might have been 'seriously and unfairly burdensome, prejudicial or damaging' to the defendant, but that action was not conducted for an improper purpose.[21] Further, the matter raised by Jeffrey & Katauskas was about the adverse costs order awarded against Rickard Construction — it was not about the

18 *Jeffery & Katauskas* (2009) 239 CLR 75.
19 *Jeffery & Katauskas* (2009) 239 CLR 75 (joint judgment of French CJ, Gummow, Hayne, and Crennan JJ).
20 *Jeffery & Katauskas* (2009) 239 CLR 75, 93 (French CJ, Gummow, Hayne, and Crennan JJ).
21 Ibid 96.

actual conduct of the proceedings. There was thus no abuse of the court's process on the part of the funder.

On the issue of whether the litigation funding arrangement was 'unfair' to the defendant, the majority of the High Court took an alternative view and held that, in a case where a litigation funder had funded a party's litigation, it would be unfair *to the litigation funder* if it was compelled to meet an adverse costs order made against the funded party.[22] In justifying why this would be unfair to the litigation funder, the majority provided some examples; such as, that it would be unfair 'to shareholders who support a company's claim, relatives who support an individual plaintiff's claim and banks who extend overdraft accommodation to a corporate plaintiff'.[23]

The implication of this decision is that litigation funders can fund a court action for a commercial gain without having to take on the responsibility of meeting any adverse costs order if the action fails. Given that the funder in this case was not a party to the litigation, the successful defendant in this case could not sue the funder to pay for any adverse costs awarded against the plaintiff. There was no agreement between the defendant and the funder and the funder was not a party to the litigation.

(b) Minority Judgment of Heydon J

Heydon J delivered a strong dissent, suggesting that the funding arrangement entered into between the plaintiff and the funder had caused enormous harm to the defendant who, although successful in the defence, was unable to recover any legal costs. His Honour stated his sympathy for the defendant as follows:

> The compliance of defendants with these state commands, on pain of punishment for contempt, can bring many costs, including the need to pay lawyers a great deal of money. Hence, litigation is something capable of causing immense harm unless its use is properly controlled and unless those who institute it and prosecute it are subject to legitimate pressures generating a measure of discrimination. The liability of the plaintiff to pay the defendant's costs if the plaintiff's allegations against the defendant are rejected by the courts is one of the mechanisms for alleviating (though only partially) the harm which the plaintiff has caused the defendant by bringing litigation based on unfounded allegations. That liability is also one of the legitimate pressures generating a measure of discrimination in conducting that litigation.[24]

Heydon J went on to express his strong criticism of the litigation funding arrangement. His Honour stated:

> The funder's 'success fee' was on one view more than double the sum advanced and on another more than treble that sum. If viewed as interests on a loan to support proceedings conducted with proper expedition, it would be extortionate to a degree, beyond the dreams of the greediest usurer. If charged by a lawyer, it would cause that lawyer to be barred from practice. It is an abuse of process, in several senses, for a non-party funder to fund the plaintiff's prosecution of proceedings in which the funder has that kind of financial interest without giving a practically effective indemnity to the plaintiff against its liability to the defendant for costs in the event that the plaintiff loses. It is manifestly and grossly unfair and unjust to the defendant. It is seriously burdensome, prejudicial and damaging to the defendant. It is productive of serious and unjustified trouble and harassment: for it caused the defendant to be vexed by baseless proceedings without being indemnified against the costs of demonstrating their baselessness. It is 'unjustifiably oppressive' to the defendant. If the funder's conduct in this case became an institutionalised practice in the administration of justice, it would be an institutionalised practice by which injustice is constantly and inevitably caused. An institutionalised practice of that kind would bring the administration of justice into disrepute.[25]

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22 Ibid 98.
23 Ibid 98.
24 Ibid 124.
25 Ibid 125.

III. Litigation Funders Requiring an Australian Financial Services Licence

Despite the absence of legislative regulations on litigation funders, the courts have, since October 2009, insisted that litigation funders must have an Australian Financial Services Licence (AFS Licence) when providing funding to parties in litigation. Below is a discussion of two appeal cases that focus on why, and how, the courts have insisted on litigation funders having an AFS Licence. This part concludes with a brief comment on ASIC's temporary exemption from the requirement that litigation funders hold an AFS Licence, and the government proposal in relation to this.

