INTO THE SHADOWS: SHADOW BANKING AND THE PRUDENTIAL REGULATION OF LITIGATION FUNDERS

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Litigation funding is at the cutting edge of financial and legal innovation, offering powerful ways to access the courts and manage litigation risks. So far, the discussion has focused on how the lack of regulation in the young industry is detrimental to legal practice, leaving financial issues in the dark. As a result, this article takes a law reform approach with an emphasis on the financial regulation of litigation funding. The author begins by defining the scope of the article by examining the forces shaping the definition of litigation funding. Flaws in the current regulatory framework are also examined with a doctrinal approach. The author argues that litigation funding is a form of shadow banking and that the experience of shadow banks during the Global Financial Crisis offers valuable insight for the regulation of litigation funders. In particular, the examination of liquidity risk, externalities and too big to fail concepts illuminate new and largely unexplored issues impacting litigation funders. A comparative approach is then taken to consider different regulatory avenues. Lessons have been taken from both US and UK responses to the GFC. Furthermore, self-regulation by both Australian and UK litigation funders has also been considered. The research culminates with the two regulatory models proposed, the market based 'Break and Dissolve' model being preferred. The author concludes that both financial and legal perspectives are required to effectively regulate litigation funding.

I INTRODUCTION

In Shakespeare's *The Merchant of Venice*,[1] the evil, self-interested Shylock relentlessly pursues his bond, a pound of flesh from the protagonist Antonio. The heroic Portia then enters the scene, posing as a virtuous and learned doctor of the law. In an ingenious display of legal acuity, she saves the day by arguing that not a drop of blood is to be drawn from Antonio, should Shylock still pursue his pound of flesh. Four hundred years after this differing depiction of the lawyer and the banker, the fine line between these professions is fast becoming blurred as litigation funders gradually enter the judicial temple.

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1 William Shakespeare, 'The Merchant of Venice' in Jowett et al (eds), *William Shakespeare: The Complete Works* (Oxford University Press, 2nd ed, 2005) 2514.

Put simply, litigation funding is the practice of financing litigation on the condition that the loan is repaid from the proceeds of a successful case.[2] This contamination of the courts with the profit motive of lenders has already caused controversy.[3] The costs and benefits are already well discussed.[4] Instead, this article proceeds on the consensus that litigation funding is a necessary development and will focus on the future regulation of the industry.[5] In particular, this article will focus on the encroachment of financial issues on the regulation of litigation funding. A law reform approach will be adopted because the current state of litigation funding regulation is still in its infancy and because financial issues in the business model have largely been sidelined by existing literature.[6]

To understand the basis for reform, a doctrinal exploration of current regulatory issues will be undertaken first. This involves a principled analysis of a possible scope for litigation funding that could be used in further debate. While a legal definition of litigation funding already exists within reg 5C.11.01,[7] there is a paucity of literature examining the elements in that definition.[8] By contrast, there has been a wealth of discussion around developing the regulatory framework. By examining the influences shaping the definition, as well as the wider regulatory development of litigation funding, this article aims to achieve a more robust appreciation of the current legal context.

Secondly, a comparative approach will be taken to evaluate previously unexplored reform opportunities for litigation funding regulation. In particular, the challenges and risks facing financial institutions provide valuable lessons for the future development of the litigation funding industry. Potential solutions to these new challenges will be sought from an analysis of international responses to the Global Financial Crisis (‘GFC’) as well as litigation funding regulation in the United Kingdom. As with any comparative study involving other jurisdictions, it is important to note the differences each litigation funding framework has before drawing conclusions.[9]

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2 See generally *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 CLR 386 (‘*Fostif*’); Michael Legg et al, ‘The Rise and Regulation of Litigation Funding in Australia’ (2011) 38 *Northern Kentucky Law Review* 625.

3 *Fostif* (2006) 229 CLR 386.

4 See generally Legg et al, above n 2; Jasminka Kalajdzic, Peter Cashman and Alana Longmoore, ‘Justice for Profit: A Comparative Analysis of Australian, Canadian and US Third Party Litigation Funding’ (2013) 61 *The American Journal of Comparative Law* 93; Productivity Commission, *Access to Justice Arrangements*, Draft Report (2014); Vince Morabito, ‘An Empirical Study of Australia’s Class Action Regimes: Litigation Funders, Competing Class Actions, Opt Out Rates, Victorian Class Actions and Class Representatives’ (Research Report No 2, Australian Research Council, September 2010); Office of the Legal Services Commissioner (NSW), ‘The Regulation of Third Party Litigation Funding in Australia’ (Discussion Paper, Office of the Legal Services Commissioner (NSW), March 2010).

5 Productivity Commission, above n 4, 539.

6 See especially Productivity Commission, above n 4, 535; see generally Legg et al, above n 2; Kalajdzic, Cashman and Longmoore, above n 4; Productivity Commission, above n 4; Morabito, above n 4; Office of the Legal Services Commissioner (NSW), above n 4.

7 *Corporations Regulations 2001* (Cth).

8 See generally Legg et al, above n 2; Jasminka, Cashman and Longmoore, above n 4; Productivity Commission, above n 4; Morabito, above n 4; Office of the Legal Services Commissioner (NSW), above n 4.

9 Kalajdzic, Cashman and Longmoore, above n 4, 95.

Finally, two models of litigation funding regulation will be proposed. Neither of these models attempts to define the specific content of the regulations. This is because the calculation of financial ratios required for financial regulation lie outside the scope of this article. Furthermore, since both models represent radically different approaches to litigation funding regulation, neither is intended to be adopted 'as is'. Instead, the subsequent analysis of each model confirms the draft findings of the Productivity Commission.[10] That is, that theoretically, the legal professional and financial regimes are best suited to addressing the unique challenges faced by litigation funders together. How differences between the two regimes are to be balanced and reconciled in practice will need to be determined before the solution can be implemented.

II DEFINING LITIGATION FUNDING

As early as 2008, Basten AJ of the New South Wales Court of Appeal had flagged that a definition was necessary for the regulation of the litigation funding industry.[11] To date, the most comprehensive definition of litigation funding is seen within reg 5C.11.01.[12] This was a response to the Federal Court decision of *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd*,[13] which characterised litigation funding as a managed investment scheme. This refers to a strategy where money's worth (of legal actions) is pooled to operate a common enterprise (litigation) producing benefits (quantum), where the members (clients) do not have day-to-day control of the scheme.[14] The purpose of reg 5C.11.01 was to overrule *Brookfield Multiplex*, exempting litigation funding schemes from the compliance burdens of managed investment schemes.[15]

Regulation 5C.11.01 is a pragmatic solution, reflecting the majority of the litigation funding industry as it is today.[16] For instance, implicit in the context of reg 5C.11.01 as an exception to managed investment schemes, and the use of language such as 'general members',[17] is the requirement that funders have to engage more than one client to fall within the present definition of a litigation funding scheme. In practice, the need for multiple clients has caused little controversy, since the industry predominantly funds class actions or insolvency litigation.[18] As a result, the literature so far has not questioned the managed investment scheme lens through which litigation funding is viewed.

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10 Productivity Commission, above n 4, 546.

11 *Green (as Liquidator of Arimco Mining Pty Ltd) v CGU Insurance Ltd* [2008] NSWCA 148 (20 June 2008) [80] (Basten J) ('*Green v CGU*').

12 *Corporations Regulations 2001* (Cth).

13 See generally [2009] 147 FCAFC 11 ('*Brookfield Multiplex*'); *Corporations Regulations 2001* (Cth) reg 5C.11.01 as inserted by *Corporations Amendment Regulation (No 6)* (Cth) sch 1 item 1; Explanatory Statement, Corporations Amendment Regulations 2012 *(No 6)* (Cth).

14 *Corporations Act 2001* (Cth) s 9 (definition of 'managed investment scheme').

15 *Corporations Amendment Regulation (No. 6)* (Cth) reg 5C.11.01(1); Explanatory Statement, Corporations Amendment Regulations 2012 *(No 6)* (Cth).

16 Productivity Commission, above n 4, 535.

17 *Corporations Regulations 2001* (Cth) Ch 5C Pt 5C.11 Div 1, reg 5C.11.01(1)(b).

18 Productivity Commission, above n 4, 535.

However, with closer examination, this lens magnifies the need for multiple clients. This is seen with reg 5C.11.01(1)(b),[19] which excludes funding schemes that involve only a single funding client from the definition of a litigation funding scheme. While this may reflect current practice,[20] this dichotomous foundation will create separate sets of regulations for litigation funders, depending on the number of clients involved in the funding arrangements. Apart from adding an extra layer of complexity and opportunity for legal arbitrage,[21] this does not suit the direction of the litigation funding industry. There is already evidence that the industry has grown to include commercial disputes such as contract and patent litigation,[22] which would only involve individual clients.[23] In reality, funders take on cases irrespective of the number of clients, so long as they are able to make a business case out of it. As a result, reg 5C.11.01 fails to provide a cohesive definition of litigation funding.[24] Instead, a more principled definition independent of the managed investment scheme regime is required.

