

## **AILA National Conference**

**1 November 2006**

### **Litigation Funding – issues of regulation\***

#### **Introduction**

The New South Wales Attorney General Bob Debus first raised the issue of the possible regulation of Litigation Funding Companies (LFCs) at the Standing Committee of Attorneys General (SCAG) in July 2005. He was concerned about the lack of supervision and consumer protection in this area. Attorneys General agreed that the question of regulatory reform should be placed on their agenda and further research into the area undertaken.

#### **The Rise of Litigation Funding**

The issues facing the Ministers are complex. Most discussion on the topic of litigation funding invariably identifies the principal competing interests as being access to justice on the one hand, and preservation of the integrity of the justice system from abuse on the other. It seems almost mandatory to commence any consideration of the topic of litigation funding with an historical analysis of the meaning of maintenance and champerty.<sup>1</sup> Indeed, for a considerable period of time, these old common law offences and torts of maintenance and champerty have been effective in standing as a barrier to unfettered funding of litigation by third parties. They were founded in the fear that the justice system would be subverted by third party interference in litigation, and particularly through third party funding arrangements.

However, it was in the area of insolvency and bankruptcy that litigation funding and insurance first established a strong foothold in Australia. It is an area where the motivation for litigation is quite clear; namely, a trustee or liquidator, who has no

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<sup>1</sup> Maintenance is defined as “assistance or encouragement, by a person who has neither an interest in litigation nor any other motive recognised as justifying the interference, to a party to the litigation”. (Halsbury’s Laws of Australia Vol. 6 para 110-7135)  
Champerty is defined as “A particular form of maintenance, namely maintenance of an action in consideration of a promise to give the maintainer a share in the proceeds or subject of the action.” (Halsbury’s Laws of Australia Vol. 6 para 110-7140)

funds to commence proceedings, is seeking to recover funds for the benefit of creditors. More recently in this area both LFCs and insurers have been able to rely on the statutory powers of the trustee or liquidator to alienate their right to sue, to enter into funding arrangements. In the past funders had to rely on common law rights, which the courts developed over many decades by gradually removing restrictions on litigation funding of insolvency related matters.

The kinds of successful arrangements made in the insolvency area are somewhat typified by the *Movitor* case.<sup>2</sup> Drummond, J outlined the scheme in that case:

*“Lumley agreed to provide funds to the liquidator necessary to enable an action to be brought for the benefit of, inter alia, the company's creditors and also agreed to indemnify the liquidator against part of the costs he may be ordered to pay the defendants in the contemplated litigation if the action fails. In return for providing these funds, Lumley is, if the action succeeds, to be reimbursed and is also to receive 12% of the net proceeds Lumley is also entitled to involve itself in the conduct of the litigation”.*<sup>3</sup>

This case and subsequent cases made clear that a trustee in bankruptcy and a liquidator could enter into litigation funding arrangements with funders without falling foul of maintenance or champerty issues. Outside the solvency area there has been an increasing judicial trend of recognising that the traditional reluctance to permit funding agreements has diminished over time. In 2002 the Full Court of the Federal Court, for example, stated:

*“...the Court must be seen to be willing to move with the times. There are ongoing concerns about the high costs of litigation; there are risks that citizens with justifiable causes of action may be kept out of courts because of their inability to pay the costs of litigation or because they fear the financial risks of litigation.”*<sup>4</sup>

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<sup>2</sup> *Re Movitor Pty Ltd* (1996) 14 ACLC 587

<sup>3</sup> *Ibid* at 593

<sup>4</sup> *Gore v Justice Corporation Pty Ltd* (2002) 119 FCR 429 at [59]

Today there are about 5 LFCs currently operating commercially in Australia providing funding for a range of actions including large commercial claims and class actions. They do not tend to be involved in personal injury cases or small individual consumer cases. They have funded a number of high profile commercial cases, which it is said would not have proceeded without their funding assistance.

