

Debunking common class action and litigation funding myths

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- The current Australian class action and litigation funding environment has improved corporate culture and encouraged improvements in continuous disclosure practices
- The maturing market for litigation funding has promoted an equality of arms between claimants and corporate and government defendants, helping to ensure cases are determined by their merits rather than by the use of attrition strategies
- The combination of Australia's 'loser pays' cost sanctions and security for costs rules offer protection to defendants against unmeritorious claims

The class action and litigation funding debate has captured significant media attention but continues to be plagued by misinformation.

Terms like 'litigation floodgates' and 'US excess' give the impression that shareholder claims are proliferating. However, the data tells a different story. This article seeks to address some common misconceptions about Australian class actions and litigation funding.

Background

Australia's federal class action regime commenced in 1992.¹ Initially, most actions were conducted on a conditional 'no-win no-fee' basis. Given the substantial cost of conducting class actions, the financial burdens became intolerable for most firms. Litigation funding developed as an alternative to the conditional fee approach. Although the commercial benefits of such arrangements were clear, doubts remained as to the legality until 2006 when the High Court expressly approved them in *Fostif*.²

An 'explosion' of class actions

In 2010 Professor Vince Morabito concluded, contrary to popular belief, '...there has been very limited (and probably inadequate) employment of the federal class action regime'.³ Over the last 21 years, class actions comprised only about 0.4 per cent

of federal actions, (or about 0.1 per cent of all actions). On average, about 14 class actions are commenced per year.⁴ Professor Morabito found that between 1992 and 2009 only 9.9 per cent of all class actions commenced were shareholder claims.⁵ Only one shareholder class action was issued in Australia in 2012.⁶

The 'impecunious' class representative

Critics argue that in order to frustrate a defendant's ability to recover costs, individuals 'of straw' are selected as class representatives. However, Professor Morabito's research found that class representatives come from 'all walks of life' and ranged in age between seven and 88 years. The reality is that most class representatives are everyday Australian citizens of average means but are not generally people with nothing to lose.⁷

'Green mail' claims myth

The 'green mail' argument suggests some incentive exists for class action 'promoters' to commence actions regardless of the merits and regardless of whether the litigation funder has adequate capital to meet adverse costs orders. In the Australian context this argument is unsustainable.

First, commencing and conducting a hopeless claim not only exposes a claimant to severe cost consequences, but it may also expose the lawyers. The court will ordinarily order the loser to pay the winner's legal costs. The court also has the power to order

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that the lawyers pay those costs if there has been a serious dereliction of the lawyer's duty to the court.⁸ The Australian approach to costs contrasts starkly with the United States, where costs orders are generally not made. Put simply, in Australia it is not in the commercial interests of claimants or litigation funders to commence actions with little or no prospects of success.

Secondly, any lawyer who advances litigation merely to generate fees acts in breach of their primary duty to the court and duty to their client. Where a lawyer becomes aware that the client's claim is instituted or continued merely for the purpose of applying pressure to a defendant, they cannot facilitate or participate in that tactic without risking court and professional sanctions.

Thirdly, defendants can, and regularly do, apply for orders for 'security for costs'. This can be done at any stage of litigation. An order requiring a claimant to provide security for costs requires the claimant (or litigation funder) to lodge funds with the court as 'security' for the likely legal costs that the defendant may ultimately be entitled to receive from the claimant should the claim fail. Litigation funders are commonly required to lodge substantial sums by way of security as a condition of the claim proceeding. Security for costs therefore provides a useful de facto capital adequacy requirement. In class actions the amount of money required as security will deter all but the most meritorious of claims.⁹

Claims not in shareholders' interests argument

The 'merry-go-round' myth suggests that shareholder actions are futile

as they merely result in a transfer of money from one group of shareholders to another. This proposition is flawed for several reasons. First, it is common for listed companies to have insurance in relation to such claims. If a responding insurance policy is available, the insurer will pay some or all of any settlement or judgment. Secondly, many victims are no longer shareholders. It is inherently unfair to victims that unlawful conduct should be immune from scrutiny simply on the basis that some victims remain shareholders. Thirdly, the myth ignores the importance of the deterrent effect of shareholder actions in improving corporate governance standards and the desirability of ensuring that those who breach the law are held to account. Recent US evidence suggests that shareholder class actions act as a path to 'discipline management' and that there is an 'association between poor disclosures prior to a securities class action'.¹⁰