Nevertheless, as a reflection of current practice, reg 5C.11.01 is a useful starting point for a principled examination of the potential elements that could be included in a definition of litigation funding.[25] This is seen with reg 5C.11.01(1)(b)(v),[26] which requires the funder to provide funds to the general members. However it is silent as to how the funds are to be repaid, if they are to be repaid at all. Theoretically this could include funding from friends or Legal Aid, who do not charge interest or require the funds to be paid back in full. Similarly, the location of reg 5C.11.01 within the definition of managed investment scheme also suggests that the Commonwealth Parliament did not have in mind non-profit funders when drafting the legislation.[27]

The issue of commerciality is explored in *Green v CGU*,[28] which portrays the commercial intentions of litigation funders as relatively harmless by comparing them to creditors owed money for goods sold.[29] In the case of litigation funding, the funder is able to profit by charging a premium for the funds loaned to the client. In the case of goods sold, the creditor is able to profit from retrieving the money owed for goods, which would already contain a profit margin from the sale of the goods. This would suggest that a commercial purpose is irrelevant to litigation funders and that any regulatory regime would apply equally to both commercial and

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19 *Corporations Regulations 2001* (Cth) reg 5C.11.01(1)(b).

20 Productivity Commission, above n 4, 535.

21 John Emmerig and Michael Legg, 'Litigation Funding in Australia: More Swings and Roundabouts as Lawyers Withdraw Application to be Funders', *Mondaq* (online), 12 February 2014 < http://www.mondaq.com/australia/x/292544/Class+Actions/Litigation+Funding+In+Australia+More+Swings+And+Roundabouts+As+Lawyers+Withdraw+Application+To+Be+Funders>.

22 LCM Litigation Fund Pty Ltd, *LCM's Track Record* <www.lcmlitigation.com.au>

23 Ibid; Productivity Commission, above n 4, 535; Explanatory Statement, Corporations Amendment Regulations 2012 (No 6) (Cth).

24 *Corporations Regulations 2001* (Cth) reg 5C.11.01.

25 Ibid.

26 Ibid.

27 Ibid Ch 5C Pt 5C.11 Div 1; Explanatory Statement, Corporations Amendment Regulations 2012 *(No 6)* (Cth).

28 [2008] NSWCA 148 (20 June 2008) [77].

29 See generally Legg et al, above n 2; Office of the Legal Services Commissioner (NSW), above n 4; Kalajdzic, Cashman and Longmoore, above n 4.

non-commercial litigation funding. This seems to be the current approach as adopted by reg 5C.11.01.[30]

By contrast, the High Court acknowledged that where a person 'hazards funds' in litigation,[31] they would wish to have control over the proceedings. Given the large amounts of money involved in commercial litigation funding portfolios, this desire for control could potentially be detrimental to the administration of justice. In particular, where matters are settled outside of court, away from judicial supervision,[32] practices such as inflaming damages, suppressing evidence, or suborning witnesses may increase. However with smaller, non-commercial arrangements, this dynamic is unlikely to be present. Given the Commonwealth Government's intentions to increase access to justice,[33] these non-profit funders will need to be protected from the heavier regulatory burdens of commercial funders.[34] Hence, a commercial criterion for litigation funding is justified.

Another potential element in the definition of litigation funding would be the requirement for a third party (other than the lawyer and client).[35] Unlike the criteria of commercial purpose and multiple clients, which have been based on managed investment schemes, the third party distinction has been imported into the regulations directly from the facts of *Brookfield Multiplex*. Regulation 5C.11.01 expressly draws a distinction between litigation funders and law firms providing conditional fee arrangements ('*no win no fee*').[36] Under a *no win no fee* arrangement, payment of the plaintiff's legal fees is conditional on a successful outcome.[37] Even though the law firm essentially funds the action with trade receivables, by paying for the lawyer's salary upfront, reg 5C.11.01 prevents conditional fees from being considered as litigation funding.[38]

In this regard, if the differences between third parties and lawyers are examined, two arguments can be made to justify the third party distinction. Firstly, one of the more common concerns raised has been the fact that third parties are not lawyers and therefore have no duty to the court.[39] This is reflected in the decision making process of third parties, which is based on

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30 *Corporations Regulations 2001* (Cth).

31 *Fostif* (2006) 229 CLR 386, 434 [89].

32 Ibid 435 [93].

33 Treasury, 'Government Acts to Ensure Access to Justice for Class Action Member' (Media Release, No. 039, 4 May 2010).

34 Minister for Financial Services, Superannuation and Corporate Law, 'Address to Shareholder Class Action Conference' (Speech delivered to the 2010 Shareholder Class Action Conference, Sydney, 4 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2010/005.htm&pageID=005&min=ceba&Year=&DocType=>.

35 *Corporations Regulations 2001* (Cth) reg 5C.11.01(1)(b)(vi).

36 *Legal Profession Act 2004* (NSW) s 323; *Legal Profession Act 2004* (Vic) s 3.4.27; *Legal Practitioners Act 1981* (SA) sch 3 item 25; *Legal Profession Act 2006* (ACT) s 283; *In the Marriage of Sheehan* (1991) 104 FLR 57.

37 *Legal Profession Act 2004* (NSW) s 323; *Legal Profession Act 2004* (Vic) s 3.4.27; *Legal Practitioners Act 1981* (SA) sch 3 item 25; *Legal Profession Act 2006* (ACT) s 283.

38 *Corporations Regulations 2001* (Cth) reg 5C.11.01(1)(b)(vi).

39 *Legal Profession Act 2004* (NSW) s 33; *Legal Profession Act 2004* (Vic) s 2.3.9; *Legal Practitioners Act 1981* (SA) s 23A; *Legal Profession Act 2006* (ACT) s 28; Law Society of New South Wales, *Professional Conduct and Practice Rules* (at 1 January 2014) r 21; Office of the Legal Services Commissioner (NSW), above n 4, 5.

expected value.[40] Expected value calculations rely on the theory that estimates become more accurate as the sample size (the number of plaintiffs funded per case) increases.[41] As a result, it would be in the best interests of funders to fund class actions, which allow them to manage risk more effectively. Since this approach increases the number of class actions relative to population size,[42] Australia may potentially become a more litigious society. At no point in a litigation funder's decision making process is there an obligation to consider any duties to the court.[43]

Secondly, litigation funders are also more specialised in handling risk than law firms, particularly funders who manage large portfolios. Large portfolios allow litigation funders to take on cases with higher payoffs and higher risks because the impact of losses can be diluted with the rest of the portfolio.[44] Thus, these intrinsic differences would require a definition that puts third parties in the regulatory spotlight. Yet, while that may be the status quo, the current regulations imposed on third parties are still much lighter than those imposed on law firms.[45]

Alternatively, a uniform definition encompassing both *no win no fee* law firms and litigation funders may be preferable, especially considering the regulatory arbitrage opportunities that would arise with a third party distinction. Since law firms are subject to the *Legal Profession Act*,[46] they are unable to charge fees that are a proportion of the settlement figure, also known as a contingency fee.[47] By contrast, there is nothing stopping a lay third party litigation funder from charging a percentage of the settlement figure.[48] As a result, law firms such as Maurice Blackburn are attempting to access this more lucrative industry through related entities that are not considered a 'law practice'.[49] In effect, the distinction between law firm and third party would allow law firms to circumvent the rules and charge contingency fees on a de facto basis.[50] However, unlike in the United States where lawyers are only paid out of the contingency fee, the

40 Legg et al, above n 2, 632.

41 Michael Smithson, *Statistics with Confidence* (Sage Publications, 2009) 38.

42 John Emmerig and Michael Legg, 'Securities Class Actions Escalate in Australia', *Mondaq* (online), 15 May 2014 <http://www.mondaq.com/australia/x/313730/Class+Actions/Securities+Class+Actions+Escalate+in+Australia&email_access=on>.

43 *Legal Profession Act 2004* (NSW) s 33; *Legal Profession Act 2004* (Vic) s 2.3.9; *Legal Practitioners Act 1981* (SA) s 23A; *Legal Profession Act 2006* (ACT) s 28; Law Society of New South Wales, *Professional Conduct and Practice Rules* (at 1 January 2014) r 21; Office of the Legal Services Commissioner (NSW), above n 4, 5.

44 Stephen Ross et al, *Fundamentals of Corporate Finance* (McGraw-Hill, 5th ed, 2011) 356–7; Kalajdzic, Cashman and Longmoore, above n 4, 141.

45 Minister for Financial Services, Superannuation and Corporate Law, 'Address to Shareholder Class Action Conference' (Speech delivered to the 2010 Shareholder Class Action Conference, Sydney, 4 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2010/005.htm&pageID=005&min=ceba&Year=&DocType=>; Wayne Attrill, 'The Regulation of Conflicts of Interest in Australian Litigation Funding' (Paper presented at UNSW Class Actions: Securities and Investor Cases Seminar, Sydney, 29 August 2013) 1.

46 *Legal Profession Act 2004* (NSW); see also *Legal Profession Act 2004* (Vic); *Legal Practitioners Act 1981* (SA); *Legal Profession Act 2006* (ACT).