A. *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd (2009)*

Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd ('*Brookfield Multiplex*')[26] is the first case that deals with a litigation funding arrangement as a 'managed investment scheme' under chapter 7 of the *Corporations Act 2001* (Cth) (CA). On 20 October 2009, the Full Federal Court found that a litigation funder who had provided funding to the plaintiffs in the class action was in breach of Chapter 7 of the CA for not having an AFS Licence.

Shareholders brought various class actions against Brookfield Multiplex Ltd for damages for their investment losses relating to the company's alleged failures of disclosure in relation to its Wembley Stadium project. The class actions were funded by International Litigation Funding Partners Pte Ltd (ILF) for shareholders who had signed the funding agreements with ILF and the retainer agreements with Maurice Blackburn & Cashman (MBC law firm). Under those arrangements, ILF paid all disbursements and 75 per cent of legal fees charged by MBC (with the remaining 25 per cent payable only if the claims were successful). In return, ILF would receive a 'commission' of between 25 per cent and 40 per cent of any damages or settlement sum paid.

Brookfield Multiplex Ltd sued ILF on the ground that the funding arrangements provided to the shareholders were a form of a 'managed investment scheme', as described in chapter 7 of the CA, and that ILF was in breach of the CA because ILF was unlicensed when providing litigation funding to the shareholders.

The term 'managed investment scheme' is defined to have three key features: (1) it involves people contributing money or money's worth to acquire an interest in a common enterprise; (2) the pooled funds are invested to produce financial benefits for scheme members; and (3) the members do not have day-to-day control over the operation of the scheme.[27] A managed investment scheme that has more than 20 members or is promoted by a professional promoter must be registered with ASIC under chapter 7 of the CA. To qualify for registration, the scheme must be operated by a public company that holds an AFS Licence and the company must have a compliance plan as required under chapter 5C of the CA.

At first instance, Finkelstein J of the Federal Court held that the litigation funding arrangements did not fall into the meaning of a managed investment scheme under chapter 7 of the CA.[28]

On appeal, the Full Federal Court by a majority of 2:1 (Sundberg and Dowsett JJ, with Jacobson J dissenting) overturned the decision of the lower court and found that the litigation funding agreement and the solicitor retainer agreement constituted a 'managed investment

26 *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd* (2009) 180 FCR 11 ('*Brookfield Multiplex*')

27 Section 9 of the *Corporations Act 2001* (Cth), quoted in *Brookfield Multiplex* (2009) 180 FCR 11, [123]. See also P Lipton and A Herzberg, *Understanding Company Law* (Thomson Lawbook, 14th ed, 2008) chh 19–20. Further discussion on 'managed investment scheme' is beyond the purpose of this article.

28 *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd (No 3)* (2009) 256 ALR 427.

scheme' requiring registration under the CA. Their Honours found that the litigation funding arrangements had all the characteristics of a 'managed investment scheme', in that the shareholders had contributed money's worth as consideration to acquire interests in the scheme; those contributions had been pooled to produce financial or other benefits; and the shareholders did not have day-to-day control over the scheme. They concluded that the scheme as described in the case should have been registered at ASIC under s 601ED of the CA and that ILF must have an AFS Licence to operate that scheme.[29]

B. *International Litigation Partners Pte Ltd v Chameleon Mining NL (2011)*

International Litigation Partners Pte Ltd v Chameleon Mining NL ('*Chameleon Mining*')[30] is the second, and latest, case dealing with a litigation funding agreement as a 'financial product' under chapter 7 of the CA. On 15 March 2011, the NSW Court of Appeal found that the litigation funding agreement was a 'financial product' and, as such, the litigation funder was required to hold an AFS Licence.

In this case, Chameleon Mining NL (Chameleon) entered into a litigation funding agreement with International Litigation Partners Pte Ltd (ILP), a Singapore litigation funding company, to fund Chameleon's Federal Court proceedings against Murchison Metals Ltd (Murchison). In August 2010, Chameleon signed a term sheet for Cape Lambert Resources Ltd to take over the court proceedings. ILP saw this as termination of the litigation funding agreement and took the necessary steps to claim for the recovery of both the 'funding fee' — that is, the legal costs already paid out — and an additional fee for terminating the funding agreement early.

