Litigation Funding and Insurance

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LITIGATION FUNDING AND INSURANCE

1. Introduction

Litigation Funding Overview

1.1 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.

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

1.3 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").

1.4 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.

1.5 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."*

1.6 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.

1.7 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) funder's 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.

1.8 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 settlement or judgment, if any.

1.9 In this presentation, claimant litigation funding provided by Government through Legal Aid and by lawyers through "no win, no fee" pricing policies will not be addressed.

1.10 The focus of this presentation is upon:

(a) Claimant funding by commercial litigation funders; and

(b) Defendant funding provided by insurers pursuant to policies of indemnity (for example motor vehicle, product liability, professional indemnity and directors and officers insurance).

2 Accountability of Litigation Funders and Insurers

Similarities Between Funders and Insurers

2.1 It is clear that insurance against risk has been an enormous advantage to society. This is so despite the fact that every insurance contract savours of maintenance (encouraging litigation). This is especially the case with professional indemnity, directors and officers, legal expense and after the event insurance where the insurable event is or likely involves disputation or litigation and the insurer has absolute control of any litigation which eventuates. By the typical insurance contract, the insurer agrees to fund any litigation in relation to the risk and the insured agrees to give over complete control of the litigation to the insurer.

2.2 The Court of Appeal in *Clairs Keeley (A Firm) v Treacy* stated that:[1]

> "...*in terms of risk of abuse, there may be no difference between a litigation funder with an eye to maximising profits and an insurance company with an eye to minimising losses. Indeed, it may be said that the litigation funder has a greater incentive to ensure that he conducts himself properly. Not only are the funder's activities likely to be the subject of close scrutiny, but any transgression is likely to have a markedly deleterious effect on the funder's ability to conduct business in the future. By contrast, only a small portion of an insurer's business is likely to lead to litigation.*"

1 (2003) 28 WAR 139 at [72].

2.3 In addition, litigation funders are always able to assess the actual risks before they eventuate whereas insurers, other than after the event insurers, rely upon statistical claims data. Austin J in *ACN 076 673 875 Ltd* said:[2]

> *"… there is the commercial reality that IMF would not, acting rationally, prosecute litigation at its expense unless there were reasonable prospects of a verdict or settlement …*"

2.4 Insurer funding of litigation in the context of a discussion concerning third party funding of litigation is relevant for the following reasons:

1. The policy issues thrown up by litigation funding, whether the third party is a claimant litigation funder or a defendant funder, are essentially the same.
2. The common law, fiduciary, ethical and regulatory responses to these issues over the last couple of hundred years in the insurer context are adaptable to claimant litigation funders as the "new kids on the block".

2.5 Insurers and claimant litigation funders share the following characteristics with respect to their involvement in litigation:

(a) both enter into tripartite contractual relations with the funded client / insured and their lawyers;
(b) both assume day to day responsibility for the provision of instructions to the lawyers with the carriage of the matter;
(c) both pay for the conduct of the litigation; and
(d) both pay any adverse cost orders, although the insurance industry currently considers their liability capped at a limit agreed to with the insured without regard to the costs they cause to the claimant or to the civil justice system.

<u>Lawyer's Fiduciary and Ethical Duties</u>

2.6 The insurance analogy also illustrates the regularity of informed arrangements whereby solicitors represent both insurer and insured as principals, even though conflicts of interest may arise.[3] In cases of conflict of interest, the law prescribes the duties of the various parties including the solicitors involved.[4] The law assumes that a lawyer-client relationship exists between the solicitor appointed by the insurer and

2 [2002] NSWSC 578; (2000) 42 ACSR 296

3 See generally Mercantile Mutual Insurance (NSW Workers Compensation) Ltd v Murray [2004] NSWCA 151, 13 ANZ Ins Cas 61-612, Fostif Pty Ltd v Campbells Cash & Carry Pty Ltd [2005] NSWCA 83 at [82] .