Conflicts of interest argument

This myth suggests that lawyers are placed in conflict by the presence of litigation funding. The myth ignores the fact that lawyers owe fiduciary duties to their clients, ethical duties to the court, statutory duties under state or territory legal profession acts, professional codes of conduct and practice rules. In particular, lawyers owe a paramount duty to the court and to the administration of justice. These duties are said to be 'paramount' because they require the lawyer to perform them even if the client gives instructions to the contrary.¹¹ Lawyers also have a duty to act in the best interests of their client. A lawyer's own

interests have always ranked a distant third, far behind these primary duties, as is demonstrated whenever a lawyer acts on a 'no-win no-fee' basis. In such circumstances, the lawyer's duty to the client has always been appropriately managed, notwithstanding the lawyer's own interest in being paid a fee. Likewise, litigation funding tensions are not insurmountable and are adequately regulated. In *Fostif* the High Court dealt with similar concerns. It was submitted '[t]he greater the share of the spoils ... the greater the temptation to stray from the path of rectitude', and that the litigation funder, '...might be tempted, for his own personal gain, to inflame the damages, to suppress evidence, or even to suborn witnesses'.¹² The court concluded that such fears are 'sufficiently addressed by existing doctrines of abuse of process and other procedural and substantive elements of the court's processes'.¹³

Further regulation of litigation funding

Some argue for additional regulation of litigation funding. However, from a policy perspective, as with all areas of legitimate economic activity, regulation should be kept to the minimum necessary to prevent significant and real prospects of abuse. Laws should not impose unreasonable barriers to entry, particularly where there is no evidence of widespread or significant abuse. There is no such evidence of significant abuse concerning litigation funding.

Litigation funding is already specifically regulated as a result of the *Multiplex* decision.¹⁴ In response to *Multiplex*, the Federal Government enacted

regulations¹⁵ to clarify that litigation funding arrangements are not managed investment schemes. In its explanatory statement, the government reiterated its support for class actions and litigation funders noting, ‘...they can provide access to justice for a large number of consumers who may otherwise have difficulties in resolving disputes’. The regulations also impose obligations to maintain adequate practices and follow certain procedures for managing conflicts of interest. These obligations are in addition to the pre-existing duties on lawyers and in addition to consumer protection laws that apply to litigation funders. In the context of class actions, further safeguards exist via court scrutiny of funding arrangements and judicial approval of settlements.¹⁶ ASIC has also subsequently issued Regulatory Guide 248,¹⁷ to assist litigation funders and lawyers to manage conflicts of interest and to protect members of litigation funding schemes.

Benefits to defendants

Litigation funding can benefit defendants in several ways, including provision of adverse costs indemnities, security for costs, imposing commercial scrutiny on the conduct of claims and restraint on litigation budgets,¹⁸ facilitating adequate legal representation¹⁹ and providing a statistically higher likelihood of early settlement.²⁰

Efficiently conducted class actions benefit all stakeholders. Early class actions in Australia were often bogged down in interlocutory skirmishes,²¹ mainly over pleadings and procedural matters; a trend bemoaned by judges.²² Parties and their legal representatives now have a statutory duty to adhere to the ‘overarching purpose’ of civil practice, which requires facilitation of the ‘just resolution’ of disputes ‘according to law’ ‘as quickly, inexpensively and efficiently as possible’.²³

Conclusion

Australian class action procedures have evolved to become an efficient means of aggregating and resolving numerous claims arising out of the same or similar circumstances. The regime provides an opportunity for just outcomes while offering adequate safeguards to defendants. Shareholder class actions are playing an effective deterrent role in ensuring better market disclosure and improved corporate governance outcomes. These private enforcement actions complement the role of government regulators.