### **Who provides litigation funding assistance?**

Publicity around the Attorneys' interest in exploring reform in this area prompted some quick responses from LFCs, expressing concern that the focus of any review should not just be on LFCs.<sup>5</sup> That raised the question; who are the other providers who should be the subject of a broader review?

In one sense the most longstanding form of litigation funding assistance has been the provision of legal aid assistance in civil matters. Generally legal aid bodies are established by statute and substantially government funded and controlled. They have provided assistance to litigants for many decades, covering legal costs of pursuing litigation and the other party's costs in the event of an unsuccessful action. However, in more recent years legal aid commissions have tended to direct a greater proportion of their funding to criminal cases with consequently less aid available for civil matters.

Lawyers have also traditionally been the suppliers of funding support through uplift fee and "no win - no fee" arrangements. These arrangements generally only cover the legal fees of pursuing litigation but do not cover the other party's legal costs if the litigation is lost. Lawyers are highly regulated and uplift fees, where permitted, are limited to a relatively small percentage of normal legal fees (generally not exceeding 25%)<sup>6</sup>.

Other third party funding providers include not for profit funders and litigation assistance schemes, which have been established in some states. For over a decade

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<sup>5</sup> IMF's managing director, John Walker, was quoted in the Business Review Weekly 29 Sep 2005 p.18) as being worried that the reforms will be one-sided and wants all third parties including insurers to be held accountable. "There should be some public debate about this", he said.

<sup>6</sup> Legal profession Act 2004 (NSW) s 324

the South Australian Law Society has managed a not for profit assistance scheme, which covers the plaintiff's legal fees in return for 15% of any settlement or verdict. In the event of a loss though the legal costs of a successful defendant, payable by the plaintiff, are not covered. The Law Institute of Victoria runs a similar scheme.

Finally, Legal Expense Insurance and After the Event Insurance products are becoming available from insurers but are not yet widely available in Australia. While terms of particular policies vary, they generally cover payment of a successful defendant's legal costs. Insurers are subject to prudential oversight by the Australian Prudential Regulatory Authority, and corporate regulation by the Australian Securities and Investments Corporation, but no specific regulation is directed to these products.

Whilst LFCs are in fact just one group of suppliers in a complex market they are not currently subject to oversight in the same way as lawyers, insurers and legal aid organisations. However, the question of the breadth of SCAG's review requires a distinction between the need for regulation or supervisory oversight of *organisations* providing litigation funding assistance, and regulation of the *kinds* of funding assistance provided. In the case of LFCs this raises, for example, issues of prudential oversight of the companies as well as issues of product regulation such as limiting percentage takes of settlement or verdict proceeds. Both aspects involve considering consumer protection and the public interest.

At their November 2005 meeting Attorneys were presented with a detailed paper covering the range of issues raised by litigation funding and the activities of LFCs. They agreed to the preparation of a Discussion Paper<sup>7</sup>, which ultimately was released in May 2006. It sought comments on a range of issues identified in the Paper and we have received over 30 detailed submissions in response. State and Territory justice officers are currently assessing those submissions and we intend to present a summary of responses to Ministers at the next SCAG meeting in Fremantle in just over a week's time. I expect more detailed proposals to be submitted to the Attorneys General early next year, and no doubt there will be more consultation with the community if a regulatory regime is to be developed.

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<sup>7</sup> Standing Committee of Attorneys General (2006) Litigation funding in Australia. Discussion Paper. [www.lawlink.gov.au/lawlink/legislation\\_policy/ll\\_lpd.nsf/pages/lp\\_index](http://www.lawlink.gov.au/lawlink/legislation_policy/ll_lpd.nsf/pages/lp_index)

Though I cannot comment on individual submissions to SCAG, I will canvass the range of key issues that Ministers will need to bear in mind when considering regulation of litigation funding.