4 See generally C Leigh-Jones, MacGillivray On Insurance Law, 10th ed, (2002) at para 28-35.

the insured, but not necessarily to the exclusion of a similar relationship with the insurer. Both insurers and the solicitors they appoint owe a duty to the insured to conduct the proceedings with due regard to the latter's interests and an action for damages will lie for breach of that duty.[5]

2.7 Additionally, insurers have the right to decide upon the proper tactics to pursue in the conduct of the litigation, provided that they do so in what they *bona fide* consider to be in the interests of themselves and the insured.[6] When the insurer takes over the conduct of the insured's defence, each party comes under an obligation, as a matter of contractual implication, to act in good faith with due regard to the interests of the other.[7]

2.8 The common law rules that have been formulated to deal with insurance contracts are readily adaptable to the regulation of litigation funders presently under consideration. In *Project 28 Pty Ltd (formerly Narui Gold Coast Pty Ltd) v Barr* [2005] NSWCA 240 at [70] the New South Wales Court of Appeal said: *'The insurance context provides a useful example of how the law copes adequately with a situation where control over litigation is given to a person who is not a party to the litigation itself."*[8]

2.9 Indeed, there seems no reason in principle or policy for a funder's involvement in litigation to be treated differently to insurers. At the extreme, if regulators and courts are discriminatory, there will be a tendency to worsen the inequality of arms between claimants and insurers presently so clearly in existence.

Lawyer's Duties in Funded Litigation

2.10 The tripartite relationship between funder, client and lawyer has the potential to create numerous conflicts. This may be of particular significance in multi-party proceedings, where the claimants could be more vulnerable to both the funder taking control of the proceedings and to lawyers who fail to sufficiently protect and promote the claimants' interests above their own.[9]

5 Groom v Crocker [1939] 1 KB 194 at 202-203.

6 Groom v Crocker [1939] 1 KB 194 at 203.

7 K/S Merc-Scandia XXXXII v Lloyd's Underwriters [2001] 2 Lloyd's Rep 563 at 572-574.

8 Project 28 Pty Ltd (Formerly Narui Gold Coast Pty Ltd) v Barr [2005] NSWCA 240 at [70]

9 V Waye, Conflicts of Interests between Claimholders, Lawyers and Litigation Entrepreneurs, (2008) 19(1) Bond Law Review 225 at 226,270.

2.11 This includes the lawyer giving advice on the benefits and risks of the funding proposal – which might be seen to be an ethically perilous undertaking if the lawyer is financially dependant on the funder for the litigation to proceed.[10] Further, not only does the lawyer face potential conflicts between the funder's and the clients' interests, there is also a potential conflict between duties owed to *different* clients if the lawyer is retained by the funder and not directly by the litigants.[11]

2.12 Subject to certain caveats noted below, the involvement of lawyers in the funder-funded party relationship solves more problems than it creates. The interposition of lawyers into the funding equation is central to ensuring that the interests of the funded litigant are not subordinated to those of the funder and reduces considerably the risk that the funded proceedings may tend to corrupt the civil justice system.[12]

2.13 It is in the interests of the funder that experienced and competent legal advisers act in the proceedings – the funder will have little chance of earning a return if corrupt or incompetent advisers are retained. The funder can also be expected to improve the efficiency and cost effectiveness of the lawyers through the funder's imposition of budgets on the lawyers and general experience in managing litigation[13] and lawyers can foster the development of the funding industry and its competitiveness by advising their clients of the options available for funding litigation.[14]

2.14 As has been argued above, many conflicts of interest which are thought to be inherent in funded proceedings can be avoided or resolved by ensuring that the lawyers' fiduciary and professional duties to the litigants are given precedence over any duties or contractual obligations the lawyer may owe to the funder.[15] A properly

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10 Ibid 267.

11 Ibid 234-5. Note Waye's comments in relation to potential conflicts for the lawyer in respect of duties to different clients – she analyses this issue on the basis that the funder is a client of the lawyer. A conflict can also arise between duties to different clients who are both (or all) claimants. For example, a conflict arises for the lawyer where one claimant is part of a "test case" and wants to settle before issues of liability are determined for the benefit of the remaining claimants.