Chameleon argued that the litigation funding agreement was a form of 'financial product' under ss 925A and 925E of the CA, and that the litigation funder was required to have an AFS Licence when providing that product. Given that ILP did not have an AFS Licence, the funding agreement was unenforceable and Chameleon was entitled to rescind the funding agreement when it served a notice of rescission on ILP.

At first instance, Hammerschlag J of the NSW Supreme Court found that the funding agreement was not a financial product within the meaning of chapter 7 of the CA and that Chameleon could not rescind that funding agreement.

In the NSW Court of Appeal, after much analysis of what a 'financial product' meant in chapter 7, a majority of 2:1 (Giles JA and Young JA, with Hodgson JA dissenting) overturned the decision of the lower court and found that the litigation funding agreement was a 'financial product' and the litigation funder was therefore required to hold an AFS Licence. The funding agreement was an agreement under which Chameleon 'managed financial risk' as described in s 763A; namely, the risk that Chameleon would be required to pay adverse costs if it was unsuccessful in the funded proceedings. The Court of Appeal concluded that the failure on the part of the litigation funder to hold an AFS Licence or to be exempted from doing so by ASIC meant that the funding agreement was unenforceable and void ab initio. The funded party, Chameleon, was thus entitled to rescind, and did validly rescind, the agreement.

C. *Similarities between Brookfield Multiplex and Chameleon Mining*

There are similarities in the approach taken by the court in *Chameleon Mining* and *Brookfield Multiplex*. While, in *Brookfield Multiplex* in 2009, the court found that the funding agreement was a 'managed investment scheme', in *Chameleon Mining* in 2011, the court declared it to be

29 *Brookfield Multiplex* (2009) 180 FCR 11, [25], [64], [104] (Sundberg and Dowsett JJ). Chapter 5C of the *Corporations Act 2001* (Cth) deals with managed investment schemes and the requirement of registration, while chapter 7 covers financial services laws and the requirement of an AFS Licence. Under ch 7 in s 766A, 'financial service' is defined to include registered managed investment scheme. Section 601ED requires managed investment scheme to be registered with ASIC.

30 *International Litigation Partners Pte Ltd v Chameleon Mining NL (2011) 276 ALR 138* ('*Chameleon Mining*')

a 'financial product'. Both 'managed investment scheme' and 'financial product' are concepts in the financial services provisions of chapter 7 of the CA; so, either way, the litigation funders were still required to hold an AFS Licence. Regardless of how a litigation funding arrangement is defined or described, the courts in subsequent proceedings may well insist that litigation funders have an AFS Licence when providing funding to parties.

The other interesting point to note is that chapter 7 of the CA does not provide a clear definition of 'managed investment scheme' or 'financial product'. The courts in both *Brookfield Multiplex* and *Chameleon Mining* struggled to define those terms by referring to the multiple sections and cross-references in Chapter 7. After much discussion, the judges provided differing views. Given the conflicting judicial opinions, both between the first instance and appeal, and between the individual judges on appeal, it remains uncertain whether a different approach for dealing with litigation funding arrangements will be adopted in future cases.

D. *ASIC's Transitional Relief and the Government Proposal for Legislative Reforms*

In response to the decision in *Brookfield Multiplex*, on 4 November 2009, ASIC issued an order to provide temporary transitional relief so that current funded court actions are exempt from the definition of 'managed investment scheme' under chapter 7 of the CA, and that funders, lawyers and their representatives involved in such actions are exempt from the requirement of holding an AFS Licence.[31] The period for which these exemptions apply has been extended several times, most recently, on 29 June 2011, to 30 September 2011. In addition, and in response to the decision in *Chameleon Mining*, ASIC has also granted a temporary exemption for litigation funding arrangements that are otherwise characterised as a 'financial product' or an interest in a financial product under chapter 7.[32] ASIC's granting of temporary exemption is said to be necessary to minimise any disruption to currently funded court actions and to allow time for the federal government to implement the necessary reforms to regulate the litigation funding industry, and also to address the issues raised in the two cases.

On 4 May 2010, the federal government announced a plan to legislate to exempt funded class actions from the definition of 'managed investment scheme' under chapter 7, and to provide an appropriate means of minimising conflicts of interest in litigation funding arrangements.