These issues include:

- Supervision of funding arrangements
  - Is the agreement solely a matter between the funder and funded?
  - Is there a public interest in the nature of funding arrangements?
  - The courts' common law supervisory role
  - The nature of a legislative regime
    - Public policy criteria
    - Prescription of compliance requirements
- How far does regulation intrude on access to courts?
  - Should courts retain “abuse of process” role?
- Supervision of LFCs as entities
  - Prudential oversight
  - Ownership and influence questions
    - Relationship with lawyers
- Regulation of fees
  - Determining the reasonable price for risk assumption

### **Supervision of funding arrangements**

In the area of insolvency litigation the courts have accepted a supervisory statutory role of approving particular funding arrangements, which may extend beyond a 3-month period. By virtue of the Corporations Act 2001 (Cth) liquidators are effectively obliged to seek approval for these litigation-funding agreements.<sup>8</sup>

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<sup>8</sup> Corporations Act 2001 (Cth) s 477(2B)

In funded proceedings in Western Australia, the funder was twice required to improve the nature of their agreements with the lawyers and their contracts with the plaintiffs, in order for a stay to be lifted.<sup>9</sup>

The New South Wales Court of Appeal has stated that

*“In general, it is simply no business of a defendant to be taking up the cudgels on behalf of the funded litigants who are either parties or represented persons, invoking interlocutory processes ostensibly on behalf of the funded litigants but in reality in its own interest. As this appeal demonstrates, such satellite proceedings have the capacity of diverting resources and attention from the true issues as between the plaintiffs (and those they represent) and the defendant.”*<sup>10</sup>

The High Court in *Fostif*<sup>11</sup> recognised that questions of illegality and public policy may arise when considering whether a funding agreement is enforceable as between the funder and the intended litigant. Particular reference was made to the saving provision in the Maintenance and Champerty Abolition Act 1993 (NSW), which provides:

*“This Act does not affect any rule of law as to the cases in which a contract is to be treated as contrary to public policy or as otherwise illegal, whether the contract was made before, or is made after, the commencement of this Act.”*

The majority was content to hold that there is no fundamental legal obstacle preventing entrepreneurial litigation funding, and that it is not necessarily against public policy for a funder to seek out claims, which may be aggregated in class action proceedings, and control the funded litigation on behalf of the class. By contrast, Justices Callinan and Heydon saw a broader role for the Court in determining whether resultant proceedings constituted an abuse of process. Justices Callinan and Heydon appear to limit the abolition legislation to the crimes and torts per se, leaving open the continuation of the older principles relating to the issue of public policy rendering

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<sup>9</sup> *Clairs Keeley (A firm) v Treacy* [2003] WASCA 229, *Clairs Keeley (A firm) v Treacy* [2004] WASCA 277

<sup>10</sup> *Fostif Pty Ltd v Campbells Cash and Carry Pty Ltd* [2005] NSWCA 83 (31 March 2005) [119].

<sup>11</sup> *Campbells Cash and Carry Pty Limited v Fostif Pty Limited* (2006) HCA 41

illegal a funded litigation arrangement. The distinction was made between the application of the law of maintenance to the party maintained and its application to the other party to the litigation, who “has the right to be free from litigation conducted by the assistance of parties working for their own interests, and not in order to give lawful professional aid to the opposing litigant”<sup>12</sup>

This distinction is important to the question whether there is a public interest in “supervising” the nature of any litigation funding agreement reached between a funder and a potential litigant. If the Court’s view is that it will only entertain questions as between the funder and the funded litigant then is there an argument for those arrangements to be legislatively regulated in the broader public interest? What are the kinds of issues that would be relevant to determining the public policy interests in such arrangements? Justices Callinan and Heydon devoted considerable attention to outlining the kinds of issues that were relevant to determining whether funded proceedings constituted an abuse of process.<sup>13</sup>

Those issues included:

- Funder’s motive being to profit from the litigation of others;
- Funder seeking and encouraging persons to sue who would not otherwise have done so;
- Undermining the normal restraints on commencing litigation by removing any risk (“What have you got to lose?”<sup>14</sup>);
- Nature and smallness of the plaintiffs’ “losses”;
- Funder’s ability to control the litigation;
- Subservience of the plaintiffs’ interests to the funder’s;
- Limited role of the plaintiffs’ solicitor; and
- Funder’s actions effectively creating a monopoly for itself in the particular litigation.

