Institute of Actuaries of Australia

LITIGATION FUNDING

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LITIGATION FUNDING

PRESENTATION TO THE INSTITUTE OF ACTUARIES OF AUSTRALIA XITH ACCIDENT COMPENSATION SEMINAR 2007

1. Introduction

Litigation funding in Australia (other than by solicitors providing legal services on a "no win, no fee" pricing policy) emanated from the insolvency market and was enabled by the Corporations Act and Bankruptcy Act providing external controllers and trustees in bankruptcy with statutory powers of sale. Since the commencement of insolvency regimes in Australia, insolvency practitioners have exercised their statutory powers of sale to sell a portion of the fruits of their actions in return for funding to conduct the litigation (the "Insolvency Market"). This was seen as an exception to the rules against maintenance and champerty as the Courts would not prohibit that which the legislature permitted.

Accordingly, from 1997 to 2001, IMF's business and the business of its predecessor was limited to funding insolvency practitioners.

In 2001, IMF listed on the Australian Stock Exchange and broadened its funding to also include:

(a) non insolvency related commercial litigation conducted solely in the Supreme Courts and Federal Court with claim values over $2 million ("Commercial Litigation"); and

(b) multi party commercial claims usually involving breaches of the Corporations Act and Trade Practices Act ("Group Actions").

This decision was based upon a belief that considerations of public policy that once found maintenance and champerty repugnant would focus more in the future on the social utility of litigation funding.

After addressing the infinitely more liberal attitude towards litigation funding shown by the Courts over the last 20 years, the President of the NSW Court of Appeal in *Fostif Pty Ltd v Campbells Cash and Carry Pty Ltd* [2005] NSWCA 83 at paragraph 100 said:

> *"These changes in attitude to funders have been influenced by concerns about access to justice and heightened awareness of the cost of litigation. Governments have promoted the legislative changes in response to spiralling costs of legal aid. Courts have recognised these trends and the matters driving them. "Ambulance chasing" still has negative connotations in many quarters, but it is now widely recognised that there are some types of claim that will simply never get off the ground unless traditional attitudes are modified. These include cases involving complex scientific and legal issues. The largely factual account in the book and film "A Civil Action" has demonstrated the social utility of funded proceedings, the financial risks assumed by funders, and the potential conflicts of interest as between group members in mass tort claims propounding difficult actions against deep-pocketed and determined defendants."*

The subsequent decision of the High Court in Fostif (*Campbells Cash and Carry v Fostif* [2006] HCA 41), which was relevantly consistent with the decision of the NSW Court of Appeal, found:

(a) there to be no public policy against litigation funding; and

(b) the funder's control of the proceeding not to be an abuse of process.

The three main effects of Fostif will be:

(a) cases funded by third party funders will not be delayed by interlocutory disputes over whether there is an abuse of process;

(b) funders involvement in cases they fund will increase; and

(c) more capital will be directed to the market and more funders will appear, so the funding market is likely to grow, with more cases likely to be funded.

Currently, there are about five or six other litigation funders in Australia providing funding broadly on the basis that the funder agrees to pay the legal costs associated with the claim and agrees to pay the defendant's costs in the event the claim fails in return for a share of the proceeds of any settlement or judgment, if any.

2. Types of Causes of Action Funded

Third party litigation funding will not assist in providing access to justice for the vast majority of civil actions currently before the Courts.

As far as I am aware, funding is limited to Commercial Litigation principally in the Supreme and Federal Courts in each State of Australia.

Personal injury claims, workers compensation claims and other causes of action for which risks may be statistically predicted with sufficient accuracy across many cases ("Insurable Risk Cases") are funded by solicitors utilising a "no win, no fee" pricing policy. This risk assumption by solicitors in respect of Insurable Risk Cases is acceptable to them due to the low risk profile of the actions across a portfolio of cases.

Insurable Risk Cases also make up the vast majority of cases obtaining After The Event insurance in the United Kingdom litigation funding market discussed below.

IMF's investment protocol until 2001 did not include a minimum size restriction. This created outcomes too often involving the majority of the settlement or judgment sum in small claims going in legal costs, insolvency practitioner fees and IMF's fee.