On 27 July 2011, the federal government released an exposure draft of litigation funding regulations for public consultation.[33] The proposed regulations clarify that funded class actions are to be exempt from 'managed investment scheme' under chapter 7 of the CA. The regulations also clarify that litigation funding arrangements are to be exempt from being classed as 'financial products' under chapter 7. The proposed exemptions, if made law, would mean that a litigation funder proposing to provide funding to a party in a court action would not be required to hold an AFS Licence. The draft proposal also provides a brief statement about managing potential conflicts of interest. It should be noted, however, that the Explanatory Commentary attached to the proposed regulations is only a little over one page; there appears to be no mechanism to manage potential conflicts of interest among the various people involved in funded class actions. The document containing the proposed regulations merely highlights the proposed exemptions, with numerous cross-references to the current chapter 7 of the CA.[34]

It is submitted that the government's proposed regulations are unclear and lack depth. The litigation funding industry has the potential to affect a wide range of people — not only the funded parties, such as the plaintiff, but also the non-funded parties such as the defendant and

31 See Australian Securities and Investments Commission (ASIC), *Funded Representative Proceedings and Funded Proof of Debt Arrangements*, CO 10/333, 5 May 2010.

32 See ASIC, *Variation of Class Order [CO 10/333]*, CO 11/555, 23 June 2011.

33 Australian Government, Treasury, *Exposure Draft — Corporations Amendment Regulations 2011 (No.) — Funded Class Actions* (27 July 2011) <http://www.treasury.gov.au/contentitem.asp?ContentID=2104&NavID>.

34 The proposed Corporations Amendment Regulations 2011 are 10 pages in length with numerous cross-references to the existing chapter 7 of the *Corporations Act 2001* (Cth).

all other persons with an interest in the matter but who may have decided not to take part in the class action.[35] It is submitted that a dedicated Act may be more suitable for regulating the conduct and activities of the litigation funders, as discussed in part V below.

IV. Outline of the Class Action Procedure in Australia

The class action procedure in Australia is governed under part IVA of the FCAA, which came into force in March 1992.[36] The procedure is available for use in a range of settings; for example, in shareholder class actions.

Set out below is an outline of what a class action is in Australia, with an emphasis on the 'opt out' provision contained in s 33J of the FCAA.[37] Because of the legalisation of litigation funding, an 'opt out' class action in Australia now appears to be more like an 'opt in' class action. This is because of the lack of clarity and definition in s 33J of the FCAA, combined with the lack of specific rules and principles governing the litigation funding industry.

A. *What is a Class Action in Australia?*

Section 33C of the FCAA defines a class action as follows:

> [W]here:
>
> (a) 7 or more persons have claims against the same person; and
>
> (b) The claims of all those persons are in respect of, or arise out of, the same, similar or related circumstances; and
>
> (c) The claims of all those persons give rise to a substantial common issue of law or fact;
>
> a proceeding may be commenced by one or more of those persons as representing some or all of them.

In simple terms, a class action is possible in Australia only if there are at least seven persons having the same, similar or related claims against a defendant and one of those persons agrees to commence litigation and represent all other members in the same class (called the 'group members').

The Australian class action is different from the American class action. In America, for a person to become a member in the class action, they must expressly agree to join the class action and have their name included in the court documents. This is commonly known as an 'opt in' class action. Australia, however, has chosen not to adopt the American procedure; instead, Australia has an 'opt out' mechanism.[38]

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35 An example of those other persons are the non-participating shareholders who have the option of joining the class action at a later stage as provided for under part IVA of the *Federal Court of Australia Act 1974* (Cth), which sets out the class action procedure.

36 Victoria is the only state that has a model almost identical to the federal 'opt out' class action. This is provided in part 4A of the *Supreme Court Act 1986* (Vic), which came into operation in January 2000.

37 For a detailed discussion of the class action procedure under part IVA of the FCAA and why it is becoming ineffective, see Lang Thai, 'Is There a Need to Reform the Corporate Class Action Procedure in Australia?' (2011) 8 *Macquarie Journal of Business Law* 134.

38 The Australian Law Reform Commission (ALRC) made a recommendation four years earlier in 1988 for an 'opt in' class action procedure, similar to the American counterpart, but the federal Parliament rejected that recommendation and introduced a class action with an 'opt out' mechanism instead, without any clear explanation: ALRC, *Grouped Proceedings in the Federal Court*, Report No 46 (1988). The theory that the Parliament had rejected the ALRC's recommendation for an 'opt in' class action procedure was perhaps to prevent the floodgate effect as seen in the US class actions.