Having found the proceedings were an abuse of process Justices Callinan and Heydon concluded:

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<sup>12</sup> Wild v Simpson (1919) 2 KB 544 at 563 per Atkin LJ

<sup>13</sup> Campbells Cash and Carry Pty Limited v Fostif Pty Limited (2006) HCA 41 at 267-286

<sup>14</sup> Op cit at 270

*“If that conclusion is thought by those who have power to enact parliamentary or delegated legislation to be unsatisfactory on the ground that the type of litigation funding involved in these appeals is beneficial, then it is open to them to exercise that power by establishing a regime permitting it. It would be for them to decide whether some safeguards against abuse should be incorporated in the relevant legislation.”<sup>15</sup>*

The Discussion Paper issued by SCAG identified a list of criteria (based on past court decisions), which might be considered by courts in assessing whether funding agreements were contrary to public policy. That list included:

- Whether there is a direct retainer and costs agreement between the plaintiff and the solicitors
- Whether the solicitors were chosen by the plaintiff
- The sophistication of the plaintiff
- Whether there has been adequate disclosure to the plaintiff by the funder
- Whether the plaintiff is in a position to make informed decisions regarding the conduct of proceedings
- Whether independent advice is reasonably available to the plaintiff
- Whether the funder has excessive control over proceedings
- Whether the funder has liability for the successful defendants’ costs

Prescribing somewhat historically based public policy considerations in legislation together with some additional criteria is superficially attractive. This approach would however create a degree of uncertainty, at least until the courts had interpreted and applied the provisions sufficiently to remove that uncertainty. For my part, if a legislative regime were to be adopted such criteria would be better expressed so as to formalise the kinds of agreements which would be considered as acceptable, rather than the bases upon which agreements might be struck down. They would need to be expressed as a mandatory set of requirements covering terms, disclosure, fees and the like.

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<sup>15</sup> Op cit at 289

Indeed a number of submissions received on this issue in response to the Discussion Paper support the courts being given a supervisory jurisdiction, and the enactment of a legislative set of criteria for valid funding agreements to comply with.

### **How far should regulation go – should courts retain “abuse of process” role?**

There may be other factors for a court to consider beyond the mere legality of a funding agreement in accordance with legislatively prescribed criteria. These factors may be best left to the courts to determine as part of a broader abuse of process issue. For example, there is the issue of whether court time, which is highly subsidised by the taxpaying community, should be used for the pursuit of litigation of questionable public interest.

Clearly the public has an interest in the orderly resolution of disputes between parties. The question becomes more interesting if in fact there is no dispute worth pursuing unless it is organised and insured by a funder. In *Fostif* the retailers’ claim was to recover windfall licence fees paid to wholesalers – in effect shifting the windfall profit to themselves, the funder, and their lawyers. “The persons who are truly out of pocket are those who purchased tobacco products from retailers who passed on the licence fee component...”<sup>16</sup> Arguably, there is little public interest in using valuable court time to shift a windfall profit from one set of undeserving pockets to another equally undeserving set! I am not suggesting courts should embark on extensive preliminary enquiries into the ultimate merits of litigation. I do submit that there will be circumstances where the courts rightly feel that their process is being abused. Although this is raised in the context of litigation funding it is by no means limited to such litigation and applies generally to all proceedings.

The ability of LFCs, unlike any other currently available assistance schemes, to take away almost all of the normal risks of litigating is said to encourage unnecessary litigation. “In conventional litigation some restraint is placed on the desire to start litigation by the risk of having to pay the defendant’s costs if the litigation fails.”<sup>17</sup> Where the enthusiasm of LFCs to find cases leads to the prosecution of unworthy and

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<sup>16</sup> Op cit at 273

<sup>17</sup> Op cit at 270

time consuming litigation, there may be a significant community interest in ensuring that taxpayer subsidised courts are not diverted to lengthy wasteful exercises.