12 Lawyers, as officers of the court, are subject to the full disciplinary power of the court over any misconduct by them in the course of the proceedings. Lawyers provide safeguards for the system of justice outside of the courtroom as well. For example, the lawyers may be required to positively certify to the court, before filing any initiating process or defence, that the lawyers consider "there are reasonable grounds for believing on the basis of provable facts and a reasonably arguable view of the law that the claim or defence (as appropriate) has reasonable prospects of success": Legal Profession Act 2004 (NSW), s 347.

13 In QPSX Limited v Ericsson Australia Pty Ltd FCA 933 French J as he then was said at paragraph 54: "There is no doubt that the cost of litigation…can be very high. Even when conducted as efficiently as it can be with the aid of skilled advisers and technical experts, it is time consuming and expensive. The development of arrangements under which the cost risk of complex commercial litigation can be spread is at least arguably an economic benefit if it supports the enforcement of legitimate claims. Where such arrangements involve the creation of budgets by funders knowledgeable in the costs of litigation it may inject a welcome element of commercial objectivity into the way in which such budgets are framed and the efficiency with which the litigation is conducted."

14 The Solicitors' Code of Conduct (2007), Rule 2.03(d) requires solicitors in England and Wales to "discuss with the client how the client will pay [for the legal services to be provided], in particular . . . whether the client's own costs are covered by insurance or may be paid by someone else such as an employer or trade union."

15 P Spender, After Fostif: Lingering uncertainties and controversies about litigation funding (2008) 18 JJA 101, 114; V Waye, Conflicts of Interests between Claimholders, Lawyers and Litigation Entrepreneurs, above n 9, 235.
See also Law Council of Australia, Standing Committee of Attorneys-General, Litigation Funding (14 September 2006), [92]: "The Law Council submits

drafted funding agreement will do just that.

2.15 This is so whether the funder or the funded litigant retains the lawyer. If the funder retains the lawyer, the funder generally seeks to control the proceedings (i.e. instruct the lawyers) – at least in jurisdictions where this is permitted. Provided the lawyers can still effectively discharge their duties to the funded litigants, the proceedings need not raise abuse of process or ethical concerns.

3 Proposals for Reform

The Victorian Law Reform Commission in its 2008 "Civil Justice Review" Report (the "LRC Report"), in Chapter 3, outlined the commission's proposal to:

"… create a new set of statutory provisions to define the overriding obligations and duties (the 'overriding obligations') to be imposed on all key participants in civil proceedings before Victorian courts, and to more clearly define the 'overriding purpose' sought to be achieved by the courts in civil proceedings. The introduction of these provisions aims to address one of the key policy objectives of this review, improving the standards of conduct of participants in the civil justice system to facilitate early dispute resolution, to narrow the issues in dispute and to reduce costs and delay".[16]

3.1 Recommendations in the LRC Report[17] included:

(a) an overriding provision to the effect that relevant legislation and procedural rules to be enacted to facilitate the just, efficient, timely and cost effective resolution of the real issues in dispute;[18]

(b) new provisions should be enacted to prescribe standards of conduct in civil proceedings, to facilitate cooperation between the participants in a civil proceeding, candor and early disclosure of relevant information and early resolution of the dispute, together with sanctions and penalties for non-compliance with these overriding obligations;[19] and

(c) the overriding obligations should be owed by parties, lawyers and their legal practices and "any person providing any financial or other assistance to any party to a civil proceeding, including an insurer or a provided of funding or

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that explicit measures to ensure independence of lawyers from LFCs are unnecessary."

16 At page 149 of the LRC Report.

17 At pages 204 to 208 of the LRC Report.

18 Recommendation 16.3. See also section 56 of the Civil Procedures Act 2005 (NSW), the Uniform Civil Procedures Rules 1999 (QLD) (Rule 5) and Magistrate's Court Civil Procedures Rules 1999 (VIC) rr 1.19-1.22.

