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Class Action Insights

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Welcome to this edition of *Class Action Insights*.

In recent months, the funding of class actions has been prominent in the legal press. The issues canvassed have included the regulation of third party funders, the case for and against lawyers charging contingency fees, attempts by lawyers to establish third party funding vehicles, the Productivity Commission's draft recommendations in relation to the private funding of litigation, and the Commonwealth Attorney-General's proposed review of the litigation funding sector.

Many of those articles have involved stakeholders putting the case for their preferred position, in some instances with a sense of impending doom for either the business community or access to the justice system. Given the range and strength of views on these issues, it can be difficult even for informed readers to 'sort the wheat from the chaff'.

With those difficulties in mind, we have prepared this edition of *Class Action Insights* with a view to providing our clients with a brief guide to the key issues and our views on how the current questions should be resolved.

The funding of class actions: where are we up to?

The High Court's decision in *Fostif* in 2006 dealt with the question of the validity of third party funding, but it did not put an end to the controversy. Not content with the acceptance of the legality of their enterprise, third party funders have repeatedly sought to push the boundaries of what is permissible under Australia's class action regimes to better suit their profit-driven business models.

Most notably, funders have done this through the use of 'opt-in' classes – a concept originally said to be repugnant to the policy of Australia's 'opt-out' class action regimes, but now generally accepted. More recently, funders have asked the courts to impose obligations to pay funding commissions on persons who have not entered into funding agreements.

At the same time, plaintiff lawyers have been exploring avenues by which they can take a share of the proceeds of class action litigation – whether by charging contingency fees or by an associated entity providing funding.

This testing of the system is taking place in an uncertain regulatory environment, which is the product of the fundamentally different views as to the virtues of third party funding held by the previous and current Federal Governments.

Each of these matters has contributed to a dynamic and uncertain funding environment.

Recent developments – the reasons for the current uncertainty

The current 'light-touch' approach to regulation of third party funders

Following the *Fostif* decision, various appellate court decisions held that funders were subject to certain regulatory requirements – including holding an Australian Financial Services Licence and, for class action funders, compliance with the regulatory regime for managed investment schemes.

The previous Federal Government implemented legislation (effective from July 2013) to reverse the effect of those decisions on the basis that third party funding was desirable because it facilitated class actions which, in turn, facilitated access to justice.[1]

The effect of that legislation is that funders are not currently subject to any form of licensing, or supervisory, reporting or operational requirements, beyond a requirement to have adequate systems in place to manage conflicts of interest. As a result, there are few barriers to entry to the funding market.

Lawyers looking for a share of the proceeds

The effect of the prohibition on contingency fees and the 'light touch' approach to the regulation of third party funding is that the lawyers bringing an action are currently the only persons not permitted to fund it in return for a share of the proceeds.

This situation has led to calls for the prohibition on contingency fees to be lifted.

It has also led to an attempt by plaintiff lawyers to enter the commercial funding market through an associated entity. In August 2013, Maurice Blackburn announced a proposal by which a funding vehicle associated with its principals would co-fund the equine influenza class action. That proposal was, however, abandoned early this year on the express basis that, given the Attorney-General's stated opposition to funding arrangements of this nature, it was likely that the arrangement would be prohibited by legislation.[2]

Funding commissions from all group members

Recently commercial funders have sought to push the boundaries of the class action regimes by seeking orders under which they would receive a funding commission from all group members who participate in a settlement or judgment, including those who have not signed a funding agreement. These applications attempt to push commercial funding beyond a voluntary contractual arrangement to a condition that the court imposes upon group members.[3]

The primary motivation for this innovation is to increase the funders' return by requiring so-called 'free riders' to pay a funding commission. It would also make 'opt-out' classes significantly more attractive to funders and, in the process, avoid some of the practical difficulties – including lack of finality and inefficiencies – that can arise from the use of 'opt-in' classes.

Although each successive application has been different, as the funders attempt to address the courts' concerns with the previous applications, the funders are yet to come up with a form that has survived challenge.[4] In the GPT class action, Justice Gordon of the Federal Court said that, although each application should be considered on its merits, 'it is difficult to conceive of a circumstance in which it would be appropriate'.[5] In February 2014, Justice Jacobson expressed significant doubts as to the Federal Court's power to make such an order.[6] The next application will be heard in the Allco Finance case in August 2014.

