BCA
Business Council of Australia

Guaranteeing a minimum return of class action proceeds to class members

Submission to Treasury Consultation Paper

June 2021

Contents

Key points

- Class actions and litigation funding are positive features of the legal system. However, the current system of class actions and litigation funding is failing class members. It allows for funders and lawyers to maximise their own profits at the expense of class members.
    - In 2019, 61 per cent of the compensation award for shareholder class actions in Australia went to litigation funders and lawyers, leaving less than 40 per cent for class members.
    - In 2018, when litigation funders provided funding for class actions, the median return to class members was 51 per cent, compared to 85 per cent in non-funded matters.
- There is an inherent potential for conflicts of interest between the interests of funders and the law firms whose fees they pay on the one hand, and the interests of class members on the other. These conflicts are not sufficiently regulated at present.
- A guaranteed minimum rate of return for class members should be implemented. Instead of an across-the-board fixed minimum such as 70 per cent, a "graduated" approach should be implemented that enables courts to determine the most appropriate return above a statutory minimum, based on the size of the claim and other relevant factors.
- Other key reforms should also be implemented at the same time:
    1. Courts should have greater powers to rationalise overlapping class actions to promote efficiency and maximise benefits for class members.
    2. Contingency fees for lawyers should be prohibited for class actions in all jurisdictions.
    3. Litigation funders should be subject to regulation as Managed Investment Schemes under the Corporations Act.
    4. Courts should be required to appoint an independent contradictor to represent the interests of class members when the court is determining the fairness of litigation funding arrangements and class action outcomes.

Overview

This is the Business Council of Australia's (BCA) submission in response to the Treasury Consultation Paper *"Guaranteeing a minimum return of class action proceeds to class members"* (Consultation Paper). The Consultation Paper invites submissions on the following issues:

> *"The best way to guarantee a statutory minimum return of gross proceeds of a class action to class members. In particular, views are sought on the potential design elements of a guaranteed minimum return, the appropriate rate and how the rate might be differentiated based on the risk, complexity, length and likely proceeds of a particular case."* [1]

The Consultation Paper also encourages submissions to consider other *"additional maters that are relevant to issues raised."*[2]

The issue of minimum returns cannot be considered in isolation. It is one of several measures that should be implemented to improve the efficiency and equity of class action processes. This submission proposes four additional complementary reforms to achieve these goals, as outlined in the "Additional Issues" section below.

Class actions play an important role in providing individuals with access to justice in response to corporate wrongdoing and can make the legal system more efficient when used appropriately. However, some practices in class action litigation are contrary to the goal of ensuring that such actions expand access to justice for a wider range of people, rather than providing opportunities for those that run and fund the proceedings to earn disproportionate profits.

The proposal for a guaranteed minimum return was a key recommendation of the 2020 report of the Parliamentary Joint Committee on Corporations and Financial Services inquiry into "*Litigation funding and the regulation of the class action industry*" (PJC Report). The PJC Report followed the report of the Australian Law Reform Commission of December 2018 "*Integrity, Fairness and Efficiency – An Inquiry into Class Actions Proceedings and Third-Party Litigation Funders*" (the ALRC Report), which also considered similar issues.

Class members are being disadvantaged

Many class actions have been underwritten by litigation funders (many based outside Australia) and rely on funders for their viability. As the number of class actions has grown, so too has the practice of funders using the system to earn disproportionate profits for themselves from the outcomes. The higher the rate of return to funders, the lower the level of compensation to actual class members. This has now reached a stage where significant injustices are being delivered to class members. In 2019, 61 per cent of the compensation award for shareholder class actions in Australia went to litigation funders and lawyers, leaving less than 40 per cent for class members.[3]

The litigation funding environment in Australia is now characterised by funders gaming the system to take advantage of the perverse incentives that enable them to make windfall profits, all of which are at the expense of the class members who have actually suffered damage.