19 Recommendation 16.1.

financial support, insofar as such person exercises any direct or indirect control or influence over the conduct of any party in a civil proceeding".[20]

3.2 This latter recommendation reflects the fact that litigation funders, including insurers, have a greater capacity than most to systematically assist or retard the Court in achieving the overriding purpose – the cheap, quick, just and efficient resolution of the matter.

IMF's Policy for the Model Conduct of Funded Civil Litigation

3.3 IMF has recently finalised and published a document 'IMF Policy for the Model Conduct of Civil Litigation' which contains *inter alia* a statement of principles in respect of its management of litigation and legal services funded by IMF.

3.4 The Policy requires that IMF act honestly, lawfully and fairly in managing all claims and litigation funded by IMF.

Disclosure of Funding Agreements and Insurance Policies

3.5 The LRC Report referred to the issue of disclosure by providers of financial or other assistance as follows:

> *"Given that our recommended overriding obligations extend to litigation funders who exercise any control or influence over the funded party in litigation, there is a need for disclosure of the existence of litigation funding arrangements.*
>
> *Similarly, the proposed overriding obligations extend to insurers who exercise control or influence over the insured party in the course of the proceeding. Accordingly, there is a corresponding need for disclosure of the existence of insurance arrangements.*
>
> *In the United States and Canada insurance arrangements may be discoverable. In some instances this may be admissible evidence.*[21]*…*
>
> *In a recent decision of Harcourt v FEF Griffin*[22] *the Queens Bench Division of the English High Court held that disclosure of insurance details may be*

20 Recommendation 16.3(2)(d).

21 Professor Greg Reinhardt, 'Can courts ignore the reality of insurance in litigation?' (Paper presented at the Australian Insurance Law Association 2007 Geoff Masel Lecture Series, Melbourne, 12 September 2007) 2. Reinhardt cites Reed v Wimmer 195 W Va 199 465 SE2d 199 (1995), Court of Appeals West Virginia.

22 Harcourt v FEF Griffin (Representatives of Pegasus Gymnastics Club) and others [2007] EWHC 1500 (QB) [19].

ordered where a claimant is able to demonstrate some real basis for suggesting that the disclosure is necessary, in order to determine whether further litigation will be useful or simply a waste of time.

In Australia where an insurer has denied indemnity the courts may permit the plaintiff to join the defendant's insurer in the proceeding in order to allow discovery.[23] *Alternatively, Professor Reinhardt suggests that 'the authorities establish that the plaintiff will be unable to effect joinder or otherwise to seek discovery direct from the insurer'.*[24] *The traditional reluctance to require the disclosure of the existence of insurance or of insurance details in Australia may be because of a lack of relevance or prejudice in the determination of liability or quantum.*[25]

However, Professor Reinhardt suggests that a number of recent Australian decisions recognise the significance of insurance in the determination of cases and that an insurer may be the real litigant.[26] *He argues that 'in all cases where there is insurance which may respond to the claimant/plaintiff's claim, discovery should be required of relevant insurance information, subject only to legal professional privilege where this applies'.*[27] *Professor Reinhardt believes that such disclosure is unlikely to prejudice the insurer. He suggests that the issue of whether there is a liability to indemnify will still need to be determined and 'the risk that the claimant/plaintiff will frame or amend their claim to take account of the available insurance should not concern the insurer. The court is obliged to look at the substance rather than the form of the claim made by the plaintiff against the defendant'.*[28]

In considering the position of insurers it is important to bear in mind that in some cases the insurer will merely be at risk of having to indemnify the insured in the event that the claim against the insured succeeds; in other situations the insurer will have paid the claim(s) against the insured and will be

23 Reinhardt cites JN Taylor Holdings Pty Ltd (in liq) v Bond (1993) 59 SASR 432: Reinhardt (2007 above n 14).

24 Ibid, citing CE Health and Casualty & General Insurance Ltd v Pyramid Building Society (1997) 9 ANZ Insurance Cases 61-345, and Beneficial Finance Corporation Ltd v Price Waterhouse (1997) 9 Australia and New Zealand Insurance Cases 61-360.