Productivity Commission's draft recommendations

In April 2014, the Productivity Commission issued its draft recommendations in its inquiry into access to justice arrangements. Those draft recommendations relevantly included that:

- third party funders should be licensed, be subject to capital adequacy requirements, and be required to meet ethical and professional standards; and
- the prohibition on contingency fees should be lifted, subject to comprehensive disclosure requirements.

Attorney-General's comments and proposed review

The Commonwealth Attorney-General has publicly stated that the litigation funding sector is under 'active consideration' and that an advisory panel would be convened to consider whether reform is required.

The Attorney-General has made it clear that he supports class actions as an important means of access to justice. His concerns appear to be generally focused on what he describes as 'wildcat and opportunistic' class actions and the potential 'conflicts of interest and moral hazards' associated with entrepreneurial funding.

He has also expressed his opposition to any lifting of the prohibition on contingency fees.

We see this as a positive development because a thoughtful review of the policy issues in this area is well overdue.

Lawyer entrepreneurialism in class action litigation

The limits on entrepreneurialism by class action lawyers have also been recently tested in shareholder class actions commenced by Melbourne City Investments Pty Ltd (***MCI***), a company managed and controlled by Melbourne-based solicitor, Mark Elliott. Mr Elliott has been acting for MCI in these cases on a 'no win, no fee' basis.

In determining applications made by the defendants that focused on the relationship between MCI and Mr Elliott, Justice Ferguson of the Supreme Court of Victoria inferred that Mr Elliott had a 'business model' of purchasing small shareholdings in listed companies with the objective of subsequently commencing class actions against some of them for breach of continuous disclosure obligations (in November 2012, MCI acquired small interests in 19 public companies) and that MCI's predominant purpose in initiating the class actions was to enable Mr Elliott to earn legal fees. [7]

Her Honour held that, in those circumstances, there was a real risk that Mr Elliott could not give detached, independent and impartial advice in the interests of all group members. Her Honour held that either Mr Elliott must cease acting or MCI had to be replaced as representative plaintiff – otherwise the proceedings cannot continue as representative proceedings.

How should these issues be resolved?

The Productivity Commission's inquiry and the Attorney-General's proposed review provide an important opportunity to review the current system. In our opinion, the question that should be considered is whether there are sufficient checks and balances in that system to provide appropriate protection to both consumers and the business community, bearing in mind the key policy objectives of the class action regimes (access to justice, efficiency and certainty for defendants).

Bearing in mind those objectives, in our view, the current uncertainties would most sensibly be resolved by the following:

Implementing a licensing regime and capital adequacy requirements

An unregulated funding market is open to abuse and does not provide sufficient protection for consumers or class action defendants. Among other things, it leaves funded litigants (and the defendants they are suing) exposed to an unscrupulous and/or impecunious funder putting itself into liquidation to avoid an adverse costs order. Accordingly, at the very least, capital adequacy requirements should be imposed.

Financial services licensing would bring funders (including offshore funders) more squarely within ASIC's supervisory jurisdiction. Among other things, it would impose obligations to act honestly, fairly and efficiently, comply with financial services laws, implement dispute resolution and risk management processes and report significant breaches to ASIC. Given the number of offshore funders entering the market, a process which anchors them into the requirements of the Australian legal system is an important protective measure.

Funding should remain a matter of contract

Third party funding has been accepted as a matter of contract, but there is significant doubt as to whether the courts have the power to impose an obligation to pay a funding commission on persons who have not signed a contract. If the courts do not have that power, the funders' desired outcome of receiving commissions from all participating group members could only be achieved through legislative amendment.

Although encouraging the funding of 'opt-out' classes may be seen as desirable in a number respects, we are far from convinced that those factors justify changing the law to facilitate litigation funders taking a bigger share of class action settlements and judgments. Particularly in circumstances in which funders would likely take that 'bigger share' at the expense of group members, it is difficult to see how this development would facilitate access to justice.