The greater the return for the funders, the lower the return for the class members. The 2018 ALRC Report found that when litigation funders provided funding for class actions, the median return to class members was 51 per cent, compared to 85 per cent in non-funded matters.[4] In one case in the New South Wales Supreme Court the Court described the return sought by the litigation funder as *"stratospheric, in the tens of thousands of per cent."*[5]

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[1] Consultation Paper, page 4
[2] Ibid, page 5
[3] Analysis by Herbert Smith Freehills reported in Australian Financial Review, *"Lawyers want a bigger slice of class actions"*, 16 June 2020
[4] ALRC Report, page 70
[5] *Tredrea v KPMG Financial Advisory Services (Australia) Pty Ltd* (No 3) [2019] NSWSC

It is simply not tenable for the current situation to continue, particularly in circumstances where over half of the returns from shareholder class actions no longer go to the plaintiffs.

The need to address conflicts of interest for litigation funders and law firms

In funded class actions, the costs of the law firms acting for the plaintiffs are not met by the plaintiffs themselves, but by the funder. The funder may have an ongoing relationship with the law firm that is commercially lucrative for the firm to maintain. This gives rise to risks that the lawyers acting for the class members may have potential or actual conflicts between their obligations to their clients and their relationship with their litigation funder.[6]

Similarly, the terms of the funding agreements are negotiated by the funder and the law firm, not by the plaintiffs. It would be inconceivable for a typical class member to have any input into such arrangements, let alone the ability to raise concerns regarding potential conflicts of interest that may adversely affect them.

Further, class members (whether knowingly or not) delegate to lawyers and funders the power to make decisions on which claims to pursue, how cases are run and, most importantly, whether and on what terms to settle cases. Those who make the decisions do not necessarily have the same interests as the class members, nor even the lead plaintiff. It has been observed that:

> *"such settlements involve the determination of legal rights of group members, who are not generally represented. The courts naturally look to representatives of the applicant for assistance, but the interests of all group members are not necessarily uniform nor the same as those of the applicant. Conflicting interests and duties are rife."* [7]

It is inherent nature of both litigation funding and class actions that they are both more at risk of potential conflicts of interest. The regulatory regime needs to be more appropriately adapted to deal with these risks.

Guiding principles for reform

In pursuing reform, the BCA proposes that any reforms be implemented in accordance with the following principles. Reforms should be implemented in a manner that:

1. Always prioritises the interests of class members above those of funders and/or legal representatives.
2. Does not limit the ability of meritorious claims that could currently be commenced from being commenced in future.
3. Gives the courts suitable discretion to make assessments of the best interests of class members, within defined parameters.
4. Prevents class action litigation being misused as an investment vehicle to third parties to make windfall profits at the expense of class members.

Australia's class action system is currently failing to achieve its original objectives of expanding access to justice and generating more efficient use of the court system. As such, the class action industry in its current form is failing those whose interests should have priority – the class members themselves.

The reform measures supported in this submission are intended to restore the primacy of the interests of class members. As such, they should be uncontroversial. The BCA endorses the conclusion of the PJC Report that *"those who most fiercely resisted comprehensive regulation of the industry were the vested interests who benefited from the status quo."* [8]

[6] Allens, submission to PJC Inquiry, page 11
[7] Jeremy Kirk SC, "*The case for contradictors in approving class action settlements*", Australian Law Journal, Vol 92, Part 9, 2018
[8] Parliamentary Joint Committee on Corporations and Financial Services "*Litigation funding and the regulation of the class action industry*", December 2020, page xiv

Response to Consultation paper questions

The Consultation Paper invites responses to six specific questions, as set out below. The BCA's response to each of these questions are as follows.

1. What is the best way to guarantee a statutory minimum return on the gross proceeds of class action litigation (including settlements)?

The PJC Report proposed a common floor of 70 per cent returns to members and recommended that *"the Australian Government investigate the best way to implement this floor."* It further recommended that the Government consider *"whether a graduated minimum return above this floor is appropriate for shorter, less risky and less complex cases."* [9]

The BCA in its submission to the PJC inquiry noted that the average class action seeks between $50 and $75 million. For a median-sized class action settlement of $50 million, a 70 per cent minimum would still allow for $15 million in returns to the funder, which would be many times more than the cost of running the proceeding.

A fixed minimum figure of 70 per cent (or any other figure) will invariably, to some extent, be an arbitrary decision that will not be appropriate in all cases.

The BCA recommends that the Government instead implement a "graduated" approach to minimum returns to class members, based on the size of the amount ultimately obtained by class members, as well as other relevant considerations outlined below. The broad parameters of the graduated scale should be set out in legislation, with the court having discretion to set an exact amount in a particular case. In setting such an amount, the legislation should prescribe that the court's overriding consideration must be the interests of class members.