The Australian system differs markedly to that operating in the United States. Differences include the significant cost disincentives against bringing unmeritorious claims. Australian courts and legislators have recognised and facilitated the appropriate role that litigation funding can play to promote an equality of arms between claimants and well-resourced defendants. This ensures claims are determined on their merits rather than by use of attrition strategies. ■

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Notes

- 1 With the introduction of Part IVA of the Federal Court of Australia Act 1976 (Cth)
- 2 In *Campbell's Cash & Carry v Fostif* [2006] HCA 41, the majority of the High Court determined that the funding arrangements between a client and third party litigation funder did not constitute an ‘abuse of process’
- 3 Morabito V, An Empirical Study of Australia's Class Action Regimes, Second Report (September 2010), at 4
- 4 Morabito V, An Empirical Study of Australia's Class Action Regimes, First Report (December 2009), at 11
- 5 *Ibid*, at 3
- 6 See Allens Linklaters, Shareholder class actions in Australia, (August 2013), which also notes that a total of 30 shareholder class actions were commenced in the period 1999 to 2012
- 7 See, for example, comments of Murphy J in *Kelly v Willmott Forests Ltd (in liq)* [2012] FCA 1446 at [131]
- 8 See, for example, *Cook v Pasmenco Ltd* (No 2) [2000] FCA 1819 (per Lindgren J);

- White Industries (Qld) Pty Ltd v Flower and Hart (1998) 156 ALR 169
- 9 In *Madgwick v Kelly* [2013] FCAFC 61 the Full Federal Court reaffirmed that security for costs applications can be made in representative proceedings, despite the operation of s 43(1A) of the Federal Court of Australia Act 1976 (Cth)
- 10 Chapple L, Clout V and Tan D, (2013) ‘Corporate governance and securities class actions’ Australian Journal of Management. Note also that ASIC’s resources are limited and private actions are an important aspect of enforcement
- 11 See *Giannerelli v Wraith* (1988) 165 CLR 543, at 556
- 12 *Campbell's Cash & Carry v Fostif* [2006] HCA 41 at [93]
- 13 *Ibid*
- 14 *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd* (2009) 260 ALR 643, [2009] HCA 43, which held that funded class actions were managed investment schemes for the purposes of the Corporations Act 2001
- 15 Corporations Amendment Regulation 2012 (No 6) (Cth)
- 16 See s 33V(1) of the Federal Court of Australia Act 1976 (Cth) and, for example, *Modtech Engineering Pty Limited v GPT Management Holdings Limited* (No 2) [2013] FCA 1163
- 17 Litigation Schemes and Proof of Debt Schemes: Managing Conflicts of Interest (RG248), effective from 13 July 2013
- 18 French J noted the benefits of litigation funding in *QPSX Limited v Ericsson Australia Pty Ltd* (No 3) [2005] FCA 933 at [54], observing that litigation funding spread the costs and risks of complex litigation, which in turn helped to support the enforcement of legitimate claims, injected a welcome element of commercial objectivity into the way legal budgets are framed and the efficiency with which litigation is conducted and was a legitimate response to need in the marketplace
- 19 *Gulf Azov Shipping Co Ltd v Idisi* [2004] EWCA Civ 292 at [54] where Lord Phillips MR observed ‘[p]ublic policy now recognises that it is desirable, in order to facilitate access to justice, that third parties should provide assistance designed to ensure that those who are involved in litigation have the benefit of legal representation’
- 20 Morabito V, An Empirical Study of Australia's Class Action Regimes, Second Report (September 2010), at 41. Professor Morabito's research in this area establishes that cases with litigation funding have a far higher settlement rate than those without funding
- 21 See *Bright v Femcare* (2002) 195 ALR 574 at [160]
- 22 See *Group Litigation in Australia — ‘Desperately Seeking’ Effective Class Action Regimes*, Prof Vince Morabito, December 2007, at 27
- 23 S 37N of the Federal Court of Australia Act 1976 (Cth)