Not rushing to lift the prohibition on lawyer funding and contingency fees

Contingency fees and lawyer-sponsored funding schemes would give lawyers a direct financial interest in decisions affecting the litigation they are running. Some say that neatly aligns the interests of lawyer and client and avoids having to pay both a lawyer and a funder. In our view, however, it has the potential to give rise to conflicts of interest on a number of levels. Accordingly any lifting of the prohibition requires careful consideration.

In circumstances in which third party funding is such an entrenched feature of our legal system (and lawyer-funding is available through conditional fee agreements), careful consideration should be given to whether there is a good policy reason to lift the ban on contingency fees. Indeed, it could be said that the nature of the Australian third party funding market (whether good or bad overall) creates an opportunity to maintain a legal profession that is free of the potential conflicts that arise from having a direct financial interest in the outcome of litigation.

These issues are explored further in the article that follows.

1. Allens Client Update: *Regulations clear the way for litigation funding (again)*

2.http://www.mauriceblackburn.com.au/legal-services/general-law/class-actions/current-class-actions/equine-influenza-class-action/

3. Common fund orders differ from the generally accepted 'funding equalisation mechanism' which spreads the commission the funder is contractually entitled to receive across all participating group members (so that the funded group members are not worse-off from their decision to help fund the claim). Under common fund orders, the funder would receive a full commission from each participating group member.

4. An order of similar effect was embedded in the settlement scheme approved by the Supreme Court of Victoria in the shareholder class action against NAB – that order was, however, made by consent and was not the subject of substantive analysis as to its appropriateness nor the court's power to make it (and, as such, is of limited precedential value). See *Pathway Investments Pty Ltd v National Australia Bank Limited (No 3)* [2012] VSC 625.

5. *Modtech Engineering Pty Limited v GPT Management Holdings Limited [2013]* FCA 626 at [60].

6. Directions hearing on 21 February 2014 in *Inabu Pty Limited v Leighton Holdings Limited* (NSD2244 of 2013). That application is currently stayed because the parties have reached a conditional settlement.

7. *Melbourne City Investments Pty Limited v Treasury Wine Estates Limited* (No.3) [2014] VSC 340.

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Taking their fair share? Lawyers as litigation funders

There is growing support for reforms that would allow lawyers to take a share of the litigation proceeds. Looking to other jurisdictions such as the US, and recent reforms in the United Kingdom, it is now suggested that Australia should lift the ban on lawyers charging contingency fees or alternatively adopt a 'common fund' approach to remunerating plaintiff lawyers who take on the risk of funding class actions.

These proposed reforms challenge traditional notions of lawyers acting as objective and impartial advisers. In our view, real questions exist as to whether they are necessary or appropriate in the Australian context.

Contingency fees vs conditional fees

The methods available to Australian lawyers to fund litigation are currently limited by the prohibition on contingency fees. Contingency fees are where the lawyer's fee is calculated as a percentage of any amount recovered for the client. Similar to a litigation funder, the lawyer effectively purchases a share in the outcome of the litigation.

Australian lawyers are, however, able to enter into conditional fee arrangements. Here, payment of the lawyer's fee is contingent on a successful outcome. These arrangements are often described as a 'no win, no fee' arrangement. They typically involve 'billing' on an hourly rate basis – with no fee charged if the claim is unsuccessful and the application of an 'uplift' if the action is successful.

The fundamental distinction between conditional fees and contingency fees is that conditional fees are charged by reference to the work undertaken and cannot be charged by reference to the value of the claim.

Productivity Commission recommends lifting the ban on contingency fees

In its recent draft report into Access to Justice Arrangements, the Productivity Commission has suggested that to increase access to justice, Australia should lift the ban on contingency fees. The Commission's position is that the incentives for lawyers under a contingency fee arrangement are no more problematic than those under a conditional fee arrangement. Further, that contingency fees align the interests of the lawyer with their client in that the incentive for both parties is for the largest payout and the lowest costs. [1]

In considering this issue, the Commission looked to a number of overseas jurisdictions which have lifted the blanket prohibitions on contingency fees, such as Canada and the United Kingdom. The UK now permits 'damages based agreements' for most civil litigation, subject to certain conditions. Caps are placed on the fees that may be charged – 50 per cent of the amount recovered in commercial cases, 35 per cent in employment cases, and 20 per cent in personal injuries cases. In the Commission's view, the experience in those jurisdictions indicates that permitting contingency fee arrangements in Australia would increase access to justice and that the retention of Australia's loser-pays costs rule would discourage any explosion of frivolous claims.[2]

Is there a case for change?