As a result of this experience, when it listed in 2001, IMF included a minimum claim size in IMF's Investment Protocol of $2 million in acknowledgement of the fact that the cost of Commercial Litigation together with the associated risks, made funding small claims commercially unviable. Most of the other litigation funders will invest in the smaller claims, although the funded parties in these cases will always run up against a high cost/benefit ratio.

An exception to the minimum $2 million claim value is where a large number of claims can be grouped together and prosecuted in a Group Action.

Where this can be achieved, claims of less than $10,000 in value can be processed economically, returning funded parties about $7,000. This outcome was achieved for about

8000 IMF funded parties in a Group Action against British and American Tobacco and Phillip Morris in 2003.

Accordingly, I consider litigation funding in Australia in the short to medium term will predominantly be limited to Commercial Litigation involving high claim values and Group Actions.

3. The Demand for Litigation Funding

People determining whether to commence Commercial Litigation or Group Actions in Australia are usually confronted with the same risks Lord Woolf identified in 1996 when he examined the English and Welsh civil justice system and remarked:

> *"The defects I identified in our present system were that it is too expensive and that the costs often exceed the value of the claim; too slow in bringing cases to a conclusion and too unequal; there is a lack of equity between the powerful, wealthy litigant and the under-resourced litigant. It is too uncertain: the difficulty of forecasting what litigation will cost and how long it will last induces the fear of the unknown; and it is incomprehensible to may litigants. Above all it is too fragmented in the way it is organised since there is no one with clear overall responsibility for the administration of civil justice; and too adversarial as cases are run by the parties, not by the courts and the rules of the court, all too often, are ignored by the parties and not enforced by the court."* (Lord Woolf, *Access to Justice: Final Report to the Lord Chancellor on the civil justice system in England and Wales (1996)).*

These risks for potential claimants ("Litigation Risks") may be listed as follows:

(a) not being able to obtain a budget from their solicitor, let alone a set fee;

(b) not being able to predict how long the litigation process will take with any degree of certainty;

(c) a pricing policy by the lawyers requiring payment for hourly rates;

(d) confronting:

  (i) well resourced defendants with the capacity to obtain the best legal and expert advice; and

  (ii) legal advice they may find difficult to understand or which does not properly identify the risks, including that the claim may fail, with the result that the claimant will not receive any money by way of judgement, will not receive reimbursement of the legal costs paid and will have to pay the other sides' costs; and

(e) no capacity to predict how much the potential adverse costs order may be in dollar terms.

As a result of potential claimants' justifiable concerns about the Litigation Risks:

(a) speculative actions are minimised; and

(b) demand for litigation funding is high and will remain high until the Litigation Risks are better managed by the Courts and the legal profession.

4. The Supply of Litigation Funding

Litigation Funding in Australia is in its infancy. In comparison to the United States of America (the "USA") and the United Kingdom (the "UK"), discussed below, capital investment in causes of action as an asset class is negligible.

IMF has raised about $30 million from the Australian capital markets over the last four years, which I would estimate to be more than all other Australian litigation funder's combined capital. The other funders are:

- Hillcrest
- Australian Litigation Fund
- Litigation Lending Services
- Firmstone

5. The Cost/Benefit of Funding

The commercial terms of IMF's offer to fund a claim are set out in a litigation funding agreement which provides for the following:

- to pay a claimant's legal costs and disbursements;
- to provide any "security for costs" the claimant may be ordered to put up;
- to pay any "adverse costs order"; and
- where appropriate, to assist the claimant with investigations and project management.

In return for those services, the litigation funder is entitled to receive from any "resolution sum" (i.e. money received pursuant to a settlement or judgment):

- reimbursement of all money it has expended; and
- an agreed percentage of the "resolution sum" – usually between 20% and 40%.

If the funded party receives nothing, neither does the litigation funder.

The litigation funder does not provide legal advice to the claimant. It is not a "client" of the solicitor and it does not interfere in the solicitor/client relationship or in the legal proceedings. A funder does not usually provide "instructions" to the claimant's solicitors, although in *Fostif* this was expressly acknowledged as legitimate.

6. Is the Price of Litigation Funding Fair?

From a broad perspective, IMF's return on capital of about $30 million over four years has been about $8 million EBIT; being about a 7% per annum return on capital.