The setting of parameters in legislation would still give litigation funders sufficient certainty to make funding decisions based on their prospects of achieving an appropriate return for themselves. The parameters should be set in such a way as to not discourage meritorious funded claims, whilst discouraging highly speculative claims motivated primarily by the prospect of inordinate profits for funders. It should also be noted that a guaranteed minimum return for class members is highly unlikely to discourage litigation funders from pursuing large claims against large corporations, as the size of the likely settlement would still have sufficient scope to provide a commercially attractive return on their investment.

2. How would the suggested mechanism interact with the class action system (including court processes) and the litigation funding regime?

The court should have board discretion to determine an appropriate minimum return to class members as part of its role in approving both funding agreements and settlements. Where matters proceed to a final determination by the court, it would also determine the minimum return that class members should receive.

As set out below, courts should also be required to approve a litigation funding agreement and have the power to vary such agreements in the interests of justice in order that the interests of class members are prioritised, as recommended by the PJC Report.[10]

3. Is a minimum gross return of 70 per cent to class members the most appropriate floor for any statutory minimum return? If not, what would be the appropriate minimum and its impact on stakeholders, the class action system and the litigation funding industry?

As outlined above, a "graduated approach" is more appropriate than a fixed amount. In a small class action claim of $2 million, a 70 per cent floor would leave $600,000 for lawyers and funders, which will not be sufficient to cover the costs of running the proceeding and providing a viable return to the funder. On the other hand, in a

[9] PJC Report, page xviii
[10] Recommendation 11

large claim for $2 billion, lawyers and funders would be able to take up to $600 million, which is clearly disproportionate and unjust to class members. An across-the-board limit of 70 per cent would risk disenfranchising class members in both smaller and larger matters.

4. Is a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases?

The BCA endorses this alternative approach. This approach was also considered by the PJC Report, which recommended[11] that the Australian Government consult on *"whether a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case is appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases."*

As outlined above, the relevant legislation should set appropriate parameters for minimum returns to class members. Courts will then be best placed to determine the precise amounts in each case within those parameters. The legislation should include a graduated scale of floors for class actions, depending on their size, with the court then having discretion to determine an appropriate amount about the floor where necessary.

The BCA proposes the following graduated scale of minimum returns to class members:

Size of recovery (after legal expenses)	Up to $5 million	$5 - $10 million	$10 - $20 million	Over $20 million
Minimum return to members	50 per cent (i.e. $2.5 million)	$2.5 million plus 80% of the amount between $5-$10 million	$6.5 million plus 90% of the amount between $10-$20 million	$15.5 million plus 95% of the amount over $20 million

This scale is likely to deliver minimum returns of at least 70 per cent in most cases, with slightly less for small cases and slightly more for larger cases. It would deliver a $5 million return for a funder for a return of $30 million and $8.5 million for a return of $100 million, in the absence of any adjustment by the court.

Under this proposal, the court's discretion to set a level above the relevant minimum would be based on certain prescribed factors. The Federal Court's Class Action Practice Note[12] sets out various factors which the court is required to consider in approving class action settlements. These factors could also form the basis of the considerations the court is required to take into account in setting the appropriate minimum return to the class:

a) the complexity and likely duration of the litigation;

b) the reaction of the class to the settlement;

c) the stage of the proceedings;

d) the risks of establishing liability;

e) the risks of establishing loss or damage;

f) the risks of maintaining a class action;

g) the ability of the respondent to withstand a greater judgment;

h) the range of reasonableness of the settlement in light of the best recovery;

i) the range of reasonableness of the settlement in light of all the attendant risks of litigation; and

j) the terms of any advice received from counsel and/or from any independent expert in relation to the issues which arise in the proceeding.

[11] Recommendation 20

[12] https://www.fedcourt.gov.au/law-and-practice/practice-documents/practice-notes/gpn-ca

In applying these factors, the court should also be required to apply the general overriding principle that the interests of class members must take priority over those of other parties. There should also be a presumption that the court appoint an independent contradictor to enable the interests of the class members to be adequately represented, as outlined below.