25 Ibid 2.

26 Ibid 6. He provides the example of Johnson Tiles Pty Ltd v Esso Australia Pty Ltd [2003] VSC27; (2003) Aust Torts Reports 81-692. This case involved claims for damages resulting from cessation of gas supplies to the plaintiffs as a result of an explosion at Longford in Victoria. Reinhardt observes that the judgment seems to suggest that 'the real litigants were insurers well able to cover themselves through an increase in premium or some other financial adjustment' (at 5). Cases relevant to the issue of insurers being the real litigant include Linsley v Petrie [1998]1 VR 427; Leader Westernpoint Printing Pty Ltd v IPD Instant Duplicating Pty Ltd (1998) SANZ Insurance Cases 60-856.

27 Ibid 8.

28 Ibid 8-9.

bringing proceedings against a third party, using a right of subrogation, in order to recover some or all of the amount paid out."[29]

3.6 The LRC Report recommended:

(a) that the parties should be required to **disclose the identity of an insurer or litigation funder** that exercises control or influence over the conduct of the insured or funded party in the course of the proceeding; and

(b) the court should have discretion to order disclosure of a party's insurance policy or funding arrangement if it thinks such disclosure is appropriate.[30]

3.7 **Disclosure** by funders and insurers **ought to be routine** rather than discretionary. This would facilitate the collection and analysis of **data** concerning funders and insurer's claims' management involvement in the civil justice system. Given the utilisation by funders and insurers of our subsidised system, our legislatures and Courts should consider collecting relevant data to ensure the funder/insurer interface with our civil justice system is properly understood and appropriately regulated. This data could include:

First: the number, type and value of claims funded by each funder and the number, type and value of defended claims funded by each insurer;

Second: the cost of the litigation to the funders, insurers and the Courts;

Third: the levels at which the parties were prepared to settle the case relative to the initial claim values; and

Finally: the value of settlements or judgments and the time each proceeding took to resolve.

3.8 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 also be relevant in any litigation funding debate.

3.9 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

29 At page 471 and 472 of the LRC Report.

30 Recommendation 86.

better protecting and promoting the interests of the Courts as well as the interests of the consumers of the Courts' services.

3.10 Disclosure of the terms of the funding agreement to the Court (as has been suggested above) also allows the judiciary to monitor any oppressive terms and guard against any improper incursion on the lawyer-client relationship by the funder.[31] In relation to the fear that the lawyers will compromise their professional duties to the litigants in return for the hope, or even the promise, of further work from the funder, it is submitted that very few competent law firms would be willing to risk damage to, or even the destruction of, their professional reputation and business which would flow from a finding that the firm had engaged in professional misconduct or an abuse of process.

3.11 If the funder has the power to instruct the lawyers and chose to order them to take steps in breach of court orders or procedural requirements, the funder would be exposed to a contempt of court finding.[32]

3.12 It follows from the preceding discussion that the important role lawyers play in funded litigation may be compromised if any of the following are missing (these are the "caveats" referred to earlier):

(i) as noted, the lawyers' professional and fiduciary duties towards the funded litigants must not be overridden or compromised in any way by the terms of the funding agreement;

(ii) the lawyers must be competent, have relevant experience in the litigation being undertaken, be alive to the risk of conflicts arising and be able to give proper and objective advice to the litigants irrespective of the funder's views including, if necessary, advising the litigants of the desirability for them to take independent advice;[33]

(iii) there must be full and accurate disclosure to all funded litigants of the terms of the lawyers' retainer and of any other financial arrangements between the lawyers and the funder or any other party;

31 P Spender, After Fostif above n 15, 114. V, Waye Conflicts of Interests between Claimholders, Lawyers and Litigation Entrepreneurs, above n 9, 270-1.

32 Project 28, above n 8 [94]

33 Clairs Keeley (A Firm) v Treacy & Ors (No 2) [2004] WASCA 277 at [75]: "The Court can be more confident that its processes will not be abused by a litigation funder if the solicitor acting for the funded party is independent of the funder, is alive to the possibility of abuse or conflict and is fully aware of his [sic] fiduciary duties to his client."