This return is not excessive, given the infancy of litigation funding in Australia and the risks inherent in investing in this market, including the Litigation Risks.

In the Insolvency Market where litigation funding has been broadly available for about 10 years and is now provided by about five funders, there has developed a pattern of insolvency practitioners tendering for litigation funding for the larger actions, with subsequent discussions with the preferred tenderer to further negotiate terms. This competitive process in respect of litigation funding is sadly lacking in respect of the retention of lawyers for these larger projects.

Once litigation funding terms in the Insolvency Market are agreed in principal, they are then subject to review by the creditor's committee of inspection, the general body of creditors or the Courts (refer to section 477(2B) of the Corporations Act).

This Court review process has over the last 10 years or so provided over 100 decisions on what the Courts consider relevant in determining whether approval is to be given to funding agreements being entered into and in particular, whether the funder's fee is to be approved.

In Group Actions, the Courts have the power to impose conditions upon granting permission for the representative proceedings to go forward. This power extends to modifying a litigation funder's proposed terms.

It is my opinion that the only way the price of litigation funding will decrease is:

(a) through more capital being allocated to litigation funding by the capital markets;

(b) if the Litigation Risks are managed more effectively by the Courts and the legal profession; or

(c) if the costs and delays in civil litigation are decreased by:

  (i) competitive tensions being introduced into the provision of legal services and other components of litigation that do not necessarily involve legal services; and

  (ii) the Courts being more proactive in ensuring quick and cheap resolution of the real issues.

In the USA, lawyers personally funding class actions must have their fees approved by the Court in all circumstances, where fees almost invariably are charged at around 30% of any settlement or judgment proceeds. This fee does not include assuming the risk of any adverse cost order as in the USA, costs orders are not made.

7. Investments

IMF funds claims that can be classified into one of three categories: Insolvency, Commercial Litigation and Group Actions.

According to the most recent IMF Investment Portfolio report, released to the ASX on 12 July, IMF had investments in 34 cases (where the budgeted IMF fee is greater than $500,000 in each case).

Of these 33 cases:

(a) 11 are Insolvency related;

(b) 13 are Commercial Litigation claims; and

(c) 9 are Group Actions.

However, Group Actions, such as the Aristocrat claim and the Finance Brokers case, provide for the majority of the value of claims.

In terms of maximum claim value:

(a) Insolvency cases comprise 17% of the total maximum claim value;

(b) Commercial claims comprise 29%, and

(c) Group Actions comprise 54% of the total maximum claim value.

8. IMF's Investment Protocol

IMF follows the following guidelines to gauge the value of investment opportunities when we receive new litigation proposals (not necessarily confined to shareholder actions):

(a) the likely claim value must be more than $2 million except under exceptional circumstances;

(b) the likely investment is less than 10% of IMF's current assets or facilities;

(c) the net return to the plaintiff must be reasonably high (i.e. greater than 60%);

(d) IMF's return on investment must be at least 300% (or 100% per annum since the average investment period is three years); and

(e) cases must rely predominantly on documentary rather than oral evidence.

Any proposal must be approved by the case or state manager and then by the investment committee on a unanimous basis.

9. IMF's Due Diligence Process

IMF conducts a through due diligence process before deciding whether to fund a case.

We will examine the claim and ask:

(a) What are the elements of the alleged cause or causes of action?

(b) What evidence of each element is available? Will it be lead as documentary or oral evidence? (Documentary evidence is preferred.)

(c) Who has these documents and who, if necessary, will be required to provide oral evidence?

(d) Are there statute of limitation issues?

(e) What is the prospect of the claim succeeding?

We will then examine the defence or potential cross claim and ask:

(a) What are the elements of any potential defence?

(b) Is the defence likely to rely on documentary or oral evidence in respect of each element of the defence?

(c) Where are these documents and who is likely to be called to give evidence for the defence?

We then turn to quantum and ask:

(a) What are the issues relevant to the quantum of the claim?

(b) Is the quantum of the claim likely to be proved and disputed through documentary or oral evidence?

(c) Where are these documents and who will be required to be called, including expert quantum evidence, if necessary?

(d) Will the claim value, when set off against the cross claim, be unattractive?

We examine the proposed defendants by asking:

(a) Are they capable of paying any settlement or judgment amount?

(b) Are they capable of paying any settlement or judgment amount?