In our view, there are a number of reasons why any lifting of the ban on contingency fees should be approached with great caution. Key among these is that contingency fees give lawyers a direct financial interest in decisions affecting the litigation they are running. Contingency fees therefore have the real potential to undermine a lawyer's independent judgment and to give rise to conflicts of interest which are not present when lawyers are charging on a fee-for-service basis. For example, in a contingency fee arrangement, advice given to a client as to the timing and amount of a settlement may be influenced, or perceived to be influenced, by the direct financial benefit that lawyer might themselves obtain.

It also has the potential to upset the balance the High Court sought to achieve in the class actions regime when originally accepting the role of third party funders. In considering the validity of third party funding, the High Court was concerned that the decisions of funders may be influenced by conflicts of interest. However, it was ultimately acknowledged that such a risk could be managed by the independence of the legal profession.[3] Such independence, and the balance sought to be struck by it, will be threatened if the ban on contingency fees is lifted. [4]

Further, given that third party litigation funding is now an entrenched feature of the class actions regime, the policy need for contingency fees is also questionable. While the draft Productivity Commission report states that contingency fees would increase access to justice, the report does not identify any 'gap' in need that contingency fees would successfully fill. In other words, it does not identify any category of claim that lawyers may be prepared to fund on a contingency fee basis which would not be funded by a third party funder or lawyers acting on a conditional fee basis.

In the class actions context, there is also little consideration of whether commercial funding agreements and contingency fee arrangements are, in practice, interchangeable. Unlike commercial funding arrangements, contingency fee arrangements do not usually involve a commitment to meet security for costs or adverse costs orders made against the lead plaintiff. There is a real question as to whether plaintiff lawyers would be prepared to take on these obligations.

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In this regard, it is important to note that to introduce contingency fees alongside third party litigation funding would take Australia beyond the position in the US. Contingency fees have long been allowed in the US and, in the case of class actions, are closely supervised by the courts. However, because of this, unlike in Australia, litigation funders have no role to play.[5] The US position suggests that contingency fees and third party funding are mutually exclusive – that there is no need for one where the other is already in place.

The US common fund approach

Some commentators have suggested that an alternative approach to contingency fees in class actions is the US court-supervised 'common fund' approach.[6] It is said that this approach would overcome the problem of 'free riders' in 'open class' class actions while avoiding the excesses of contingency fees.

In the US, the common fund approach provides that group members who obtain the benefit of a damages award or settlement without contributing to legal costs should not be enriched at the successful representative plaintiff's expense. Those group members are required to contribute to the legal costs incurred, regardless of whether they each have a contractual agreement with the plaintiff lawyer. These fees are deducted from the 'common fund' created by the litigation, before payments are made to eligible group members.

The legal costs deducted from the common fund can be a percentage of the award that goes over and above the actual legal costs incurred. The court also plays a significant oversight role in the 'common fund' approach, including specifying the eventual fee award. While applications to establish a common fund are made at the outset of proceedings, the reasonableness of the legal fees is determined at the end of the class action.

Adopting the common fund approach in Australia?

In our view, it is neither necessary nor appropriate to apply the common fund approach in the Australian context. Unlike Australia, the US is a 'no costs' jurisdiction. That is, in the US the successful representative plaintiff does not usually receive an order that the defendant pay their legal costs. The common fund doctrine is intended to operate as an exception to this general rule.