47 *Legal Profession Act 2004* (NSW) s 325; *Legal Profession Act 2004* (Vic) s 3.4.29; *Practitioners Act 1981* (SA) item 27; *Legal Profession Act 2006* (ACT) s 285.

48 Productivity Commission, above n 4, 542–3; see especially Emmerig and Legg, 'Litigation Funding in Australia', above n 21,

49 Emmerig and Legg, 'Litigation Funding in Australia', above n 21; *Legal Profession Act 2004* (NSW) s 325.

50 Emmerig and Legg, 'Litigation Funding in Australia', above n 21.

use of two entities allows Australian law firms to charge the client twice: once from the interest rate on the loan, and again as the law firm providing legal services.[51] In recognition of this deficiency, the Commonwealth Attorney-General has suggested that the regulatory gap will be closed, with more regulation for litigation funders in the future.[52] Implicit in this statement is an understanding by the Commonwealth Government that litigation funding is to involve a third party.

After an analysis of the criteria in reg 5C.11.01, it is evident that the litigation funding industry will outgrow its definition based on managed investment schemes. It is immaterial whether the funding goes to a single proceeding or a class of proceedings. Instead, a definition of litigation funding involving third parties with a commercial purpose will ensure a more sustainable foundation for further regulatory developments. Consequently, references to litigation funding in this article will refer to commercial, third party litigation funding.

III LEGAL FRAMEWORK

Traditionally, litigation funding would have been considered maintenance (improperly encouraging litigation) and champerty (funding litigation for profit).[53] Thus, only litigation funding in New South Wales, Victoria, South Australia and the Australian Capital Territory, where the offences have been abolished, will be discussed.[54] As the first judicially considered case involving litigation funding in Australia, it is not surprising that concerns echoing maintenance and champerty were raised in *Fostif*.[55] The facts of *Fostif* concerned a third party commercial litigation funder heading a class action on behalf of tobacco retailers.[56] While the case turned on the validity of the class action,[57] the obiter highlighted the historical tension between ensuring the due administration of justice and enabling access to justice for the poor.[58] While the abolition of maintenance and champerty increased access to justice, public policy concerns about the impact litigation funding would have on the courts threatened the validity of the funding contract.[59] Ultimately, the court held that maintenance and champerty did not necessarily offend public policy and therefore upheld the freedom to enter and enforce funding agreements.[60] Other general public policy concerns about the administration of justice were limited to matters concerning abuse of process.[61]

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51 Ibid; Productivity Commission, above n 4, 25.

52 Emmerig and Legg, 'Litigation Funding in Australia', above n 21; Productivity Commission, above n 4, 543.

53 Legg et al, above n 2, 627.

54 *Civil Liability Act 2002* (NSW) sch 2 item 2; *Crimes Act 1900* (NSW) sch 3 item 5; *Wrongs Act 1958* (Vic) s 32; *Civil Law (Wrongs) Act 2002* (ACT) s 221; *Criminal Law Consolidation Act 1935* (SA) sch 11 item 1.

55 *Fostif* (2006) 229 CLR 386, 425 [67].

56 Ibid 412, 436, 470.

57 Ibid; Howard K Insall, 'Litigation Funding and the Impact of the Decision in *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd*' (Paper presented at the Australian Insurance Law Association National Conference, Sydney, 1 November 2006) 3.

58 *Fostif* (2006) 229 CLR 386, 444 [125].

59 Ibid 425, 433–6 quoting *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW) s 6, as repealed by *Crimes Act 1900* (NSW) sch 3 item 5; see especially *Civil Liability Act 2002* (NSW) sch 2 item 2(2).

60 Ibid 432 [84].

61 Ibid 435 [93].

Another conception of litigation funding can be seen in *Brookfield Multiplex* which characterises the practice as a registered managed investment scheme. [62] As a result, clients would have been entitled to the protections afforded by ch 5C of the *Corporations Act.* [63] This includes an obligation on the responsible entity (in this case, [64] the litigation funder) to act honestly,[65] to resolve conflicts of interests in the member's favour,[66] and to comply with its constitution and compliance plan.[67]

Unlike *Fostif,* which only focused on mitigating the risks to the administration of justice,[68] the Federal Court pursued a more proactive approach to protect litigation funding clients. In particular, the Federal Court looked to the legislature's concern regarding the financial risks scheme members faced.[69] Recognising that litigation funding clients were also subject to such risks, [70] the Federal Court extended the definition and protections of managed investment schemes to include litigation funding arrangements.

However, less than six months after the ruling in *Brookfield Multiplex,*[71] the Commonwealth Treasury convened a round table discussion with key stakeholders.[72] This resulted in a string of Australian Securities and Investments Commission (ASIC) Class Orders starting from 5 May 2010, [73] explicitly carving out litigation funding from the definition of managed investment scheme. The reason for this change was that it reduced regulatory costs for litigation funders, thereby ensuring greater access to justice by small consumers.[74] This lack of access has been confirmed by Morabito, who notes that class actions have never constituted more than 0.74% of Federal Court proceedings, with only 18 being funded actions.[75] The Commonwealth Treasury also noted the lack of harms so far, in order to justify their policies in favour of industry development.[76] However, because the sample size of funded actions is still quite small,[77] this empirical evidence cannot support an inference of adequate industry safeguards.

The idea of a litigation funding contract being a financial product was explored in *International Litigation Partners v Chameleon Mining NL.*[78] In a 2:1 majority, the NSW Court of Appeal held that litigation funding could be used to manage the financial risk of having to pay an adverse

62 *Brookfield Multiplex* [2009] 147 FCAFC 11; *Corporations Act 2001* (Cth) s 601ED(1)(a).
63 *Corporations Act 2001* (Cth) ch 5C.
64 Ibid s 601FB.
65 Ibid s 601FD(1)(a).
66 Ibid s 601FD(1)(c).
67 Ibid s 601FD(1)(f).
68 *Fostif* (2006) 229 CLR 386, 432 [84].
69 *Brookfield Multiplex* [2009] 147 FCAFC 11, 21–2, 31.
70 Ibid 20.
71 Office of the Legal Services Commissioner (NSW), above n 4, 7.
72 Treasury, above n 33.
73 Australian Securities and Investments Commission, *ASIC Class Order – Funded Representative Proceedings and Funded Proof of Debt Arrangements*, CO 10/333, 5 May 2010 item 4.
74 Treasury, above n 33.
75 Morabito, above n 4, 5.
76 Treasury, above n 33.
77 James T McClave and Terry Sincich, *Statistics* (Pearson Education, 11th ed, 2009) 290.
78 *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] 50 NSWCA 149 ('*Chameleon Mining*').

costs order.[79] As a result, litigation funding contracts would be financial products and funders would be required to obtain an Australian Financial Services Licence.[80] In turn, this affords clients the protections under the licence such as prudent balance sheet requirements,[81] some liquidity requirements,[82] and best interest obligations.[83]

Similar to *Brookfield Multiplex*, *Chameleon Mining* also used a purposive approach to interpret the *Corporations Act*.[84] Seeing that the purpose was to protect the investing public,[85] the Court of Appeal was very reluctant to impose a narrow interpretation of the provisions, echoing the earlier *Brookfield Multiplex* decision. This approach was even followed on appeal in the High Court, which overruled litigation funding contracts being a 'financial product'.[86] The High Court's broad interpretation of 'financial accommodation'[87] meant that litigation funders were considered 'credit facilities'.[88] This was because they had financial arrangements in place to accommodate disbursements on behalf of their clients over the course of litigation. As a result, the High Court considered litigation funding contracts to be debt instruments despite the existence of the debt being contingent upon a successful outcome. Since litigation funders were credit facilities, they were to be regulated under the *National Consumer Credit Protection Act.*[89]

Both of these regimes would increase the regulatory cost for litigation funders.[90] As a result, the Commonwealth Government stepped in again by denying that litigation funding was a credit facility,[91] affirming that it is a financial product,[92] yet exempting funders from holding an Australian Financial Services Licence or being considered a managed investment scheme.[93] Apart from the conflict of interest management obligations,[94] these regulatory changes essentially bring the regulation of the industry back to square one.

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79 Ibid 157 [45], 180 [209]; *Corporations Act 2001* (Cth) s 763C; *Civil Procedure Act 2005* (NSW) s 98.

80 *Corporations Act 2001* (Cth) ss 763C, 911A(1).

81 Australian Securities and Investments Commission, *Pro Forma 209: Australian Financial Services Licence Conditions*, PF 209, November 2013, item 13.

82 Ibid item 21.

83 *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) sch 1 item 23 s 961B(1).

84 [2011] 50 NSWCA 149, 180 [208]; *Corporations Act 2001* (Cth)

85 *Chameleon Mining* [2011] 50 NSWCA 149, 180 [208]

86 *Chameleon Mining* [2011] 50 NSWCA 149, revd (2012) 246 CLR 455.