Excessively aggressive behaviour by LFCs in identifying claimants or “stirring up” litigation could undermine the integrity of the justice process. Successful defendants are never fully compensated for their defence costs let alone the business costs of time spent defending cases. In many cases defendants are effectively forced to compromise cases because they simply cannot justify the time and expense in defending a matter. Often a commercial decision is made to settle a claim otherwise considered to be without foundation. Concern about the use of litigation to “blackmail” a defendant into settlement has been expressed throughout the ages. There is nothing special about identifying the possibility that LFCs might engage in such behaviour; it is a possibility open to any well-heeled or insured litigant.

On the other hand there is little doubt that without access to such funding, perfectly good claims would go unlitigated simply because of a lack of available funds. Litigation funders point to the commercial reality that it is not in their interests to promote or fund litigation destined to be unsuccessful. Detailed assessments are undertaken by LFCs of the merits of each case before they agree to support the proposed litigation. These are strong protections they say against the prospect that their funding will lead to a proliferation of vexatious or unwarranted litigation.

If there are lingering concerns about the protection of potential defendants from these kinds of litigious excesses, it is surely a matter best determined by the courts themselves. It is open to defendants who feel aggrieved by what they see as an abuse of court process to raise that with the court. These matters do not appear to be the kinds of matters that can be effectively resolved by legislation although the courts’ role might be clarified.

These concerns are not entirely hypothetical, as NSW has recently seen some examples where commercial causes of action have absorbed exceptionally long periods of judicial time and where the ultimate decision is that the litigation was groundless. These cases tend to be the exception and it is difficult to imagine just

how legislative rules could be designed to restrict such actions whilst allowing meritorious proceedings to continue.

The legitimate grievance, which underlies some of these concerns about misuse of the courts, is the high cost of litigation. Quite rightly court reform directed to reducing the cost of litigation and promoting more timely disposition of cases is seen to be a considerable part of the solution to this problem. Indeed in NSW, this has been a focus of the courts and the Attorney General's Department for some time. The recent enactment of the Civil Procedure Act 2005 represented a substantial overhaul of civil procedures across the Supreme, District and Local Courts of NSW. Significant procedural reform has also occurred in the Dust Diseases Tribunal with greater use of mediation and arbitration as a central plank of the reforms. Alternative dispute resolution has been encouraged by the enactment of powers for all courts to refer matters to mediation or arbitration. The greater use of technology for court proceedings is seen to have the potential to reduce costs, as is the focus on more efficient use of expert witnesses. The Judiciary is playing a very strong role in the implementation of court procedural reforms.

### **Supervision of LFCs**

Aside from the issue of legislating for a scheme to regulate the nature of funding agreements that may be lawfully entered into, is there a case for regulating the entities themselves? As I have indicated, insurers, lawyers and legal aid commissions are all subject to extensive oversight and accountability regimes. All corporations are subject to general oversight of the Australian Securities and Investments Commission but it does not undertake prudential regulation.

There appear to be two key concerns about the nature of LFCs. First, will they be able to meet their obligations financially, and second, should there be ownership restrictions? The issue of financial soundness will ultimately rest on the extent of capitalisation of an LFC and the appropriateness of its reserves having regard to its risk exposure. The nature of LFC business is a strange mixture of financial lending and the insurance of risks. There seems to be a good case for arguing that in relation to their risk exposure they should adopt prudential standards not unlike those of

insurers. If LFCs were required to hold the appropriate Australian Financial Services Licence then compliance with the conditions of such a licence requires certain prudential standards to be met. The question may be whether those requirements are sufficient. Client access to details of the financial position of a LFC would be essential if a client is to make an informed decision to engage a LFC.

One of the key issues raised in considering the appropriateness of funding agreements is the extent to which they affect the normal solicitor-client relationship. In particular, is the power to determine key matters relating to the conduct of the litigation taken away by the funding agreement from the client? The separation of the solicitor-client relationship from the client-funder relationship is seen to be crucial. Would there be concerns if the solicitors, who are acting for a client, owned the litigation funding company providing the funds?