However, Australia is a 'costs' jurisdiction and in the event that the representative plaintiff is successful, they will receive a costs order in their favour. In addition, to ensure that a representative plaintiff is not out of pocket for its legal expenses, section 33ZJ of the *Federal Court Act 1976* (Cth) permits a representative applicant to apply for a further contribution to its legal costs where a court has made an award of damages. An application under s33ZJ can only be made at the end of the proceedings, after damages have been awarded. Further, ss33V and 33ZF, when read together, allow the court to make similar orders when the matter is subject to a court-approved settlement. In short, the Australian regime already addresses the possibility of a representative applicant being out of pocket for its legal expenses and, as such, the common fund approach has no place in the Australian context.

The introduction of the common fund approach in Australia also raises broader questions as to the current profit driven nature of our class actions landscape. There is in an implicit assumption in commentary concerning the common fund approach that there will be always be a pool of money available to group members at the conclusion of every case – whether by way of settlement or by judgment. However, not all class actions are successful and it may be that the lead plaintiff and potentially their lawyers are required to meet substantial costs orders in favour of the defendant in the event that the case is lost. In seeking to promote alternative means of funding class action litigation, lawyers must be willing to take the risks with the rewards.

1 See page 533 of the draft Report. The final Report is due to be released in September 2014.

2 Ibid, page 530.

3 See the minority decision in *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58.

4 These concerns are also reflected in *Melbourne City Investments Pty Ltd v Treasury Wine Estates Limited (No. 3)* [2014] VSC 340.

5 See Jarrah Hoffmann-Elkstein, 'Funding open classes through common fund applications', (2013) 87 ALJ 331. According to Hoffmann-Elkstein, there does not appear to have been a reported instance of a litigation funder funding a class action in the US to date.

6 Michael Legg, ' Contingency fee debate continues', *Australian Financial Review,* 23 May 2014. Michael Legg's article is specifically concerned with the US common fund approach. This is to be distinguished from the 'common funder' applications which have been made in recent times which seek to impose an obligation to pay a funding commission on all group members. (as discussed in the previous article in this edition of *Class Action Insights*).

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Spotlights

Federal Court to consider the test for causation

Perhaps the most important unanswered question in Australian class action law is the test for causation in the context of shareholder class actions. In short, the question is whether each shareholder must prove that they relied on the contravening conduct or whether causation can be established by notions of reliance by the market affecting the price at which each shareholder purchased and/or sold their shares. This issue is yet to be the subject of a judgment of a court. It was, however, raised in proceedings against Babcock & Brown which were heard by Justice Perram of the Federal Court in July. His Honour's decision is currently reserved.

US Supreme Court rejects challenge to 'fraud on the market'

In securities class actions in the United States, causation is often addressed by the 'fraud on the market' theory. Although the 'fraud on the market' theory is not directly transferable to the Australian legal system, both it and the Australian concept of market-based causation have their basis in the efficient market hypothesis. The US Supreme Court recently heard a challenge to the validity of the 'fraud on the market' theory which was based on a claim that markets are not fundamentally efficient. The Supreme Court rejected that challenge on the basis that fraud on the market is not dependent on an 'unjustifiably robust' view of market efficiency, but rather on the 'fairly modest' premise that 'market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices'. Had the Supreme Court taken a different view and rejected the 'fraud on the market' theory because it depended on an overstated theory of market efficiency, it would have substantially weakened the case for recognising 'market-based' causation in Australia. The survival of the theory preserves the status quo and brings us no closer to knowing how the Australian position will be resolved. See our Client Update for more information.

Our Recent Publications

- **Client Update:** The limits of lawyer-driven litigation
- **Client Update:** 'Fraud on the market' theory survives challenge in the US
- **Focus:** Productivity Commission - third party litigation funding and contingency fees
- **Paper:** Class actions in Australia
- **Paper:** Shareholder class actions in Australia

Federal Court's growing acceptance of litigation funding

Two recent decisions highlight the extent of the Federal Court's acceptance of litigation funding in class actions. It was held to be in the interests of justice, and in keeping with the court's supervisory role in class action proceedings, to require that class members in an investor class action be informed that there was a risk that funding for the proceedings would be withdrawn if sufficient class members did not enter into an agreement with the third-party funder. In another investor class action, the Full Federal Court held that a failure to provide evidence as to why the class action was not being commercially funded was a factor in favour of requiring the representative plaintiff to provide security for the respondents' costs. See our Client Update for more information.

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