87 Ibid 455, 459, 465 [31] quoting *Corporations Regulations 2001* (Cth) reg 7.1.06(3)(b).

88 Ibid 465 [33].

89 Ibid 463, 465 [33]; *Corporations Regulations 2001* (Cth) reg 7.1.06(3); see also *National Consumer Credit Protection Act 2009* (Cth).

90 *National Consumer Credit Protection Act 2009* (Cth); *Corporations Act 2001* (Cth) ch 7.

91 *Corporations Regulations 2001* (Cth), as inserted by *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth) sch 1 item 1B.

92 Ibid sch 1 item 1A.

93 Ibid sch 1 item 6, 7.6.01AB(1); *Corporations Act 2001* (Cth) s 911A; *Corporations Regulations 2001* (Cth) reg 5C.11.01, as amended by *Corporations Amendment Regulation (No 6)* (Cth) sch 1 item 1.

94 *Corporations Regulations 2001* (Cth), as inserted by *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth) sch 1 item 6, 7.6.01AB(2); see generally Australian Securities Investment Commissions, *Litigation Schemes and Proof of Debt Schemes: Managing Conflicts of Interest*, RG 248, April 2013.

The almost diametrically opposed views of the judiciary and the government reflect the influence litigation funders have as stakeholders in shaping regulation. The common law demonstrates that litigation funders are able to support the creation of favourable precedents by choosing to fund parties whose interests align with the funder's interests.[95] If that is unsuccessful, funders are also able to exert political pressure on the government by aligning the funder's interests with the voting public by framing the debate in terms of access to justice.[96] As a result, issues such as financial risks and prudential regulation have been left largely unaddressed by the literature.

IV LITIGATION FUNDING AS SHADOW BANKING

So far, the recent amendments have placed litigation funding in a regulatory black hole.[97] Despite this lack of legal character, litigation funding has an economic fingerprint similar to that of many financial institutions. A path out of this legal void can potentially be illuminated by a comparative analysis of how financial institutions are regulated against systemic shock. In particular, the class of financial institutions that draws the most economic parallels with litigation funders are called shadow banks.[98]

The international body currently monitoring shadow banks, known as the Financial Stability Board, defines shadow banking as non-prudentially regulated institutions that engage in disintermediation.[99] Similar to credit intermediation, disintermediation involves the raising of funds which are then loaned out to borrowers.[100] Yet unlike credit intermediation where funds are raised by banks through deposits, disintermediation involves the use of capital markets.[101]

Using this definition, litigation funders can be classified as shadow banks for two reasons. Firstly, in anticipation of new mutations of shadow banking,[102] the Financial Stability Board recommends a focus on economic impacts as opposed to legal status.[103] In this regard, litigation funders are able to disintermediate by raising funds in capital markets and using the proceeds to provide credit for litigation.[104] This has been confirmed by the High Court with their classification of funding contracts as 'credit facilities'.[105] By considering 'matters of substance as

95 *2008 Annual Report* (IMF (Australia) Limited, 25 August 2008) 6; Legg et al, above n 2, 633.

96 *Fostif* (2006) 229 CLR 386, 398 (S J Gageler SC) (during argument); Treasury, above n 33.

97 *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth).

98 Steven L Schwarcz, 'Regulating Shadows: Financial Regulation and Responsibility Failure' (2013) 70 *Washington and Lee Law Review* 1781, 1783; Tobias Adrian and Adam B Ashcraft, 'Shadow Banking Regulation' (Paper presented at the Annual Review of Financial Economics, New York, April 2012) 5; Erik F Gerding, 'The Shadow Banking System and Its Legal Origins' (2011) *SelectedWorks* 2 n 3 <http://works.bepress.com/erik_gerding/9/>; 'Shadow Banking: Scoping the Issues – A Background Note of the Financial Stability Board' (Financial Stability Board, 12 April 2011) 2–3.

99 'Shadow Banking', above n 98, 2; see also Financial Stability Review, 'A Closer Look at the Shadow Banking System in Australia' (Reserve Bank of Australia, March 2012) 69.

100 'Shadow Banking', above n 98, 3; Gerding, above n 98, 6; Schwarcz, above n 98, 1781.

101 Schwarcz, above n 98, 1797; Gerding, above n 98, 6.

102 'Shadow Banking', above n 98, 2.

103 Ibid.

104 IMF (Australia) Limited, 'Release to Australian Securities Exchange: Share Placement Plan' (ASX Release, IMF#1267526, 9 October 2013); *Entitlement Issue Prospectus* (Hillcrest Litigation Services Limited, 6 December 2010).

105 *Chameleon Mining* (2012) 246 CLR 455.

well as of form',[106] their Honours implicitly included litigation funding into the realm of shadow banking. While *Chameleon Mining* has since been overturned by the legislature, the High Court's analysis of the facts gives strong support to extending the definition of shadow banks to include litigation funders.

Secondly, litigation funders are not prudentially regulated by the Australian Prudential Regulation Authority ('*APRA*').[107] Since litigation funding does not involve directly taking 'money on deposit',[108] the practice is not considered a 'banking business'[109] and therefore cannot be considered an Authorised Deposit-taking Institution ('*ADI*').[110] As a 'Registered Financial Corporation',[111] litigation funders fall within the definition of shadow banking.[112]

Since litigation funders engage in disintermediation, they also become exposed to the risks faced by shadow banks. In particular, the primary risk is that of the collapse of the litigation funder[113] as seen with the GFC. In 2007, firms held high levels of debt and low levels of equity in order to become more competitive.[114] This made them more sensitive to shocks in the financial system.[115] The subsequent shock, in the form of a property crash,[116] placed pressure on firms to liquidate their assets and use their equity to service the debt. Since equity levels were low to begin with, the shock in property prices caused many firms to become insolvent.[117]

Given a litigation funder's position between the financial markets,[118] and the courts, shocks in financial markets could potentially spread into the justice system. This is because litigation funding clients usually engage funders to manage their disbursements and gain access to the legal system.[119] The industry's focus on class actions and insolvency cases has in a sense provided justice for the masses. For many plaintiffs, their case may be one of the few experiences they have of the courts and the dispute resolution system.[120] When a funder collapses, leaving plaintiffs standing before the courts unable to proceed, this will have far

106 Ibid 464 [28].
107 Ken Davis, 'The Australian Financial System in the 2000s: Dodging the Bullet' in Hugo Gerard and Jonathon Kearns (eds), *The Australian Economy in the 2000s* (Reserve Bank of Australia, 14 December 2011) 301, 344.
108 *Banking Act 1959* (Cth) s 5 (definition of 'banking business').
109 Ibid s 9(3).
110 Ibid ss 9, 5 (definition of 'authorised deposit-taking institution').
111 Financial Stability Review, 'A Closer Look at the Shadow Banking System in Australia' (Reserve Bank of Australia, March 2012) 69–71; *Australian Constitution* s 51(xx); see generally *Re Ku-ring-gai Co-operative Building Society (No 12) Ltd* (1978) 36 FLR 134; *Financial Sector (Collection of Data) Act 2001* s 7(1)(a).
112 *Banking Act 1959* (Cth) s 11AF; Financial Stability Review, 'A Closer Look at the Shadow Banking System in Australia' (Reserve Bank of Australia, March 2012) 69–71.
113 *Brookfield Multiplex* [2009] 147 FCAFC 11, 22 [32].
114 Schwarcz, above n 98, 1805 n 94 citing Martin H Wolfson, 'Minsky's Theory of Financial Crisis in a Global Context' (2002) 36 *Journal of Economic Issues* 393, 394.
115 Ibid.
116 Viral V Acharya and S Viswanathan, 'Leverage, Moral Hazard and Liquidity' (2009) 66(1) *Journal of Finance* 99, 100.
117 Ibid.
118 *Bentham IMF Bonds Prospectus* (Bentham IMF Limited, 7 April 2014); *Entitlement Issue Prospectus* (Hillcrest Litigation Services Limited, 6 December 2010).
119 *Chameleon Mining* [2011] 50 NSWCA 149, 157 [45].
120 Productivity Commission, above n 4, 539.

reaching impacts on the industry's reputation. In turn, this will deter potential clients from engaging a funder and accessing the courts despite having meritorious cases. This demonstrates that under the status quo, the current regulations may ironically result in an outcome contrary to the Commonwealth Government's intention to increase access to justice.[121]

Furthermore, a collapsed funder would drain court resources and crowd out other proceedings. Each time a class action or insolvency proceeding is commenced, significant judicial and legal resources are required to navigate the complexities of the matter.[122] Not only does that represent an investment by the funder, it is also an investment by the legal system of its limited labour and time towards resolving the dispute between the parties. Should a litigation funder collapse, the cost is therefore also borne in terms of time and resources wasted by counsel and the courts. This is because discontinuance of proceedings does not bar the plaintiffs from commencing fresh proceedings.[123] As a result, the time and legal resources used to reach settlement will increase. The cost of a litigation funder's collapse is borne by the public who have been crowded out of the legal system by all the plaintiffs seeking to re-start discontinued actions. In particular, unfunded litigation, such as human rights or public law litigation, will be affected the most since they will be getting a smaller share of the limited legal resources available.[124] Thus, the insolvent litigation funder is shielded from the full consequences of their risk taking at the opportunity cost of other stakeholders not getting their day in court.