This issue becomes particularly complicated because of the restrictions placed on lawyers against their entering into any arrangements where they could be seen to have a financial interest in the litigation, outside recovery of their legal costs. All Australian states prohibit lawyers from entering into contingency agreements, by which they may be entitled to recover a proportion of the sum recovered by the litigation they are conducting. With multi-disciplinary partnerships and incorporated legal practices the issues of cross-ownership are now more than hypothetical. Are the current controls over the activities of lawyers sufficient to ensure appropriate separation of interests?

Other countries do allow lawyers to enter into contingency fee arrangements and there is only a small step from that to allowing lawyers to own or operate LFCs. There are considerable policy issues here to weigh up, most of which centre around the notion of keeping the advisory and decision-making role of lawyers free of any conflicts arising from personal financial interests. Clearly the views of the legal profession will be of interest on this issue.

## **How much is too much profit for the funder?**

I have referred earlier to the list of matters, which may be considered as a basic starting point for any legislative regulatory regime. Those factors were primarily formulated over time to address issues of integrity in the litigation funding process. A more commercial factor is how much should LFCs be able to charge for their services.

It is regularly stated that were it not for funding provided by LFCs a claimant would not be able to seek and receive justice. Undeniably, funding provided on reasonable grounds can substantially increase the community's access to justice, at least in relation to the currently limited kinds of cases funded. However, if a claimant were to receive only 10% of what the court had assessed as their legitimate entitlement would justice have been done, and would the use of public resources to achieve that outcome have been justified? At what level of return does a funder unduly profit and a litigant unduly suffer?

LFCs are in the business of taking on risks. They seek to minimise their total risks by "picking winners". Significant effort is made to obtain full advice on the prospects of a case and professionally run LFCs have very clear criteria by which to assess applications. Clearly the more professionally a funder approaches this assessment task the lower their risk should be and consequently the lower the fee required to cover that risk.

No matter how careful they are, no-one would doubt litigation is an inherently risky business. The question is whether pricing should be left entirely to the market or whether there should be government regulation. It is clear that the industry is still in its infancy and with only 5 LFCs currently operating some may think the level of competition is far from mature. The fees charged by LFCs vary between themselves and across the matters they fund. The percentage take of settlement or verdict moneys has ranged as high as 70% and in rare cases higher. Calculating what is a reasonable percentage as a general maximum would be difficult but not impossible. There may be a risk that as with scales of legal costs in the past the maximum may over time become the standard fee charged, especially if the level of competition is

low. The task could be given to the courts, as is currently the case in relation to some insolvency litigation. This would involve agreements being approved at the time of commencement of litigation. The real task is the weighing up of how much risk is being taken on and what is a reasonable price to cover that risk as well as the other services provided. This is a task that is particularly well known to actuaries and insurers and they may well be able to assist if a regime for regulating fees were considered to be appropriate.

## **Conclusion**

The issue of whether there should be a regulatory regime for LFCs raises a host of interesting and challenging policy questions reaching beyond LFCs to the legal profession and the courts. The Standing Committee of Attorneys General will be giving careful consideration to these matters in 2007.

In its 1994 Discussion Paper on “Barratry, maintenance and champerty”<sup>18</sup> the NSW Law Reform Commission recognised that with the abolition in 1993<sup>19</sup> of these offences in NSW “lawmakers have an excellent opportunity to turn their attention to the public policy issues, defining the legal limits to agreements which were previously champertous.”<sup>20</sup> That opportunity is perhaps at last being taken up.

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<sup>18</sup> New South Wales Law Reform Commission (1994) Barratry, Maintenance and Champerty, Discussion Paper

<sup>19</sup> Maintenance and Champerty Abolition Act 1993 (NSW)

<sup>20</sup> New South Wales Law Reform Commission (1994) Barratry, Maintenance and Champerty, Discussion Paper p.16