B. *The 'Opt-Out' Mechanism is Ineffective and Obsolete*

Section 33J is problematic, particularly when a class action is commercially funded by a litigation funder. Litigation funders generally require the funded parties to sign a litigation funding agreement (that is, to 'opt in' to the funding agreement), in which case the 'opt out' mechanism referred to in s 33J becomes ineffective and redundant. Section 33J is as follows:

> (1) The Court must fix a date before which a group member may opt out of a representative proceeding.
>
> (2) A group member may opt out of the representative proceeding by written notice given under the Rules of Court before the date so fixed.

Essentially, s 33J provides that, if group members do not wish to have a decision binding on them in a class action, they can file a notice to court to opt out of the class action.[39] The provision may sound simple, but it is difficult to apply in practice. There is nothing in part IVA of the FCAA that helps to explain what an 'opt out' class action actually means. Section 33J does not make it clear what the consequences are if a group member wishing to opt out of the class action has failed to file the court with a notice by the prescribed date.[40]

A more serious problem relates to a gradual corrosion of the 'opt out' mechanism referred to in s 33J. Now that the High Court's decision allows plaintiffs to engage a litigation funder, s 33J becomes problematic. When plaintiffs sign a litigation funding agreement, they are opting into the funding agreement. Given the nature of funding arrangements, which usually impose early termination fees on parties who withdraw from the agreement, they are, in effect, also opting into the class action. An 'opt out' class action under s 33J has now taken on the characteristics of an 'opt in' class action due to the liberalisation of the litigation funding industry and the absence of proper regulation.

There are numerous cases where an 'opt out' class action has seemed more like an 'opt in' class action.[41] The statement of Finkelstein J in *Dawson Nominees Pty Ltd v Multiplex Limited* provides some rational explanation about why this is so:

> The advantage of the retainer and the funding agreements to each group member is obvious. If it were not for those agreements and the class action procedure, the action would probably not have gotten off the ground. Individually, most group members would not have the financial strength to bring their opponents to court. For those that do the potential benefits of bringing an action would be outweighed by the quantum of the costs.[42]

Putting aside the difference between 'opt in' and 'opt out', one would indeed accept the view that litigation funding is doing some good for the plaintiffs. However, the difficulty is not so much the litigation funding itself, but whether, by getting people to *sign into* — that is, opt into — the litigation funding agreement, it would make the whole process inconsistent with the opt out rules in part IVA of the FCAA, particularly s 33J. In other words, there are compelling arguments that litigation funding arrangements work on the basis of *excluding* some eligible group members from the class action, while the opt out class action procedure in Part IVA focuses on *including* all group members.

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39 *Federal Court of Australia Act 1976* (Cth) s 33ZB refers to judgment of the court as binding on all group members, except those who have chosen to opt out of the class action.

40 This may occur in a situation where, for example, a shareholder has filed for an oppression action based on a set of similar circumstances. An oppression action is a personal action covered under part 2F.1 of the *Corporations Act 2001* (Cth).

41 Examples of cases are: *Dorajay* (2005) 147 FCR 394; *Dawson Nominees* [2007] FCA 1061; *Campbells Cash and Carry* (2006) 229 CLR 386. See also, V Morabito, 'Corporate Accountability, Third Parties and Class Actions' (Working Paper No 3, Corporate Law and Accountability Research Group, October 2006) 17–18.

42 See *Dawson Nominees* [2007] FCA 1061, [34] (Finkelstein J).

V. Current Problems in Litigation Funding and Suggestions for Reform

As discussed at part III above, the federal government released a draft proposal for litigation funding regulations on 27 July 2011. However, the proposal is impractical because there is no clear direction on how litigation funders are to be regulated.[43] In fact, there are still many issues that have not been addressed in the proposal. The purpose of this part is to highlight those issues and to offer some suggestions for reform.