Given the potentially serious impacts a collapsed litigation funder will have on the justice system, regulators need to have an understanding of the economic issues impacting the business model. The three most pertinent issues for litigation funders, as flagged by shadow banking, are liquidity risk, the government's approach to externalities and the 'Too Big to Fail' mentality. [125]

V LIQUIDITY RISK

In the disintermediated shadow banking sector, liquidity risk is one of the main culprits for institutional collapse.[126] This is because both banks and shadow banks profit by being rewarded for taking the risks inherent with maturity transformation.[127] This refers to the process of raising funds through a liability such as a deposit account, where consumers are free to retrieve all their cash at any time. The sum of these deposits is then transformed into a long-term asset, such as a home loan, where most of the funds cannot be accessed until the home loan is paid off. To

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[121] *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth); Minister for Financial Services, Superannuation and Corporate Law, 'Address to Shareholder Class Action Conference' (Speech delivered to the 2010 Shareholder Class Action Conference, Sydney, 4 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2010/005.htm&pageID=005&min=ceba&Year=&DocType=>.

[122] Productivity Commission, above n 4, 538.

[123] *Uniform Civil Procedure Rules 2005* (NSW) reg 12.3; *Supreme Court (General Civil Procedure) Rules 2002* (Vic) reg 25.06; *Supreme Court Civil Rules 2006* (SA) reg 108; *Court Procedures Rules 2006* (ACT) reg 1167.

[124] Productivity Commission, above n 4, 540.

[125] See generally Lissa Lamkin Broome, 'The Dodd-Frank Act: Tarp Bailout Backlash and Too Big To Fail' (2011) 15 *North Carolina Banking Institute* 69.

[126] Schwarcz, above n 98, 1793–4.

[127] Ibid 1804–6; 'Shadow Banking', above n 98, 3–4.

service the cash demands of consumers in the meantime, banks and shadow banks 'roll over' their short term liabilities.[128] That is, they pay for short term cash withdrawals to the consumer with any new deposits received. Liquidity is vital.

However, the reliance on 'rolling over' short term liabilities to remain solvent gives rise to two assumptions. First, it is assumed that, combined with any cash reserves, enough new deposits will be attracted by the bank to enable it to pay customers who wish to withdraw cash from their accounts. The second assumption is that customers will only want a small fraction of their total deposits at any one time, allowing the bank to lend out the rest of the funds. When these assumptions fail, the banks are subject to a bank run. That is, where a bank appears to be about to collapse, most customers will attempt to withdraw all their funds before they lose everything. However, since banks lend out most of their money in long term loans, they will not be able to attract enough new deposits in the short term to cover all the withdrawals. By not being able to meet its immediate obligations to its customers, the bank defaults and collapses.[129] The banking business model therefore facilitates a self-fulfilling prophecy. Even rumours of a bank run occurring will trigger customers to demand payment from the bank, causing otherwise healthy banks to default.

As a result, a government guarantee on deposits protects consumers, promotes stability and increases confidence by minimising the chance of bank runs.[130] This guarantee is also one of the major differences between the banking and shadow banking industries because only traditional deposit-taking banks have access to the guarantee.[131] This is seen with the Commonwealth Government's Financial Claims Scheme, which protects deposits up to $250 000 per account holder per bank.[132] To be eligible, institutions must comply with the corresponding regulatory regime for ADIs.[133] However, this comes at the cost of having to meet minimum liquidity requirements, which limit a bank's ability to issue profit producing long-term loans.[134] This makes them less competitive compared to non-guaranteed shadow banks. Accordingly, since litigation funders are shadow banks, they are free to lend out as much cash as they desire. Absent any regulations to the contrary, funders are likely to tie up their cash in litigation. Thus, an unexpected 'bank run' scenario, such as higher than expected legal fees or an adverse costs orders, could potentially end in insolvency.

However in practice, there are two indications to the contrary. Firstly, funders such as Bentham IMF Ltd recognise the need for a high degree of industry self-regulation and have committed to keeping a minimum of $70 million in cash on their balance sheet.[135] While this is an honourable undertaking by the board (perhaps motivated by their legal background),[136] it is unsustainable.

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128 Tobias Adrian and Adam B Ashcraft, 'Shadow Banking Regulation' (Paper presented at the Annual Review of Financial Economics, New York, April 2012) 5.

129 Schwarcz, above n 98, 1804–6; *Corporations Act 2001* (Cth) s 95A.

130 Australian Prudential Regulation Authority, 'APRA Releases Final Prudential Standard for Financial Claims Scheme' (Media Release, No. 13.19, 24 June 2013); Australian Government, *Financial Claims Scheme*, Consultation Paper (2011) 1 [1.6].

131 Australian Prudential Regulation Authority, *Financial Claims Scheme*, APS 910, January 2012.

132 Ibid.

133 Ibid item 2.

134 Australian Prudential Regulation Authority, *Capital Adequacy*, APS 110, January 2013 items 22–3.

135 *2013 Annual Report* (IMF (Australia) Limited, 21 August 2013) 55.

136 IMF (Australia) Limited, *Our Team* (2013) <http://www.imf.com.au/about-us/our-team>.

This is seen with the four largest substantial holders of ordinary shares being institutional investors holding a total of 29.49%, a figure dwarfing the 14.4% owned by management.[137] Given the greater voting power of the institutional investors, it is likely that pressure will be placed on the board to increase performance measures by investing more cash into litigation.

Another example of industry self-regulation is seen with the Association of Litigation Funders (‘*ALF*’) of England and Wales which has established a Code of Conduct for litigation funders in the region.[138] This code imposes specific financial obligations onto litigation funders, such as having access to a minimum of £2 million of capital at all times.[139] Unlike the financial ratios normally used in banking regulation,[140] the static £2 million requirement applies to all members of the ALF regardless of size. In effect, this acts as a barrier of entry to the industry. Furthermore, if compared to the capital of a large funder such as IMF Bentham of $125 million,[141] the £2 million (A$3.6m) requirement gives funders plenty of leeway and legitimises the practice of holding little equity for emergency cash.[142] Such rules will allow the invisible hand of the market to push liquidity down to dangerous levels.

The second argument against a bank run for litigation funders is that empirical evidence suggests litigation funders hold far too little debt for there to be any impact on liquidity. Hillcrest Litigation Services Ltd and LCM Litigation Fund Pty Ltd are both fully equity funded ventures.[143] If there were to be a panic for investors to withdraw their funds, they would be able to sell their shares to buyers on a secondary market without disrupting funding operations. The only impact of this would be to drive down the market value of the litigation funder.

Nevertheless, because there is no secondary market for litigation funding contracts, the funder’s only ready access to liquidity would be by directly raising funds with a rights issue (issuing more equity) or convertible notes (debt – with the option to be converted into equity at maturity).[144] In both cases, investor panic would increase the risks of the funder not being able to roll over its convertible notes or implement a fully subscribed rights issue.[145] The reliance on rights issues also risks diluting the voting power of management and their resolve to keep a high level of cash. Consequently, the lack of liquidity requirements for litigation funders exposes them to a destabilising force drawing them closer to the prospect of insolvency.

An attempt to regulate against liquidity risk is seen in the aftermath of the GFC in the United States. The newly established Financial Stability Oversight Council (‘*FSOC*’) is able to impose prudential requirements on non-bank financial institutions with assets at or greater than $50

137 *2013 Annual Report*, above n 135, 73–5.

138 See generally Association of Litigation Funders, *Code of Conduct for Litigation Funders*, (at January 2014)

139 Ibid r 9.4.2.

140 Basel Committee on Banking Supervision, ‘Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’ (Document No 92 9197 912 0, Bank for International Settlements, January 2013) 1 [1].

141 *2013 Annual Report*, above n 135, 24.

142 *Currency Converter* (3 June 2014) Foreign Currency Exchange Rates and Currency Converter Calculator <http://aud.fx-exchange.com/gbp/2000000-exchange-rates.html >.

143 *Annual Report 30 June 2013* (Hillcrest Litigation Services Limited, 29 August 2013) 18; LCM Litigation Fund Pty Ltd, *About Us* <www.lcmlitigation.com.au>.

144 Kalajdzic, Cashman and Longmoore, above n 4, 142; cf *Annual Report 30 June 2013* (Hillcrest Litigation Services Limited, 29 August 2013) 26; *2013 Annual Report* (IMF (Australia) Limited, 21 August 2013) 24.

145 *2013 Annual Report*, above n 135, 24, 54.

billion.[146] The language of the enabling legislation provides for a wide discretion for the FSOC to determine which institutions or classes of institutions are to be subject to extra regulations.[147] However, such an approach suffers from the 'boundary problem'.[148] That is, with the high level of discretion afforded to the FSOC, there will be a high degree of uncertainty concerning the scope of institutions covered. There would also be ambiguity concerning the ad-hoc nature of the FSOC's discretionary powers. Furthermore, the use of an explicit asset threshold would suggest the legislation is aimed at protecting the financial system and would therefore preclude much smaller litigation funders.