(c) Are they insured and, if so, is the policy answerable?

We will also assess whether the claimant is someone we are prepared to have control of the proceedings.

Finally, it is important to examine the project from a broad perspective by asking:

(a) Are the risks capable of causing the loss of the investment open to qualitative and quantitative identification within temporal and fiscal frameworks?

(b) Is the manner in which the investment may be competently and efficiently managed capable of identification and achievement?

(c) In which jurisdiction, Court and list will the claim be filed?

(d) How long is the claim likely to take to reach closure of pleadings, discovery, statements, preparation for trial and judgment?

(e) How much is this claim likely to cost for each of these phases?

(f) How much are adverse cost orders, if made, likely to be?

(g) Is the project economically viable having regard to the identified risks and returns?

10. The UK experience

10.1 Introduction

The UK market provides significant insights into how the insurance sector has responded to the introduction of conditional fee agreements, which allow lawyers to take a case on a “no win, no fee” arrangement with their client.

In a similar way to Australia, litigation funding must be viewed in light of the torts of maintenance and champerty. If anything, the UK Courts were initially the stronger advocates of the dangers of such arrangements.

The UK prevented conditional fee agreements until 1995.

The 1979 Royal Commission on legal services unanimously rejected contingency fees as a way of financing litigation on the ground they would have a corrupting effect on lawyers.

However, the Thatcher Government’s 1989 Green papers considered relaxing existing standards, offering a number of suggested reforms, ranging from authorising uplift fees – where a lawyer can take on a case on a “no win, no fee” arrangement, and charge an “uplift”

of their normal hourly rate should the case be successful – to allowing lawyers to take a percentage of the damages upon successful resolution of a case.

It was the uplift model that was eventually adopted. Section 58 of the Courts and Legal Services Act of 1990 legitimised conditional fee agreements by providing for uplift fees should a case be successful. The arrangements came into operation in 1995 subject to rules laid down by delegated legislation.

As a sign of things to come, the Civil Justice Council published a paper in August 2005 entitled *Improved Access to Justice – Funding Options for Proportionate Costs – Report and Recommendations* and recommended "Consideration should be given to the introduction of contingency fees on a regulated basis along similar lines to those permitted in Ontario by the Solicitors' Act 2002 particularly to assist access to justice in group actions and other complex cases where no other method of funding is available."

10.2 Reaction of Insurers to CFAs

The introduction of conditional fee agreements – which have become the standard way of funding litigation led to the introduction of a new product – **After The Event insurance**.

CFAs also enabled the abolition of legal aid for all damages and money claims, which further shifted the funding of litigation away from government towards lawyers and insurers.

ATE policies are normally taken out to cover any adverse cost order should a case be unsuccessful and the claimant's own disbursements.

The claimant's legal fees are not usually covered as lawyers are acting on a "no win, no fee" CFA.

However, in some cases ATE policies cover claimants' legal costs should the lawyer decide not to operate under a CFA.

In practice, almost all ATE policies are written on personal injury claims (CFAs were initially limited to person injury, insolvency and human rights cases. In 1998, the government extended CFAs to all civil cases except for family work) and other claims with predictable outcomes over a portfolio of cases capable of statistical analysis. They rarely feature in large commercial claims.

10.3 Access to Justice

Just a year after conditional fee arrangements came into effect, Lord Woolf released a ground-breaking report in 1996 titled *Access to Justice* which highlighted a *"lack of proportionality" between legal costs and legal claims and attributed it to the "uncontrolled nature of the litigation process"*. He recommended the Courts take a more active approach in terms of case management to control costs.

The report's recommendations culminated in the Access to Justice Act of 1999, which further extended CFAs, for example to arbitrations and family work relating solely to financial matters and property.

But more importantly, the Act made both the premium payable (against the risk of having to pay costs), and the success fee payable by the client, recoverable from the losing defendant.

This provision was first floated in a consultation paper released by the Lord Chancellor Lord Irvine in 1998. The reason, it said, was that both types of cost were incurred directly because the loser had put the successful party to the cost of taking proceedings - and they should therefore be recoverable in the same way as other costs.

The insurance industry has been strongly opposed to the recoverability of insurance premiums and success fees and the jury is out on whether its opposition will be effective.