A. *Plaintiffs Are Not Free to Negotiate Terms and Conditions with Litigation Funders*

Litigation funders can currently set their own terms and conditions in funding agreements. It is not unusual for litigation funders to demand a high percentage of returned fees in the funding agreement. Some commentators have noted that the 'agreed' percentage of the revenues imposed by the litigation funder has been as high as 75 per cent.[44] In *Jeffery & Katauskas*,[45] a litigation funder was found to be unwilling to accept any adverse costs awarded against the plaintiff; however, the High Court held there was no abuse of process on the part of the litigation funder.[46]

A lack of competition in the litigation funding industry is also a problem for plaintiffs, meaning that they are unable to negotiate freely on terms and conditions. There are currently six or seven main litigation funding companies in Australia which dominate about 95 per cent of all litigation funding.[47] Only two of these funders are listed on the Australian Securities Exchange — IMF (Australia) Ltd and Hillcrest Litigation Services Ltd. Given the level of exposure these companies have in the litigation funding market, they can demand a high percentage of earnings from high-profile cases. For example, IMF (Australia) Ltd has stated that it will agree to fund a court action only if the claim is over $2 million.[48]

B. *Problem of Recovering Adverse Costs from Impecunious Plaintiffs and from their Funder*

In *Jeffery & Katauskas*,[49] the successful defendant was barred from pursuing its costs order against the litigation funder. In that case, the funder had agreed to fund the plaintiff to commence a court action, but it was reluctant to extend finance to cover costs awarded against the plaintiff. By a 4:1 majority, the High Court of Australia held that the funder had not done anything unlawful or against the public policy such as to constitute an abuse of process. The implication of the High Court decision is that it was up to the plaintiff and the funder to agree on the terms of their funding agreement. Since the funder was not a party to the litigation, the successful

43 Currently, there are no specific rules and principles governing the behaviour and conduct of litigation funders. Litigation funders are free to conduct their own business without constraints from any specific legislation (other than the common law contract principles and the general anti-misleading and deceptive conduct provisions under the *Competition and Consumer Act 2010* (Cth), under s 1041H of the CA, and under s 12DA of the *Australian Securities and Investment Commission Act 2001* (Cth)). The general consumer protection law may not be applicable against litigation funders because the plaintiff is *not* a 'consumer' as such, as both the funder and the plaintiff are often dealing in a commercial context.

44 See, eg, Stuart Clark and Christina Harris, 'The Push to Reform Class Action Procedure in Australia: Evolution or Revolution?' (2008) 32 *Melbourne University Law Review* 775, 789; Stuart Clark and Michael Legg, 'The Continued Rise of Litigation Funding' (2006) 22(9) *Company Director* 34, 36. See also Standing Committee of Attorneys-General, *Litigation Funding in Australia* (May 2006) <http://www.scag.gov.au/lawlink/SCAG/ll_scag.nsf/pages/scag_pastconsultations>.

45 *Jeffery & Katauskas* (2009) 239 CLR 75.

46 *Jeffery & Katauskas* (2009) 239 CLR 75.

47 Michael Legg et al, 'Litigation Funding in Australia' (Working Paper No 12, University of New South Wales Faculty of Law, 2010) 2.

48 IMF (Australia) Ltd, *About Us* <http://www.imf.com.au/about.asp>.

49 Part III of this article provides a detailed discussion of this case.

defendant could not claim costs from it. Heydon J, who was in the minority, pointed out that the decision was seriously harsh and unfair to the successful defendant.[50].

C. *The Floodgate Effect Seen in the Court Room*

Since the legalisation of the litigation funding arrangement in 2006, and with the absence of specific rules and principles governing the industry, there are now numerous commercially-funded court actions. This 'floodgate effect' is partly attributable to litigation funders having too much freedom in setting terms and conditions in litigation funding agreements.

In order to control or minimise the problems mentioned so far, the government should legislate to provide that funders comply with certain basic requirements, which are not able to be excluded from the funding agreements. This approach could ensure greater fairness to both parties in litigation and that there is no abuse of the court's processes. It would also reassure plaintiffs that their vulnerability is not to be exploited by the funder, and reassure defendants that their costs is to be recoverable if they are ultimately successful.

D. *Confusion over the Terms 'Opt In' and 'Opt Out'*

In a commercially-funded class action, where the class action procedure under part IVA of the FCAA comes in contact with the so-called 'law of litigation funding', the consequence is the confusion over the terms 'opt out' and 'opt in'. By signing a litigation funding agreement with a funder to fund a class action, the plaintiff and other group members are not only opting into the funding arrangement, but also *opting into* the class action. If group members later decide to 'opt out' of the funding agreement, the funder may impose an early termination fee under the funding agreement. Practically, the early termination fee may deter group members from opting out. For this reason, 'opt out' class actions have become more like 'opt in' class actions.