5. How would a graduated approach to guaranteed returns for class members be implemented? This can include how a decision is made that a particular case if straightforward, how cases could best be classified to determine the minimum return applicable to a particular case and at what stage of an action such a determination could be made.

See response to Question 4 above.

6. What other implementation considerations would be relevant to the issues raised in this consultation paper? Please provide examples.

See "Additional Issues" below.

Additional Issues

A mechanism to guarantee a return to class members is highly desirable but is not sufficient in itself to achieve the degree of reform necessary to make the class action system more efficient and more equitable to class action members. The BCA recommends the following four reforms also be implemented as a priority. They are highlighted as the most pressing areas in need of reform that will most benefit class members. They are not intended to be an exhaustive list.

1. Empower courts to rationalize competing actions and define classes

One of the key virtues of class actions is that they enable greater efficiency and economies-of-scale for plaintiffs by dealing with common claims on a collective basis. This advantage for plaintiffs is substantially diminished where there are multiple claims litigating the same subject matter.

At present, there is nothing to prevent multiple class actions being filed against the same defendant covering the same subject matter and the same class members. Courts should have greater powers to rationalize multiple claims in order to achieve more efficient and less costly actions. It has been estimated that around 34 per cent of all class action claims filed in Australia have overlapped with other claims.[13]

The BCA endorses the findings of the PJC Report that:

> *"Separate and concurrent class actions which litigate the same legal claims, for the same or overlapping class members, against the same defendant, undermine the objectives of the class action, which is for a single decision to resolve many claims that are the same or similar."* [14]

The BCA supports the recommendation of the PJC that Part IVA of the *Federal Court of Australia Act 1976* be amended to provide an express power for the court to rationalize competing class action claims where appropriate.[15]

2. Prohibit contingency fees for lawyers

The class action system is currently being used by funders and certain law firms to make unjustifiable profits from their investments at the expense of class members. Where market power is misused in other markets for

[13] Herbert Smith Freehills, submission to PJC Inquiry, page 2
[14] PJC Report, page xvi
[15] Recommendation 2

services, such conduct is either already unlawful or is met with an appropriate regulatory response. Such a response is now required in the litigation funding market.

The use of the class action system to make inordinate investment returns at the expense of class members is particularly concerning when it is engaged in by law firms acting on behalf of the class members. This can be done through contingency fees, which are outcome-based rather than time-based fees charged by lawyers, in which they are paid a percentage of what is recovered on behalf of the client, in a similar manner to the arrangements for litigation funders.

Lawyers have fiduciary obligations not to put their own commercial interests above the interests of their clients. A leading Australian authority on lawyers' professional ethics, Professor Gino Del Pont, has described the obligation in this way:

> *"...a lawyer must shun situations involving a conflict between the lawyer's personal interest and the duty to the client, and refrain from using the lawyer-client relationship in order to profit apart from a reasonable professional fee"* [16]

The opportunity to enhance their own returns at the expense of their clients creates an inherent conflict of interest for lawyers and is clearly contrary to their fiduciary obligations.

It is notable that as long ago as 1988 the Australian Law Reform Commission recommended that contingency fees based on a percentage of the returns obtained be prohibited for class actions.[17]

In 2020 the Victorian Government introduced changes that now permit lawyers to charge contingency fees in class actions in the Victorian Supreme Court. This is likely to encourage many class actions to 'migrate' to the Victorian jurisdiction, not out of concern for the interests of members, but due to the self-interest of the law firms that run the proceedings.

The conflict of interest inherent in contingency fees should not be considered acceptable in any jurisdiction. It is not possible to reconcile the financial interests of the lawyers who profit from them with those of the class action members whose returns are subsequently diminished. As such, the Commonwealth Parliament should amend relevant Commonwealth legislation so that contingency fees can form no part of arrangements relating to any claims under Commonwealth laws. The Victorian legislation to allow for contingency fees should also be repealed by the Victorian Parliament in due course.

3. Regulate litigation funding as a financial services product

As the Consultation Paper notes, litigation funding schemes were previously subject to the laws governing financial products and services under the *Corporations Act 2001*. In 2009 the Federal Court ruled[18] that litigation funding arrangements were likely to constitute a Managed Investment Scheme (MIS) and thus be subject to the regime for such schemes under Chapter 5C of the Corporations Act.