By contrast, the United Kingdom has adopted a less government-centric solution that seeks to 'ring fence' the operations of banking institutions.[149] Under this model, the deposit taking arm of the bank is to be an entity independent of the investment banking arm of the bank. If the investment banking arm's exposure to financial risks caused a collapse, the ring fence around the deposit taking arm will protect depositors.[150] Given, the primary aim of this response is to protect depositors, there is little direct application to litigation funders that are funded by equity. Nevertheless, the principle behind this regulatory approach can be applied by ring fencing the litigation funding arm of the funder from the capital raising arm. Thus, if the capital raising operations of the litigation funder become subject to liquidity risk, the ring fence will be able to protect clients and ensure minimum disruption to their cases in progress.

VI EXTERNALITIES

Another financial issue impacting litigation funding is that of externalities. Externalities refer to an exchange that imposes a cost on non-consenting third parties.[151] In this case, this would refer to an exchange of money from the funder in return for a cause of action from the client. The non-consenting third party would be the general public who have had an 'important public institution'[152] (the courts) put at risk of abuses of process and other detriments to the administration of justice.[153]

In his analysis, Trebilcock advances two conceptions of externalities.[154] First, a liberal approach is taken, where externalities are characterised as a harm on non-consenting third parties. As a result, the harm principle would justify the government stepping in to intervene on behalf of those third parties.[155] This analysis is consistent with Schwarcz, who suggests the externalities

146 *Dodd-Frank Wall Street Reform and Consumer Protection Act*, 12 USC §§ 115, 165(a)(1) (2012) ('*Dodd-Frank*').
147 Ibid.
148 Schwarcz, above n 98, 1820; Broome, above n 125, 76.
149 Timothy Edmonds, *The Independent Commission on Banking: The Vickers Report*, House of Commons Paper No SNBT 6171, Session 2013 – 14 (2013) 5, 10
150 Ibid 3.
151 Michael J Trebilcock, *The Limits of Freedom of Contract* (Harvard University Press, 1993) 58.
152 Ibid 61.
153 *Fostif* (2006) 229 CLR 386, 435 [93].
154 Trebilcock, above n 151, 59–64.
155 Ibid 61.

during the GFC were caused not by market failure, but by government inaction.[156] That is, externalities are symptomatic of the government's failure to take responsibility.[157]

The second view of externalities takes a utilitarian approach whereby externalities are seen as another transaction cost.[158] As opposed to stepping in on behalf of injured third parties, the government in this case would step back and make a utility maximising judgement that increases the overall benefit for all parties.[159] That is, the government is justified in allowing some externalities to exist provided the benefits of their existence outweigh the costs. This was the view taken by the Commonwealth Government in their minimalist regulation of litigation funding,[160] citing the increased access to justice as the overall benefit justifying the potential threats to justice.[161] By contrast, the High Court's view is that public policy concerns justify court intervention in litigation funding contracts on behalf of society.[162] Since this power is exercised regardless of any benefit the contract would have produced, it is more aligned to the liberal view of externalities.

The value of taking a shadow banking perspective is also evident with its impact on the role of government. After the deregulation of the late 1980s,[163] United States regulators took a relatively hands off approach in light of the perceived benefits free markets would bring.[164] This parallels the current approach to litigation funding, where the Commonwealth Government has allowed externalities in return for greater access to justice. However, after the GFC, this laissez-faire approach has been subject to much criticism, with many commentators calling for a paradigm shift to a more proactive approach.[165] This has been reflected in both United States and United Kingdom reactions to the GFC, with these governments taking a much more involved approach to financial regulation.[166] The Commonwealth Government's current approach to litigation funding is inconsistent with this post-GFC paradigm shift and leaves litigation funders exposed to pre-GFC era financial risks.

VII Too Big to Fail

The third shadow banking issue impacting litigation funding is the 'Too Big to Fail' mentality. During the GFC, the bailouts of the Bank of America and Citigroup created an implicit

156 Schwarcz, above n 98, 1820.
157 Ibid 1806–7, 1812.
158 Trebilcock, above n 151, 59.
159 Ibid.
160 *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth).
161 Minister for Financial Services, Superannuation and Corporate Law, 'Address to Shareholder Class Action Conference' (Speech delivered to the 2010 Shareholder Class Action Conference, Sydney, 4 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2010/005.htm&pageID=005&min=ceba&Year=&DocType=>; Treasury, above n 33.
162 *Fostif* (2006) 229 CLR 386, 417 [39].
163 John Nugee, 'Current Issues in Financial Regulation, and the Return of the Political Economy' (2012) 11 *Journal of International Business and Law* 333, 334.
164 Ibid 333–4.
165 Ibid 334; Schwarcz, above n 98, 1800–4; Broome, above n 125, 80–1.
166 See generally *Dodd-Frank*, 12 USC (2012); Timothy Edmonds, *The Independent Commission on Banking: The Vickers Report*, House of Commons Paper No SNBT 6171, Session 2013 – 14 (2013).

expectation that such 'systemically significant'[167] institutions were 'Too Big to Fail' and would attract government bailout money.[168] Such an expectation amounts to a moral hazard, that is, where a party is protected from the full consequences of their risky actions.[169] Since those banks did not fear a collapse, they were more willing to take make riskier investments and accelerated systemic problems.

However, Australia's shadow banking industry is relatively small, accounting for only 15% of total financial assets.[170] It is unlikely that any litigation funder would be able to be considered as 'systemically significant'.[171] Nevertheless, the litigation funder's speciality in organising masses of plaintiffs for class actions and insolvency cases could position them to be seen as 'Too Important to Fail' and, as a result, be subject to the same moral hazard. That is, if such an expectation exists, litigation funders could get away with funding riskier cases and carry less liquidity in order to drive up performance. When they face the prospect of insolvency, the litigation funder would be able to draw on the sheer number of plaintiffs affected to obtain a bail out from the government.

'Too Big to Fail' was addressed in the United States with the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.[172] This legislation restricted emergency lending with tighter regulations and the requirement for enough security to protect taxpayers.[173] Section 1101 also clarified that the purpose of emergency lending was to inject liquidity into the financial system, as opposed to saving any individual institution. If this approach is mirrored, litigation funders would have access to emergency funds only on the basis of protecting the integrity of the justice system. On the other hand, the United Kingdom's approach is to require 'designated investment firms'[174] to have Recovery and Resolution plans ('living wills'),[175] detailing how the institutions would recover from a stress scenario and what steps would need to be taken to wind up the institution.[176] By contrast to the United States approach, which is still reliant on taxpayer money, the United Kingdom approach is a 'bail-in' model where the costs of institutional collapse are borne by the senior creditors.[177] As a result, this would provide an incentive for senior creditors to become de facto regulators of the institution while protecting the taxpayer from the collapse.

The aforementioned solutions to the challenges of liquidity risk, externalities and 'Too Big to Fail', lend themselves to two broad regulatory approaches. The first model, Command and

167 Broome, above n 125, 76; Financial Stability Review, 'A Closer Look at the Shadow Banking System in Australia' (Reserve Bank of Australia, March 2012) 69.
168 Broome, above n 125, 69.
169 Schwarcz, above n 98, 1803.
170 Financial Stability Review, 'A Closer Look at the Shadow Banking System in Australia' (Reserve Bank of Australia, March 2012) 69.
171 *Dodd-Frank*, 12 USC § 165(a)(1) (2012).
172 Ibid.
173 Ibid § 1101; Legal Information Institute, *Wex*, (at 30 May 2014) Dodd-Frank, 'Federal Reserve System Provisions'.
174 Bank of England Prudential Regulation Authority, *Policy Statement PS 8/13: Recovery and Resolution Plans*, PRA 2013/37, December 2013, 3, annex A s 1.1
175 Broome, above n 125, 77; Schwarcz, above n 98, 1818–20.
176 See also Bank of England Prudential Regulation Authority, *Policy Statement PS 8/13: Recovery and Resolution Plans*, PRA 2013/37, December 2013, 3, annex A ss 2–3.
177 Ibid 3 [6].

Control, places the government in centre stage. The second model, Break and Dissolve is a compromise, using a 'Litigation Continuation Fund' to leverage self-regulation while also acknowledging the valuable role of regulators.

VIII MODEL 1: COMMAND AND CONTROL

Internationally, litigation funding has been largely regulated by the courts and self-regulation.[178] As seen in the doctrinal analysis above, the experience of Australia's early litigation funders has been similar. However, the recent increase in government involvement—in particular, their classification of litigation funding as a financial product—[179] suggests the time is ripe for a departure from this laissez-faire approach. As a result, this model seeks to address liquidity risk, prevent 'Too Big to Fail' and reconcile the unique ethical issues posed by litigation. In addition, the model also demonstrates the government's reluctance to address externalities.