(iv) the lawyers must keep the funded litigants adequately informed of all significant developments in the litigation and must inform any litigant of any matter which might adversely affect that litigant's interests; and

(v) the litigants themselves must retain the right to instruct the lawyers directly in relation to their own claims in the event the lawyers' instructions come from the funder or, in a group proceeding, a committee or other representative.

A competent funder will ensure that each of these factors is provided for in the constitution and conduct of the funded proceedings.

4 Management of litigation involving insured claims

4.1 The securing of litigation funding for claims brings a fresh set of considerations for insurers contemplating the management of funded litigation.

Defending Funded Litigation

4.2 Litigation funders as a matter of course must conduct a thorough due diligence on any funding proposal they receive, with reference to both the prospects of success of the proposed Claim and also the likely quantum of the Claim in the event that it is successfully pursued (by reference to either an estimated settlement sum or sum at judgment).

4.3 Commercial litigation funders will simply not fund matters which they are not confident of resolving favourably. Funders' business models will accommodate the funding of only a very limited number of unsuccessful matters, and the prospect of an adverse costs order only increases the scrutiny that the funding proposal is subjected to during the course of the funder's due diligence process.

4.4 In this light, the advent of litigation funders and their decision to fund a particular Claim should focus the mind of an insurer to the reality that the Claim's prospects have been subjected to a third party's objective and commercial review. Funders in this regard provide a kind of "reality check" as to the prospects of the Claim and also its commercial merits. It is also IMF's policy to make its involvement known to the defendant.

4.5 It may be that such scrutiny of Claims by litigation funders will bring with an increased willingness by insurers to seek to resolve Claims at any early stage and prior to extensive costs being incurred by both parties to the litigation. If litigation funders have formed a view that the litigation they contract to fund will be successful in the event that it proceeds to trial, then surely it is incumbent on insurers to factor in that view when contemplating the manner in which they will manage the defence of the litigation.

4.6 The securing of litigation funding for the pursuit of Claims may have the effect of diminishing the use of "diversion and delay" tactics by defenders of these Claims, in particular with reference to situations where such tactics were utilised as a means of "out-resourcing" a plaintiff. In this regard litigation funding may be viewed as bringing "equality of arms" to the proceedings.

4.7 Claims funded by litigation funders with strong balance sheets should not, theoretically, be as susceptible to tactics incorporating diversion and delay. Litigation funders, once they have agreed to fund a matter, are reluctant to walk away, for generally all of the costs they incur in the matter until that time cannot be recovered.

Funding of Subrogated Claims

4.8 Subrogation, for insurance purposes, is the right of the insurer to 'stand in the shoes' of the insured in order to pursue any benefit that the insured has against a third party[34].

4.9 The common law says that an insurer is entitled to exercise its rights of subrogation if:

(a) the insurer has paid the full amount due under the policy; and
(b) the insurer's rights of subrogation are not excluded or modified by a term of the policy.

4.10 Where an insurer is entitled to pursue a third party by way of subrogation, it is conceivable that the insurer could source funding for the pursuit of such a claim from a litigation funder.

34 The Owners Strata Plan 66601 v Majestic Constructions Pty Ltd & Ors [2008] NSWSC 735

4.11 Such funding has not, however, yet been secured to the knowledge of IMF.

4.12 If this type of funding was to move beyond a mere possibility, the following issues would need to be considered:

(a) whether Claims subrogated to insurers and litigated can in turn be assigned to third party litigation funders;

(b) whether insurers would be willing to assign these Claims; and

(c) if such Claims were to be assigned to funders, the:

(i) form of the funding arrangements; and

(ii) commercial considerations, including the commission payable to the funder from the proceeds of any recovery.

Analysis of Defendant Litigation Funding

4.13 On the defendant's side of the fence, net premiums paid by potential Australian defendants to obtain indemnities and manage the Litigation Risks are in excess of **$15 billion per year**.