As of two years ago, there were some 60 providers of After The Event insurance in the UK.

Premiums have soared. The UK Office of Fair Trading said in December 2004, announcing a review of liability insurance markets, that there were concerns that the ATE insurance combined with conditional fee agreements were *"contributing to rising legal costs for personal injury claims which in turn are contributing to rising liability insurance premiums"*.

Claims management companies have also become common. These companies solicit claims and then farm them out to solicitors on their panel for a referral fee. Typically, lawyers take such cases on the basis of their usual costs, which are covered by "both sides insurance". A number of high profile claims managers have fallen into financial difficulties, such as Claims Direct, which was listed on the London Stock Exchange in July 2000 but went into administration two years later with massive debt.

11. The USA Experience

11.1 Introduction

The Economist reported in August 2005 that it had been a *"blazing summer"* for shareholder lawsuits in the United States of America (the "USA").

Total settlements have increased from $145 million in 1997 (in 2005 money) to $5.5 billion in 2005, whilst the number of lawsuits remained relatively constant, according to Cornerstone Research, which monitors class action filings.

Over a five-year period, the average public corporation has a 10% probability that it will face at least one shareholder class action lawsuit.

However, there a number of differences between the USA and Australian legal systems that suggest that Australia is not likely to witness the same proliferation of securities laws suits as has the USA.

- The American Experience

In the USA:

(a) trial lawyers are entitled to charge a percentage of the recovery in consideration for their services; and

(b) Courts do not grant adverse cost orders.

In class action claims, there is invariably a rush by trial lawyers to have the first suit filed due to the Court's favouring the lawyers who first file the suit in their decision as to which suit will proceed.

The successful trial lawyers then become entitled to a reasonable percentage of the recovery by everyone in the class under the guidance of the Courts, without the trial lawyers seeking or needing the class members to agree to this pricing policy.

As a result of the structure referred to in the three preceding paragraphs:

(a) there have been a great number of class actions taken, particularly in respect of shareholder actions alleging fraud on the market ("Private Attorney" claims);

(b) there are actions which are commenced before there has been a proper appraisal of the claim's value; and

(c) some trial lawyers expect the defendants to settle (from which the trial lawyers will be paid) even if the claim has little or no substance.

- The Australian Experience

In Australia:

(a) lawyers are ethically restricted from charging a fee proportionate to the recovery, given their fiduciary duties to their clients; and

(b) the indemnity principle ensures that the successful party in litigation recovers the cost of that litigation from the unsuccessful party.

Litigation funders will not fund commencement of proceedings unless and until:

(a) a viable cause of action is identified, valued and costed (including the potential for an adverse cost order); and

(b) there are sufficient shareholders who wish to enter into funding agreements with sufficient loss to make the litigation commercially viable.

As a result of the structure referred to in the two preceding paragraphs:

(a) there have been very few Group Actions taken in Australia to date;

(b) they are not commenced before there has been a proper appraisal of the claim's value; and

(c) no speculative proceedings are funded as to do so risks the loss of the investment and payment of adverse cost orders.

Unfunded representative proceedings that respondents successfully defend almost invariably result in unenforceable cost orders as no solvent person in their right mind would undertake the Litigation Risks on behalf of all the other members of the group and so the practice has developed for lead plaintiffs being parties of straw so that, even if the litigation is lost and an order is made against the lead plaintiff, the defendant rarely collects his costs. This is, of course, particularly unfair on the defendants in Group Actions.

One option is for the Courts to begin ordering lead plaintiffs to provide security for costs. However, as the lead plaintiff is usually a man of straw, an order will generally stifle the litigation.

If the lead plaintiff receives litigation funding then this will ensure that successful defendants receive their taxed costs and, in appropriate cases, all of their costs on an indemnity basis.

If there is any doubt about the funder's capacity to pay the adverse costs in due course then the Court can make an order that the lead plaintiff provides security for costs and if the litigation funder does not provide that security then the litigation will not go forward.

The lead plaintiff in an Australian Group Action cannot agree, on behalf of all of the members of the group, that the litigation funder will receive a percentage of each group member's judgment. Nor, it appears, can the Court make such an order. As a result, litigation funders may only fund Group Actions in Australia where each member of the group has signed a litigation funding agreement. It is virtually impossible for the litigation funder to fund all members of the group. Accordingly, the group is generally defined as those persons who have suffered loss at the hands of the particular defendant and who have signed a litigation funding agreement. By definition, this will be a smaller group than those who have suffered loss at the hands of the defendant.