The confusion may be illustrated in two conflicting shareholder class action cases. On the one hand, Stone J in *Dorajay Pty Ltd v Aristocrat Leisure Ltd* favoured a strict literal interpretation of the legislation. Stone J considered that the fact that Parliament had rejected the Australian Law Reform Commission's recommendation for an 'opt in' approach in the class action procedure indicated that Parliament intended the Australian class action procedure to have an 'opt out' mechanism.[51] In refusing to allow the commercially-funded class action to continue, her Honour concluded that the requirement that group members opt in to the proceeding through the funding agreement was 'inconsistent with the terms and policy of Part IVA' of the FCAA.[52] A contrary view was expressed by Finkelstein J in *P Dawson Nominees Pty Ltd v Multiplex Ltd*.[53] In allowing the shareholder class action to be commercially funded, Finkelstein J stated that, if it were not for the funding arrangement, 'the [class] action would probably not have gotten off the ground'.[54] His Honour noted that, although the shareholders had opted in to the funding agreement, there was nothing in part IVA of the FCAA preventing them from opting out of the class action at a later date.[55]

A further reason for confusion may be that, on the one hand, under s 33E, group members can join a class action whenever they like — there is no set date. On the other hand, under s 33J, group members can opt out of the class action by simply filing a notice to court to that effect, without needing to give any reason for doing so. In effect, group members can come and go freely in a class action.

The lack of clarity and definition of the term 'opt out' in Part IVA of the FCAA has also contributed to the confusion over the distinction between 'opt out' and 'opt in'. It appears that

50 *Jeffery & Katauskas* (2009) 239 CLR 75, 124

51 *Dorajay Pty Ltd v Aristocrat Leisure Ltd* (2005) 147 FCR 394, 429 ('*Dorajay*').

52 Ibid 431.

53 *P Dawson Nominees Pty Ltd v Multiplex Ltd* [2007] FCA 1061 ('*Dawson Nominees*').

54 Ibid [34].

55 Ibid [52].

an ‘opt out’ class action could become an ‘opt in’ class action through the influence of litigation funders.

E. *Third Line Forcing*

When plaintiffs and group members sign a litigation funding agreement to obtain funding for their class action, the funder may compel the plaintiffs to agree to engage or accept a law firm chosen by the funder. It is possible that a commercially-funded class action could constitute third line forcing if there is clear evidence that the funder is making a decision on the choice of law firm to act on the matter. Third line forcing is prohibited under s 47 of the *Competition and Consumer Act 2010* (Cth).

Third line forcing takes away the element of fair competition. It removes the will of group members to shop around and negotiate with other law firms. Plaintiffs and group members in class action cases generally have no choice but to accept the terms presented to them. They are unlikely to succeed in challenging a litigation funder or a law firm if they are in desperate need of funding for their class action.

F. *Benefits Go to the Litigation Funders and Law Firms*

When a law firm takes on a commercially-funded class action, it is acting not only for the class plaintiff, but it may also be ‘acting’ for the litigation funder, as the funder pays all legal costs. On the one hand, the law firm receives instructions in the form of facts and evidence from the plaintiffs and other group members; on the other hand, however, the law firm provides the funder with progress reports. In effect, both the litigation funder and the class plaintiffs are *clients* of the law firm in some sense, which may raise problems of potential conflict of interest.[56]

G. *Defendant under Pressure to Settle*

It is not surprising to hear that only ‘very few cases [on class actions] have gone to full judgment’.[57] In a commercially-funded class action, a defendant is more likely to be under pressure to settle out of court. One possible reason is that a litigation funder is unlikely to give up on a class action that it has chosen to take on to provide funding. There is a tendency for the litigation funder to press on with the class action until a satisfactory outcome is reached, when the funder is certain that it has made a profit.

H. *Suggestions for Reform*

As noted in part III above, the government proposes to simply amend chapter 7 of the CA[58] by inserting a provision to exempt litigation funding arrangements from being termed as ‘managed investment scheme’ or ‘financial products’. This would exempt litigation funders and lawyers representing class plaintiffs and group members from having to obtain an AFS Licence. The proposal would also require litigation funders to put in place arrangements to manage conflicts of interest. However, many of the other important issues highlighted above appear to have

56 See also Peter Cashman, ‘Class Actions on Behalf of Clients: Is This Permissible?’ (2006) 80(11) *Australian Law Journal* 738, 744–6; Vince Morabito, ‘Class Actions Instituted Only for the Benefit of the Clients of the Class Representative’s Solicitors’ (2007) 29(5) *Sydney Law Review* 5, 38.