However, the impact of this decision was reversed by a Regulation[19] made by the Commonwealth Government in 2012 to exempt litigation funders from both the MIS regime under Chapter 5C as well as the regime governing Financial Services and Markets under Chapter 7, which would require funders to hold an Australian Financial Services Licence (AFSL). This Regulation has been described as a *"bespoke exemption from the financial services and licensing conduct regimes that would otherwise apply"*[20] and the reasons for the exemption were never adequately explained.

In 2020 the Commonwealth Government announced that it would reverse the 2013 exemption and require litigation funding arrangements to be treated as an MIS and to hold an AFSL. This policy is strongly supported by the BCA. In addition, in the event that contingency fees remain possible in any jurisdiction, the BCA strongly

[16] Dal Pont, G. E. "*Lawyers Professional Responsibility*" (6th ed), Lawbook Co, 2017, page 121
[17] Australian Law Reform Commission, "*Grouped Proceedings in the Federal Court*", Final Report, December 1988
[18] *Brookfield Multiplex Limited v International Funding Partners Pty Ltd* (2009) 180 FCR 1
[19] Corporations Amendment Regulation 2012 (No 6)
[20] King & Wood Mallesons, submission to PJC Inquiry, page 1

endorses the PJC recommendation[21] that *"The Australian Government review the feasibility of applying the Australian Financial Services Licence and the Managed Investment Scheme regimes to lawyers operating on a contingency fee basis."*

Given that litigation funding is clearly not a typical investment scheme, it may not be sufficient for such arrangements to be subject to the general regulatory regime under Chapter 5C. The Government should also give consideration to whether Chapter 5C should be amended to provide more bespoke arrangements that are specifically adapted to the distinct characteristics of litigation funding.

4. Court-appointed contradictors

Finally, the *Federal Court of Australia Act 1976* should also be amended to require the court to appoint a contradictor when considering the fairness of both funding arrangements and the proceeds from the outcome whenever it is necessary to ensure that the interests of class members are protected and prioritised.

As outlined above, it is inherent in the nature of litigation funding that the potential will always exists for conflicts of interest to arise between the commercial interests of litigation funders and the best interests of class members. Any additional returns on investment obtained by litigation funders will invariably be at the expense of class members.

Where a litigation funder is bankrolling a case, they will have a significant, and often determinative say over how the case is won and if, and on what terms, it settles. This is contrary to the usual practice in non-funded cases, where a plaintiff's instructions to lawyers determine such matters. As one Federal Court judgement noted:

> *"Those acting for applicants have an important role in the administration of justice in ensuring that the interests of group members are not swamped by the interests of funders in obtaining predictable and early returns."* [22]

Further, as outlined above, the existence of contingency fees charged by lawyers in class actions create an inherent conflict of interest with class members and are simply not compatible with lawyers' fiduciary obligations to their clients.

These factors mean that class actions are a unique form of litigation in which the interests of plaintiffs require extra protection. Regardless of whether or not contingency fees are prohibited, the unique risks to the interests of plaintiffs in class actions should require the courts to take proactive steps to ensure their interests are protected.

The BCA endorses the recommendation of the PJC Report[23] that there be a presumption that the Federal Court appoint a contradictor *"in instances where there is the potential for significant conflicts of interest to arise, or complex issues are likely to arise at the settlement approval application."*

There should be a presumption that the court should appoint a contradictor when considering the costs arrangements and distribution of the proceeds of the proceeding. This obligation should apply regardless of whether the matter is ultimately determined by the court or settled by the parties. The contradictor would be a suitably qualified advocate, typically a senior counsel, whose role is to act for the interests of class members where those interests may come in conflict with those of funders or lawyers. Their role would be to give effect to the obligation on the court to ensure that the interests of class members take precedence over funders and lawyers. They would have the ability to provide appropriate evidence to the court and call witnesses, including, for example, expert witnesses on funding arrangements.

The consideration of such matters by the court would also provide for greater public transparency of funding arrangements. Individual plaintiffs in the class delegate to their lawyer and funder the power to make unilateral decisions on their behalf. The leads to obvious risks, which require a more proactive approach from courts.

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[21] Recommendation 21
[22] *CJMcG Ltd as Trustee for the CJMcG Superannuation Fund v Boral Limited* (No 2) [2021] FCA 350
[23] Recommendation 18

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