There does not seem, however, to be any qualitative or quantitative data currently available to the Courts or the public in respect of:

First: the proportion of insurance claims by category or in total that require legal proceedings to be commenced before they are resolved;

Second: the proportion of litigated claims where the insurer denies indemnity;

Third: the cost to the claimant, the Court and the insurer of claims resolved after proceedings are commenced;

Fourth: the delays involved in respect of these proceedings; and

Finally: the percentage of defended claims that are resolved by settlement or judgment in favour of the claimant.

4.14 In particular, there is no publicly available data identifying what proportion of insurer payouts benefit Australian claimants and what proportion goes in the cost incurred by the general insurance industry in minimising pay outs for the industry's benefit.

4.15 In any event, unless the quantum of any claim is greater than the maximum insured amount, the insured has no economic demand for the insurer to defend the action. The risk has been transferred to the insurer who, for all currently relevant purposes, controls the defence to manage its risks in its own interests which in turn may lead to delay and diversion rather than efficient resolution of claims. This in turn increases the demand for claimant litigation funding.

5 What are the likely Insured Causes of Action?

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

5.2 Third party funding is limited to commercial litigation principally in the Supreme and Federal Court in each State of Australia.

5.3 Personal injury, workers' compensation claims and other causes of action for which risks may be statistically predicted with sufficient accuracy across many cases are funded by solicitors utilizing a "no win, no fee' pricing policy.

5.4 IMF's investment protocol form 2001 included a minimum claim size of $2million in acknowledgement of the fact that the cost of commercial litigation along with the associated risks made funding small claims commercially unviable. In addition, it was found that small claims led to the majority of the settlement or judgment sum going in legal costs, insolvency practitioner fees and IMF's fee.

5.5 An exception to the $2 million minimum claim value is the pooling of individual's claim that are individually less than $2 million but collectively can be far more – normally referred to as Class Actions or Group Actions.

5.6 "Shareholder claims" are an example of claims conducted as Group Actions.

Shareholder Claims

5.7 Shareholder claims that are funded by IMF will invariably be taken on the basis of the following statutory protections:

(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)"

All section references are to sections of the Corporations Act (2001) (Cth)

(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

5.8 An interesting development at present is the pleading of such actions against entities that fall under the control of an external administrator ("Sons of Gwalia claims").

5.9 Funded actions against both Sons of Gwalia and ION have created issues that have warranted the attention of the Corporations and Markets Advisory Committee ("CAMAC") and are being followed closely in the mainstream press.

Claims against Directors

5.10 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.

5.11 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”.

5.12 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.

5.13 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)).

5.14 In addition, section 588G of the Corporations Act, creates a statutory duty upon directors to ensure the companies they control do not incur further debts after the companies are insolvent – prosecutions under this section will continue if directors unreasonably believe their companies’ fortunes will improve.

Claims against Professionals

5.15 Finally, professional indemnity claims will continue even though limited professional liability has clearly decreased the ability of some clients to successfully obtain large damages from their professional wrongdoers. The pressures experienced 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.

6 Implications of litigation funding for Insurers

The prospect of increased litigation

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

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

6.3 There are key differences between the USA and Australian legal systems that will prevent this from occurring. These differences are described below.

6.3.1 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.

6.3.2 By contrast, 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) parties are exposed to adverse costs and funders pay all adverse cost orders.

6.4 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 proceedings commencing and continuously review the merits of the case once proceedings are commenced.

6.5 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 strong prospects of success.

The prospect of larger claims

6.6 As consumers in the form of market participants, including institutional participants, seek redress for perceived wrongs perpetrated by corporate entities, it is likely that shareholder claims will increase in number and size.

6.7 However, it is too early to predict how these matters will be adjudicated upon in terms of loss methodology, causation and reliance. Until these issues are addressed by the judiciary in one of the actions, conjecture will remain as to the prospect of increased payouts in these types of claims.

Implications for D&O Insurance Premiums

6.8 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." "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."*

6.9 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 settlements of the Concept Sports and Aristocrat matters (which was IMF funded), no other litigated shareholder

actions for compensation of which IMF is aware have resulted in any payouts by D&O insurers.