In the USA, as class actions are funded by the solicitors, this issue does not arise i.e. the lead plaintiff agrees the percentage with the solicitor and that percentage is ratified by the Court. There is no requirement for each member of the class to make a separate agreement with the solicitor.

The result is that in Australian Group Actions the litigation will be conducted on behalf of a sub set of the group, being only those who are prepared to pay for the proceeding by forgoing part of their entitlement in favour of the litigation funder.

Australia is fast coming to the position that meaningful (and large) cost orders will be made against lead plaintiffs in unsuccessful Group Actions and it is this fact which clearly differentiates the USA and Australian systems.

- Punitive Damages

Most civil litigation systems in the USA include a punitive element in their damages i.e. a payment by the defendant to the plaintiff as a punishment of the defendant. By way of example, the recent Texas verdict in the *Vioxx* case against the pharmaceutical company Merck totalled US$253,450,000 of which US$229,000,000 was in the nature of punitive damages (the actual economic loss was only US$450,000). It is the possibility, if not the probability, of this very high punitive payment which encourages class actions in the USA.

No such system applies in Australia. A plaintiff in a Group Action in Australia will receive recompense for economic loss and, in appropriate cases, damages for personal injury but in no case will an award of damages be made in order to punish the defendant.

- The Jury System

Even in a litigation system where punitive damages may be paid, such damages will be restrained if a judicial officer, used to dealing with such cases, makes the damage determination.

This is also the case in relation to general damages for economic loss and for personal injury.

In the USA such determinations are routinely made by juries whereas in Australia the almost invariable practice is that these cases come before a judge sitting alone.

The USA system therefore contains the potent mix of punitive damages in the hands of untrained juries which are only too happy to punish big business in favour of the individual. This problem simply does not arise in Australian Group Actions.

- Depositions

  It will almost always be the case in any Group Action that the facts are best known by the officers of the defendant.

  In the USA the plaintiff has an early and potent opportunity to get at these facts and those officers. The plaintiff is entitled to depose the officers of the defendant (i.e. question the officers on oath).

  This is a powerful tool in the hands of a class action lawyer.

  The only similar tool available to Australian Group Action lawyers is the relatively staid right to deliver written interrogatories and as yet untested discretionary powers.

- Settlement

  All of these elements come together in the question of settlement. A Group Action will be much more readily instigated if there is a high chance of early settlement.

  In the USA the class action defendant faces a jury armed with the power to award punitive damages in circumstances where the plaintiff does not have to pay for failure and the officers of the defendants are put under the spotlight from the beginning.

  This leads to early high levels of settlement and to allegations that many unmeritorious class actions are instigated with the knowledge that many defendants will settle even though they do not believe they are liable.

  This situation does not appertain in Australia. The Australian Group Action defendant faces a judge who has heard it all before, who does not have the power to award punitive damages and who will invariably award costs, and in some cases indemnity costs, to successful defendants. Rather than have an early confrontation by way of deposition the Australian Group Action defendant can (and generally does) put off the evil day for many years happy to run the plaintiffs out of patience or funds or both.

12. Accountability of Funders & Insurers

Insurers when managing claims by indemnified, defendant insureds are also in the business of providing litigation funding. Insurers, like funders, determine which claims are prosecuted and defended, choose the lawyers, instruct the lawyers and pay them and indemnify the insured in respect of adverse cost orders. None of these activities are currently regulated, leaving insurers, like funders, currently unaccountable for these activities.

After reciting that the overriding purpose of the Civil Procedure Act 2005 (NSW) is to facilitate the just, quick and cheap resolution of the real issues in proceedings (sub section 56(1)), the Act:

1. obliges the Court to seek to give effect to that overriding purpose when it exercises power or interprets any provision of the Act or Rules (sec 56(2));
2. obliges the parties to civil procedures to assist the Court to further that overriding purpose (sec 56(3)); and
3. prohibits lawyers from causing their clients to breach their duty to the Court (sec 56(4)).