Under the Command and Control model, liquidity risk will be managed by the '*Litigation Funding Act*', which will insert a new chapter into the *Corporations Act* devoted to litigation funders.[180] The new chapter will be overseen by ASIC, which already administers a liquidity requirement (albeit limited to the holding of client monies) for non-APRA regulated bodies.[181] In particular, this new chapter will give ASIC a wider discretion to impose liquidity requirements, much like the Financial Stability Oversight Council in the United States.

Compared to the courts and legal industry bodies, ASIC is in a far better position to regulate liquidity. This is because it is common practice throughout the banking sector to manage liquidity through the calculation of a Liquidity Coverage Ratio.[182] The calculation of this ratio involves financial modelling that ensures banks are able to survive up to 30 calendar days in stress scenarios similar to the GFC.[183] Given the quantitative nature of this endeavour, regulators would need access to an immense amount of financial data. Since companies already lodge their financial reports with ASIC every financial year,[184] ASIC is in the best position to determine a Liquidity Coverage Ratio for non-prudentially regulated entities.

To prevent 'Too Big to Fail' situations, ASIC will also be given powers to request systemically significant funders to create living wills. These documents allow funders to fail without having an adverse impact on the legal system. For instance, they could include clauses to ensure that creditors only retrieve their funds conditional to any ongoing proceedings getting to settlement. By introducing the prospect of failure to systemically important funders, there will be a disincentive for them to take on high risk litigation.

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178 Kalajdzic, Cashman and Longmoore, above n 4, 122, 125; Association of Litigation Funders, *Code of Conduct for Litigation Funders*, (at January 2014).

179 *Corporations Regulations 2001* (Cth), as inserted by *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth) sch 1 item 1A.

180 *Corporations Act 2001* (Cth).

181 Australian Securities and Investments Commission, *Pro Forma 209: Australian Financial Services Licence Conditions*, PF 209, November 2013, item 21.

182 See generally Basel Committee on Banking Supervision, above n 140.

183 Ibid 20.

184 *Corporations Act 2001* (Cth) s 319.

Nevertheless, ASIC's data advantage may also become a disadvantage when it comes to preventing 'Too Big to Fail'. This is seen with the boundary problem that is inherent with the Command and Control approach to regulation.[185] That is, in determining which litigation funders are systemically significant enough to require a living will,[186] it is likely that the line will be drawn with financial criteria.[187] As a result, the legal system would still be exposed to moral hazard from financially small but legally 'Too Important to Fail' litigation funders.

Similarly, commentators have criticised this overly financial approach on the grounds that the regime does not incorporate professional legal and ethical standards.[188] However there are some indications to the contrary.[189] For instance, the recent reforms have imposed conflict of interest management obligations on litigation funders.[190] One of the situations in which conflicts of interest may arise is where the litigation funder needs to improve their cash flow and thus force their client to accept a lower settlement.[191] In this situation, the law requires that litigation funders have 'adequate practices' and follow 'certain procedures' to manage such conflicts of interest.[192] To comply with these obligations, funders will need to have documentation of these policies.[193] Thus, in the above scenario, it is IMF's policy that their instructions can be overruled by the client issuing their own instructions.[194] Disagreements concerning settlement are managed by seeking the advice of counsel on whether the settlement is 'reasonable in all of the circumstances'.[195]

Furthermore, after the collapse of Storm Financial and Opes Prime during the GFC, there was a loss of public trust and confidence in Australian financial institutions.[196] As a result, there has been a trend towards higher professional standards being placed on the finance industry. For

185 Schwarcz, above n 98, 1820; Broome, above n 125, 76.

186 Financial Stability Review, 'A Closer Look at the Shadow Banking System in Australia' (Reserve Bank of Australia, March 2012) 69; Broome, above n 125, 76.

187 *Australian Securities and Investments Commission Act 2001* (Cth) s 1(2)(a).

188 Office of the Legal Services Commissioner (NSW), above n 4, 3–4; see generally *Legal Profession Act 2004* (NSW); *Legal Profession Act 2004* (Vic); *Legal Practitioners Act 1981* (SA); *Legal Profession Act 2006* (ACT); Law Society of New South Wales, *Professional Conduct and Practice Rules* (at 1 January 2014).

189 *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) sch 1 item 23 s 961B(1); *Corporations Regulations 2001* (Cth), as inserted by *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth) sch 1 item 6, reg 7.6.01AB(2); see generally Australian Securities Investment Commissions, *Litigation Schemes and Proof of Debt Schemes: Managing Conflicts of Interest*, RG 248, April 2013.

190 *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth) sch 1 item 6, reg 7.6.01AB.

191 John Walker, 'Policy and Regulatory Issues in Litigation Funding Revisited' (2014) 55 *Canadian Business Law Journal* 85, 96–7.

192 *Corporations Amendment Regulation (No 6) Amendment Regulation 2012 (No 1)* (Cth) sch 1 item 6, regs 7.6.01AB(1), 7.6.01AB(2)(a).

193 Ibid reg 7.6.01AB(4); Australian Securities Investment Commissions, *Litigation Schemes and Proof of Debt Schemes: Managing Conflicts of Interest*, RG 248, April 2013, 12.

194 Walker, above n 191, 100.

195 Ibid 101.

196 Explanatory Memorandum, Corporations Amendment (Further Future of Financial Advice) Bill 2012 (Cth) 3; Minister for Financial Services and Superannuation, (Speech delivered to the Financial Planners Association Luncheon, 13 April 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2011/012.htm&pageID=005&min=brs&Year=&DocType=1>.

example, the 'best interest obligation'[197] has been imposed on the provision of financial advice. Similar to a lawyer's fiduciary duty, this obligation, if imposed on litigation funders advising potential claimants, would require them to act in the best interests of the claimant.[198] However unlike a common law fiduciary duty,[199] the legislature outlines in detail how best interest obligations would be fulfilled.[200] Both the conflict of interest and best interest obligations demonstrate a post-GFC financial regulatory regime that is able and willing to impose professional duties on the industry. Thus, the lack of professional or ethical standards could potentially be unfounded in the long term as this regulatory trend continues.

Regardless of which regulator administers the Command and Control regime, this model is reliant on the government to remedy externalities. However Archarya suggests this reliance may be misplaced because governments are subject to moral hazard.[201] This is seen with the United States Government's acquiescence to the pre-GFC growth of shadow banks which allowed for cheaper mortgages and greater access to housing.[202] As a result, governments had an immediate political incentive not to regulate the industry,[203] while the consequences of that decision would be borne by future governments during the GFC. Similarly, the Commonwealth Government's reliance on shadow banks to increase access to justice creates an immediate political benefit, leaving the adverse consequences to successive governments. As a result, externalities will remain unregulated where there is only government supervision.

IX MODEL 2: BREAK AND DISSOLVE AND THE LITIGATION CONTINUATION FUND

Alternatively, a less government-centric model would involve two components. Firstly, the litigation funding business model will be broken up into a fundraising entity and a ring fenced litigation entity. This ensures issues such as liquidity risk and 'Too Big to Fail' are addressed. Secondly, a 'Litigation Continuation Fund' will be established that harnesses competition to reduce externalities. Finally, the relative merits of both models, in particular concerning legal ethics will be considered.

Under the Break and Dissolve model, liquidity risk is managed by dissolving the regulation of the fundraising entity into existing financial and corporate law, and the regulation of the litigation entity into the existing legal professional regime. Since the fundraising entity is independent of the litigation entity, it is likely that existing financial institutions, such as banks, money market funds, or investment banks, will perform that function.[204] As a result, this article is only concerned with what happens after wholesale funding is raised by the fundraising entity.

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197 *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) sch 1 item 23 s 961B(1).

198 Ibid.

199 *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1, 568 [4552].

200 *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) sch 1 item 23 s 961B(2).

201 Viral V Acharya, 'Governments as Shadow Banks: The Looming Threat to Financial Stability' (2012) 90 *Texas Law Review* 1745.

202 See especially ibid 1769–70.

203 Ibid 1749, 1763–4.

204 Financial Stability Review, 'A Closer Look at the Shadow Banking System in Australia' (Reserve Bank of Australia, March 2012).

Since institutional investors are able to provide longer term loans to the litigation funder, the funder no longer profits from maturity transformation. The litigation entity's decreased reliance on being able to 'roll over' funds significantly reduce their exposure to liquidity risk. Instead, litigation entities would profit from management fees charged for their fund management role. These characteristics would essentially place litigation entities within the definition of a hedge fund.[205]

Nevertheless, the liquidity risk facing litigation entities can still be managed through security for costs orders.[206] While the power is discretionary,[207] *Green v CGU*[208] suggests that, in practice, courts tend to order security for costs to match the financial rewards the funder gains funding the litigation with the attendant risks of the litigation. In essence, this imposes a specific liquidity ratio for each litigation venture and prima facie negates the need to ring fence the funding clients.