57 M Duffy, ‘Procedural Dilemmas for Contemporary Shareholder Remedies — Derivative Action or Class Action’ (2004) 22 *Company and Securities Law Journal* 46, 60.

58 Chapter 7 of the CA is wholly about financial services and financial products and the provision of those services or products requires an AFS Licence from ASIC.

been overlooked.[59] It is submitted that the current chapter 7 of the CA is already convoluted and difficult to understand with numerous cross-references within that chapter.[60] The litigation funding industry is far too important for all the rules relating to it to be squeezed into the current chapter 7. The author suggests that a whole new Act may be far more suitable to regulate this important area, with provisions concentrating on the following:

- A requirement of 'base floor' terms to protect funded parties. Litigation funders should be subject to a clear regulatory framework, with the inclusion of the minimum base floor terms implied into the funding agreement; for example, the maximum 'commission' and 'early termination fee' permitted to be charged by the funder, and allowing a reasonable cooling off period for the funded party.
- Terms to protect a successful defendant's interest. To protect defendants' interests, and to prevent litigation funders from escaping liability for costs if the funded party loses, the defendant should be entitled to know in advance, with clarity, the type of funding structure that the funded party has with the litigation funder and whether there is any clause in the agreement dealing with potential adverse costs. A base floor term should be included in the legislation to allow a successful defendant to claim against the litigation funder for any adverse costs order made against the funded party.
- A clear management plan to avoid conflicts of interest. In avoiding potential conflict between a law firm and a litigation funder, and between a law firm and its clients, legislation should clarify the respective roles and responsibilities. For example, legislation should make it clear that the law firm is strictly prohibited from colluding with the litigation funder, and that the litigation funder cannot give instructions to the law firm without express consent from its clients. Currently, the government's proposal is that litigation funders are required to provide a plan of how they manage potential conflicts of interest, without providing any guidance on how this is to be achieved. The proposal is impractical without any criteria by which to judge whether a conflict management plan is acceptable.
- That litigation funders be required to prove sufficient assets. Legislation should provide that litigation funders give assurances that they have sufficient assets to fund a court action, and that the action will remain funded for the duration. Such assurances should include that they have assets sufficient to meet any costs orders made against the funded party. This would ensure that a foreign litigation funding company has sufficient assets in Australia to satisfy all relevant costs and to minimise situations where the funded party may be stranded for lack of funding, or the successful defendant may not be able to recover costs. Legislation could include a security for costs clause as a requirement for entering into a litigation funding arrangement.

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59 In the Explanatory Commentary to the exposure draft of the litigation funding regulations, it says in one part that 'the Government supports class actions and litigation funders as they provide access to justice for a large number of consumers …'. It concludes that 'the proposed Regulations would also provide exemptions from the licensing, conduct and disclosure requirements in that Chapter [that is, Chapter 7 of the CA].' It is unclear as to why the government does not consider these requirements as an important part of the regulatory framework in the litigation funding industry.

60 In *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50, [152]–[153], Young JA stated:

> Chapter 7 of the *Corporations Act* 2001 (C'th) is drafted in 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.

VI. Conclusion

The litigation funding industry is still largely unregulated. This is a matter of major concern, not only for plaintiffs in funded actions, but also for defendants, the courts and the general community.

The federal government's draft regulations do not address many important issues, such as those raised in the High Court decision in *Jeffery & Katauskas*. That decision opens up more opportunities for litigation funders to exercise their power on both plaintiffs *and* defendants, by using their legal entitlement to refuse to provide security for costs and to refuse to pay any adverse costs potentially awarded against the plaintiffs. The situation could become worse if the government does not regulate this industry now. It is hoped that the views presented in this article will help to put further pressure on the federal government to pass a new Act, wholly for the purpose of governing the litigation funders, and putting a regulatory framework into place. By simply adding provisions into the existing chapter 7 of the CA to exempt litigation funding arrangements from being a managed investment scheme or a financial product, and to waive the requirement of an AFS Licence, is not doing any good to either funded parties or defendants in the long term.