To achieve the specified overriding purpose it will be necessary to overcome shortcomings similar to those identified by Lord Woolf in section 3 earlier.

Litigation funders, including insurers, have a greater capacity than most to systematically assist or retard the Court in achieving the overriding purpose.

With these concerns in mind, it seems appropriate to:

1. require parties to inform the Court, at the commencement of proceedings, if the conduct of their case is to be funded in whole or in part by a third party and, if so, to identify that party; and
2. change sub section 56(3) of the Civil Procedure Act so that it reads:

> "A party <u>and any person paying any part of the legal costs of a party</u> to civil proceedings is under a duty to assist the court to further the overriding purpose…"

Further, there is no specific public data available concerning funders or insurer's claims management expenditure in our civil justice system. Given the utilisation by funders and insurers of our subsidised system, our legislature and Courts should consider collecting relevant data to ensure the funder/insurer interface with our civil justice system is understood and appropriately regulated. This data could include:

(a) the number, type and value of claims funded by each funder and the number, type and value of defended claims funded by each insurer;

(b) the cost of the litigation to the funders, insurers and the Courts;

(c) the levels at which the parties were prepared to settle the case; and

(d) the value of settlements or judgments and the time each proceedings took to resolve.

This data could provide some surprising statistics. For example, it is acknowledged by the insurance industry that about 75 cents in every dollar paid out by insurers on directors and officers policies goes in defending the claims, with only 25 cents going to the claimants. This type of statistical data was powerfully used in the recent tort reform debate and must be relevant in any litigation funding debate.

Making funders, including insurers, accountable for their involvement in the Court process in the same way as the parties themselves, seems an obvious means of better protecting and promoting the interests of the Courts as well as the interests of the consumers of the Courts' services.

13. What are the Likely Insured Causes of Action?

For the cases that are pursued, the following provides an outline of the most common

protections pleaded in shareholder Group Actions.

13.1 Shareholder Claims

(a) Disclosure documents protection:

- s 710(1) – compulsory disclosures in a prospectus
- s 728(1) – disclosure documents must not be misleading
- s 728(2) – must have reasonable grounds for making a statement about the future
- s 729(1) – list of people from whom a shareholder may recover, including "6. a person who contravenes, or is involved in the contravention of, ss 728(1)"

(b) Continuous disclosure protection:

- s 674(2) – compulsory notification of information a reasonable person would expect, if it were available, to have a material effect on the price or value of the shares
- s 674(2A) – a person involved in the companies' contravention contravenes this section

(c) Protection from misleading and deceptive conduct

- s 1041H – a person must not engage in misleading or deceptive conduct, or conduct that is likely to mislead or deceive, in relation to a financial product
- s 769C – representations about future matters are misleading unless representor has reasonable grounds

13.2 Claims against Directors

In an action for damages under the Corporations Act or Trade Practices Act, investors can claim damages against a person who directly engaged in the misconduct or against "any person involved in the contravention": section 1041I of the Corporations Act, section 82 of the Trade Practices Act.

It is commonly pleaded that the defendant company engaged in the contravening conduct is the principal offender, whilst individuals, such as directors, are alleged to have an "accessorial liability".

A "person involved in a contravention" is defined in section 79 of the Corporations Act and section 75B of the trade Practices Act as a person who:

(a) has aided, abetted, counseled or procured the contravention;

(b) has induced, whether by threats or promises or otherwise, the contravention;

(c) has been in any way, directly or indirectly, knowingly concerned in, or party to, the contravention; or

(d) has conspired with other to effect the contravention.

The Corporations Act also contains other breaches for which directors may be liable, and thereby be exposed to pecuniary penalty orders (section 1317G) and compensation orders (section 1317H):

(a) failure to exercise and discharge duties with due care and diligence (section 180);

(b) failure to exercise powers and discharge duties in good faith and for a proper purpose (sections 181 and 184(1)):

(c) improper use of position as a director or office of corporation for personnel advantage or to cause detriment to the corporation (sections 182 and 184(2));

(d) improper use of information obtained in office for personal advantage or to cause detriment to the corporation (sections 183 and 184(3)).

Finally, section 588G of the Corporations Act, creating a statutory duty upon directors to ensure the companies they control do not incur further debts after the companies are insolvent, will continue to be breached as directors unreasonably believe their companies' fortunes will improve.