6.10 Based on comments made at a directors and officers insurance conference in late 2008, directors and officers insurance premium rates have reduced significantly and the annual premium pool is now insufficient to cover recent claims experience in relation to securities actions. This suggests that there may be changes in the directors and officers insurance market.

6.11 .Side C cover usually describes cover which relates to securities actions against the company. Payments made to settle securities claims under Side C cover may exhaust general policy limits which may leave the people for whom the policy was designed (ie the directors and officers) exposed to claims without the benefit of the full limit of the policy.

6.12 In response to recent claims experience and other changes within the insurance market, IMF understands that insurers may be looking at creating stand-alone Side C policies, charging higher premia for Side C cover, imposing sub-limits on Side C cover or creating priority of payment arrangements to ensure that directors and officers retain the principal benefit of the policies.

Exclusions to D&O Policies

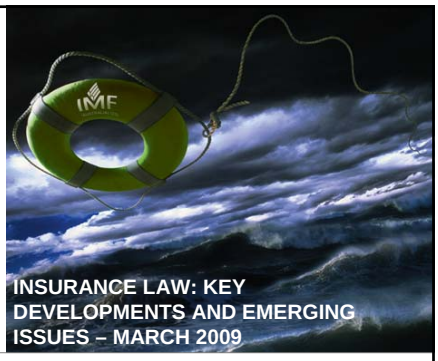
6.13 The following are not usually covered by insurance contracts:

(a) Employment practices cover;
(b) OH & S breaches;
(c) Environmental law breaches; and
(d) Trade practices liability.

6.14 Typical *exclusions* commonly 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.

6.15 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.



Litigation Funding and Insurance

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Overview

- Claimant litigation funding in Australia
  - Development of IMF's business
  - The Fostif decision
- Accountability of funders and insurers
  - Similarities
  - Lawyer's duties
- Proposals for reform
- Funded litigation involving insured claims
- Some concluding remarks

Litigation Funding Overview

Up to 2001 – Insolvency Market

Funder – Agrees to investigate, manage and fund the claim

Client – Agrees to reimburse funding and pay a percentage fee from the settlement or judgment, if any

From 2001 – Funding for commercial litigation and class actions

Litigation Funding Overview (Cont'd)

- Maintenance and Champerty
- The Fostif decision
- Third Party financing and control not contrary to public policy
- The funder's role, obligations etc

Accountability of Funders and Insurers

- Similarities between funders and insurers may inform regulation of funders
- Lawyer's Duties:
  - Generally
  - In funded litigation
- Importance of lawyers to serve interests of client and funder

Court's Control of Non Parties

Victorian Law Reform Commission Recommendations

- An overriding provision – to facilitate the just, efficient and cost effective resolution of the real issues in dispute
- Prescribe standards of conduct, together with sanctions for non-compliance
- The overriding obligations should be owed by parties, lawyers and their legal practices and "any person providing any financial or other assistance…, including an insurer or a provider of funding…in so far as such person exercises any direct or indirect control or influence over the conduct of any party in a civil proceeding".

Disclosure of Funders / Insurers Involvement

- Recommendations of Victorian Law Reform Commission
- Disclosure of funding agreements and insurance policies ought to be routine
- Make funders, including insurers, accountable for their involvement

Management of Litigation involving insured claims

- Funder's due diligence
- An objective "merits" check
- Motivation to explore early resolution of claims
- "Defendant" litigation funding

What are the likely Insured Causes of Action?

- Shareholder claims
- Corporations Act breaches
  - Disclosure documents
  - Continuous disclosure protection
  - Protection from misleading and deceptive conduct
- Claims against directors

Implications of Litigation Funding for Insurers

- Prospect of increased litigation – a realistic fear?
- Comparison to the USA
- Prospect of larger claims
- Implications for directors and officers cover and premiums

Conclusion

- Clear similarities between litigation funding and insurer funding of litigation
- Positive development
  - Access to justice
  - Makes market protection regulations enforceable
  - Floodgates unlikely to open
- Need for safeguards & appropriate regulation