However, there are three drawbacks to this approach. First, security for costs is ordered 'on the application of the defendant'[209] and would directly impact the profitability of the litigation venture for the litigation funder. This would therefore likely lead to satellite litigation,[210] which would prolong the proceedings for all parties. Second, the determination of the quantum of security is a hypothetical exercise, subject to a high degree of uncertainty.[211] As a result, this translates into higher financial risks taken on by the funders. Accordingly, in order to compensate for the risks taken, funders charge higher fees, which ultimately reduce access to justice. Third, security for costs would only apply to matters before the courts. Thus, the liquidity risk facing litigation funders in matters conducted out of court remain an issue for defendants.[212] While the security for costs regime may still operate under the Break and Dissolve model, ring fencing the litigation arm of the funder allows funders to charge more competitive fees and offers a minimum level of liquidity protection for out of court matters.

The Break and Dissolve approach would also prevent 'Too Big to Fail' by placing litigation funders under the office of the various state based Legal Service Commissioners.[213] Although Legal Service Commissioners would still be dealing with the boundary problem of identifying systemically important entities, they are much better equipped than ASIC. Unlike ASIC's approach, systemically important litigation entities could be defined by reference to the number of plaintiffs the funder has funded. As opposed to a financial benchmark, this indicator is a

205 Australian Securities Investment Commissions, *Hedge Funds: Improving Disclosure*, RG 240, October 2013, 240.3.

206 *Federal Court of Australia Act 1976* (Cth) s 56; *Uniform Civil Procedure Rules 2005* (NSW) reg 42.21; *Supreme Court (General Civil Procedure) Rules 2005* (Vic) O 62; *Supreme Court Civil Rules 2006* (SA) Pt 14; *Civil Procedures Rules 2006* (ACT) Ch 2 Pt 2.17 Div 2.17.8.

207 *Federal Court of Australia Act 1976* (Cth) s 56(1)*Uniform Civil Procedure Rules 2005* (NSW) reg 42.21(1); *Supreme Court (General Civil Procedure) Rules 2005* (Vic) reg 62.02(1); *Supreme Court Civil Rules 2006* (SA) s 194(1); *Civil Procedures Rules 2006* (ACT) s 1901.

208 [2008] NSWCA 148 (20 June 2008) [51].

209 *Federal Court of Australia Act 1976* (Cth) s 56(1); *Uniform Civil Procedure Rules 2005* (NSW) reg 42.21(1); *Supreme Court (General Civil Procedure) Rules 2002* (Vic) reg 62.02(1).

210 Legg et al, above n 2, 234.

211 Ibid.

212 *Fostif* (2006) 229 CLR 386, 435 [93].

213 *Legal Profession Act 2004* (NSW) Pt 7.3; *Legal Profession Act 2004* (Vic) Pt 6.3; *Legal Practitioners Act 1981* (SA) Pt 6 Div 2; *Legal Profession act 2006* (ACT) Ch 8.

superior way to navigate the boundary problem as it captures all potentially at-risk funding entities, regardless of financial size.

Furthermore, ring fencing the litigation entity ensures that client proceedings are protected from the financial risks faced by the funding entity. By ensuring that discontinuance is avoided,[214] ring fencing minimises the disruption to the courts and the drain on legal resources in times of financial stress. Since this reduces the severity of the funder's collapse on their clients and the legal system, funders will be allowed to fail and will therefore make more prudent investments.

The second component of this model is the 'Litigation Continuation Fund', which is a market-based solution to reduce externalities. The fund will provide emergency finance to any ongoing proceedings at the time a funder collapses. The fund is to be financed by an annual tax on litigation investment entities.[215] While the idea is not new, the 'Litigation Continuation Fund' differs from the failed Justice Fund proposal in 2008 in two respects.[216] Firstly, the Justice Fund was an attempt by the Victorian government to address externalities by stepping in and replacing the existing 'no win no fee' law firms and private litigation funders.[217] Not surprisingly, this was met with resistance.[218] For this reason, the 'Litigation Continuation Fund' does not seek to replace commercial litigation funders. Instead, the fund complements commercial activities by providing emergency cash in the event of a commercial funder collapse.

The second difference is that the Justice Fund's only purpose was litigation funding, which placed a focus on it being the 'likely province of endless bureaucracy'.[219] By contrast, the 'Litigation Continuation Fund' has a much more powerful purpose than just the provision of funds. Since the fund is financed by the litigation funding industry, industry participants will become de-facto regulators of each other,[220] ensuring that no funder will abuse the existence of the fund by funding risky cases or otherwise doing harm to the courts. Under this model, the interests of the non-consenting third parties become aligned with the commercial interests of the funders. Unlike the Command and Control model, this allows externalities to be reduced independently of morally hazardous government policy.

Furthermore, the Break and Dissolve model acknowledges the value of both ASIC and the legal professional regime by allowing the disparate entities to be dissolved into the existing regimes. A similar but more general approach has been outlined by the Productivity Commission.[221] In particular, the legal professional rules regime includes the *Legal Profession Act*,[222] the common

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214 *Uniform Civil Procedure Rules 2005* (NSW) reg 12.3; *Supreme Court (General Civil Procedure) Rules 2002* (Vic) reg 25.06; *Supreme Court Civil Rules 2006* (SA) reg 108; *Court Procedures Rules 2006* (ACT) reg 1167.

215 Schwarcz, above n 98, 1814.

216 Victorian Law Reform Commission, *Civil Justice Review*, Report No 14 (2008) 614–8.

217 Ibid 614–5.

218 Ibid 621–2.

219 Ibid 622.

220 Schwarcz, above n 98, 1814.

221 Productivity Commission, above n 4, 546.

222 *Legal Profession Act 2004* (NSW) see also *Legal Profession Act 2004* (Vic); *Legal Practitioners Act 1981* (SA); *Legal Profession Act 2006* (ACT)

law duties imposed on the profession,[223] the *Solicitors Rules,*[224] and the *Barristers Rules*.[225] Under this model, litigation entities will be held by Legal Services Commissioners and the courts to the same standards and duties as those imposed on lawyers. Importantly, litigation entities will owe a paramount duty to the court,[226] a duty unique to lawyers, which is out of scope under the current ASIC regime.[227]

As held in *Brookfield Multiplex*, clients engage litigation funders for several reasons – from getting an ability to access justice to managing the financial risks of litigation. As a result, the regulation of the industry has required a balance between achieving those two ends. Nevertheless, just because both ends are achieved through the funding contract does not imply they are of equal importance or that both are deserving of equal levels of regulation. Not surprisingly, the primary concern of the literature is on granting access to justice and preserving the integrity of the legal system as opposed to allowing companies to hedge their litigation risk.[228] As a result, the Break and Dissolve model with a 'Litigation Continuation Fund' would be the preferred model because of its use of the legal professional rules regime.

X CONCLUSION

The 'greed is good' mantra of the financial world in the 1980s has well and truly died down after the GFC. Valuable lessons can be learnt from the experiences of the shadow banks and the greater financial system after the GFC, which can be applied to the regulation of litigation funding.

By moving away from managed investment schemes and setting the legal definition of litigation funders as third party commercial litigation funders, this article has implicitly drawn out the distinctions between the financial system and the legal system. Furthermore, the current regulations suggest litigation funders are shadow banks, sitting at the crux between these diverse systems. As a result, a myriad of new issues have been uncovered by taking a shadow banking perspective to litigation funding regulation. Issues such as liquidity risk, the government's role in relation to externalities, and the 'Too Big to Fail' mentality pose unique challenges for the regulators of litigation funding. Ironically, the exploration of regulatory approaches has led to a Break and Dissolve model that acknowledges the strengths inherent in the existing financial and

223 LexisNexis, *Riley Solicitor's Manual*, (at March 2014) Relationship Between Lawyer and Client, '2 Lawyer-client Duties – Introduction' [2025].

224 Law Society of New South Wales, *Professional Conduct and Practice Rules* (at 1 January 2014); New South Wales Bar; Law Institute of Victoria, *Professional Conduct and Practice Rules 2005* (at 20 June 2005); Law Society of South Australia, *Rules of Profession Conduct & Practice* (at 1 March 2003); Law Society of the Australian Capital Territory, *Legal Profession (Solicitors) Rules 2007* (at 1 October 2007).

225 *New South Wales Barristers' Rules* (at 6 January 2014); Victorian Bar, *The Victorian Bar Incorporated Practice Rules* (at 22 September 2009); South Australian Bar Association, *Barrister's Conduct Rules* (at 14 November 2013); Australian Capital Territory Bar Association, *Legal Profession (Barristers) Rules 2014* (at 20 August 2014).

226 LexisNexis, *Riley Solicitor's Manual*, (at March 2014) Relationship Between Lawyer and the Administration of Justice, '20 Duty to the Court – Introduction' [20 005.5].

227 *Australian Securities and Investments Commission Act 2001* (Cth) s 1.

228 See generally Legg et al, above n 2; Kalajdzic, Cashman and Longmoore, above n 4; Productivity Commission, above n 4; Morabito, above n 4; Office of the Legal Services Commissioner (NSW), above n 4.

legal regulatory regimes. As a result, there is no need for an independent regime, especially for litigation funders as with the Command and Control model. Regardless of which approach is taken, the analysis confirms that in both cases litigation funding requires greater financial regulation.

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