13.3 Claims against Professionals

Finally, professional indemnity claims will continue even though limited liability has clearly decreased the ability of clients to successfully obtain large damages from their professional wrongdoers. The pressures experience by the legal profession by their bank clients against this limited liability push are an indication that there will always be a real risk for insurers to manage on behalf of their professional clients.

14. Implications for D&O Insurance Premiums

It is clear that some underwriters are using the arrival of shareholder actions to predict increases in premiums. This quote from Vanessa Maher, vice president of claims for Liberty International Underwriters, at the Australian Insurance Law Association conference, June 2006 is illustrative of the attitude:

> *"Spurred on by increasing shareholder activism and a plaintiff-friendly legal regime, there are currently a number of shareholder class actions that have the potential to substantially impact the D&O market. Based on current reports, these factors could result in claims payouts in excess of an estimated $850m. Some of these actions, even individually, have the potential to put a significant dent in the D&O premium pool."*

In response, the following points should be considered:

(a) companies, directors and insurance underwriters have been aware of shareholder actions now for several years. (The AMP/GIO action (which was not funded) was initiated in 1999 and settled in 2003 (and shareholders received $97 million)); and

(b) apart from the AMP/GIO case and the settlement last year of the Concept Sports matter (which was IMF funded), no other shareholder actions for compensation of which IMF is aware have resulted in any payouts by D&O insurers.

According to Liberty Underwriters, the 2004 Australian D&O premium pool was between $250m to $300m. Anecdotal evidence suggests that $100m is held in reserves to cover future claims.

In Australia, reports suggest that insurance premiums will continue to fall, after three years of significant price cuts. The Australian Financial Review quoted Mike Wilkins of Promina in an article in January 2007: "Our experience since June is that we are still seeing some very aggressive price cutting."

It remains to be seen whether shareholder actions will be assessed differently in a tightening marketing. Moves in premiums are probably related more to the competitive environment for insurance than the potential for shareholder claims.

Exclusions to D&O Policies

(a) Employment practices cover;

(b) OHS breaches;

(c) Environmental law breaches; and

(d) Trade practices liability.

But typical *exclusions* include:

(a) Prospectus liability;

(b) Breach of professional duty;

(c) Insider trading;

(d) Dishonesty fraud and wilful conduct; and

(e) Insolvency related claims for start up companies or those in financial difficulties.

In light of the discussion above regarding the typical causes of action in cases funded by IMF, it would be practically important to ensure that D&O policies cover prospectus liability and breaches of the *Corporations Act*.

However, looking at the list of typical exclusions, few shareholder actions currently being funded by IMF involve pleading a breach of professional duty, insider trading or dishonesty, fraud or wilful conduct.

15. Is Australia so plaintiff-friendly?

The observation from Ms Maher also suggests that Australia is a plaintiff-friendly jurisdiction and that it is relatively easy to bring actions in Australia, even when compared in the United States.

Such as assertion warrants further consideration.

There have been no new developments in Australian caselaw to make the class action regime any easier. Most of the class actions face interlocutory hearings on a range of procedural issues.

As for the similarities with the US and potential for Australia to turn into a US-style litigation industry, I doubt we will see this in Australia.

There are key differences between the USA and Australian legal systems that will prevent

this from occurring, namely:

In the USA:

(i) attorneys race to be first to file to control the class;

(ii) attorneys fees, usually around 30% of the recoveries (subject to Court approval), is payable from the global recovery, without the need for contractual consent of the class members; and

(iii) neither attorneys, nor the class members, are liable for adverse costs orders.

But in Australia:

(iv) solicitors are ethically and legislatively prohibited from charging their clients a percentage of the recovery;

(v) funders, with contractual agreement of each client, charge a percentage of the recovery and pay all costs associated with the litigation; and

(vi) funders pay all adverse cost orders.

As a result of being exposed to the costs of the other side if a proceeding is unsuccessful, funders must conduct an extensive due diligence *prior* to the proceeding commencing and continuously review the merits of the case once proceedings are commenced.

Litigation funding companies therefore act as a *merits check* on speculative cases as no funder will be willing to fund proceedings that do not have a strong prospects of success.

Dated: 15 March 2007
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