TWO'S COMPANY, THREE'S A CROWD? REGULATING THIRD-PARTY LITIGATION FUNDING, CLAIMANT PROTECTION IN THE TRIPARTITE CONTRACT, AND THE LENS OF THEORY

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> [A]greements of this kind ought to be carefully watched, and when found to be extortionate and unconscionable, so as to be inequitable against the party … effect ought not to be given to them.[1]
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> United Kingdom Privy Council (1876)

> [T]o ask whether the bargain struck between a funder and intended litigant is 'fair' assumes that there is some ascertainable objective standard against which fairness is to be measured and that the courts should exercise some (unidentified) power to relieve persons of full age and capacity from bargains otherwise untainted by infirmity.[2]
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> Justices Gummow, Hayne and Crennan (2006)

I INTRODUCTION

The advent of third-party litigation funding ('TPLF') is arguably one of the most significant developments in civil litigation in Australia for many decades.[3] While third party-funded and indemnified defendants have appeared in common law courts for some centuries, the recent corresponding appearance of third party-funded and indemnified plaintiffs is in many ways a seismic shift in our civil litigation culture. Whether this has been a welcome and overdue move towards improved access to justice and protection of rights of ordinary citizens or a dangerous step towards the creation, multiplication and inflammation of otherwise sleeping controversies is a topic of considerable and sometimes fierce debate. Nevertheless, TPLF is here and spreading rapidly so that the burning question appears to be: what is to be done? The author's focus in this article therefore will be on the governance of the relationship between litigant, funder

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1 *Ram Coomar Coondoo v Chunder Canto Mookerjee* (1876) 2 App Cas 186, 210 (Sir Montague E Smith).

2 *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 CLR 386, 434–5 [92] (Gummow, Hayne and Crennan JJ) ('*Fostif HC*').

3 Though the introduction of representative claims (class actions) is clearly of comparable significance.

and lawyer, with some bias towards the protection of the litigant as the more vulnerable party of the three.[4] Given the importance of contract in governing TPLF arrangements, the author will explore some key theoretical insights into the phenomenon of complex multi-party contracting and the extent to which these have application to TPLF arrangements. Insights from both game theory and transaction cost economics will be applied for the first time to analyse the tripartite contractual relationships between lawyer, litigant and funder. The author will also further develop at some length the application of agency theory.[5] In doing so, the author will seek to answer difficult questions of how government and regulators should deal with TPLF, including analysis of the regulatory options.

The structure of this article is therefore to consider in Part II the basics of relevant non-legal theoretical perspectives – game theory, agency theory and transaction cost economics. In Part III, I will note the debate about TPLF and consider the key cases that have affected TPLF – particularly as they have considered the governance of the tripartite arrangement and possible regulation – as well as regulatory responses thereto. In the Part IV, I will apply the theoretical perspectives discussed – game theory, agency theory and transaction cost economics – to the issues of governance of the tripartite relationship and note tentative conclusions. In Part V, I will apply the insights gained to comment on the appropriateness of the various regulatory options.

II COMPLEX MULTI-PARTY CONTRACTING – A THEORETICAL PRIMER

In recent decades there has been growing interest in the nature of contract as a key component of the economic system and the incentives and governance structures that influence contractors in their relations. Contract in its many forms lies at the heart of much of commerce both in short-term consumer transactions and in longer-term commercial relationships. While substantive law has developed principles governing how and when contracts will be enforced by the courts, other disciplines have developed more theoretical approaches such as game theory, agency theory and transaction cost economics. These concepts have relevance to all contracts but particularly to complex longer-term multi-party contractual relations. TPLF, involving relatively complex contracts of some duration and uncertainty between multiple parties (litigant, funder and lawyer)

4 An assumption that may be justified in many though not all cases. Repeat-playing funded claimant litigants such as liquidators and institutional investors may be thought to be well able to look after themselves. As Waye has pointed out, the consumer-anchored concern about litigation funding may ignore this, as well as the potential for opportunistic behaviour by the claimant themselves: Vicki Waye, 'Litigation Risk Transfer and Law Firm Financial Arrangements' (2014) 17 *Legal Ethics* 107, 126–30.

5 As to previous utilisation of agency theory to analyse TPLF in Australia, see especially Vicki Waye, 'Conflicts of Interests between Claimholders, Lawyers and Litigation Entrepreneurs' (2008) 19 *Bond Law Review* 225.

clearly raises many of the issues that theory has addressed and, in considering any future regulation, will benefit from its insights. I will now review some of the relevant theoretical approaches.

A Game Theory

> Coalitions though successful have always found this, that their triumph has been brief.[6]
>
> Benjamin Disraeli (1852)

Game theory focuses on how groups of people interact. Modern game theory is generally dated from the work of mathematician Ernst Zermelo who developed a mathematical proof in 1913 that every competitive two-person game had a best strategy for both players, provided that both players had complete information about each other's intentions and preferences.[7] In 1928, there followed a proof from another mathematician, John von Neumann, that there exists a strategy for each player in a competitive game where no player regrets his or her choice of strategy at the conclusion of the game (sometimes referred to as the minimax theorem).[8] These ideas were further enhanced in 1951 by the work of John Nash, who studied games of both pure and mixed strategies. A pure strategy was where the player had a plan for the entire game which set out in advance what the player would do in every situation. A mixed strategy allowed at least one player to randomly select a pure strategy and have a probability distribution of choices of pure strategies. Nash extended the minimax theorem by showing that every competitive game had an equilibrium point in both mixed strategy and pure strategy games. It followed that, at this point, players had no incentive to deviate, as their strategy was the best that could be used given what other players were doing.[9]

Another insight from game theory is the 'prisoner's dilemma' game. Unveiled by AW Tucker in 1950,[10] it presented a scenario of two accomplices having the choice to cooperate with the authorities and to give evidence against the other, or not to cooperate and not to give evidence. The prison sentence if they both gave evidence (defected) was two years but only one year if both said nothing. However, if one defected and the other did not, the defector would go free and the non-defector would get three years. Thus, though it was better for

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6 Dick Leonard, *The Great Rivalry: Gladstone & Disraeli* (I B Tauris, 2013) 85.

7 E Zermelo, 'Über eine Anwendung der Mengenlehre auf die Theorie des Schachspiels' [About an Application of Set Theory to the Theory of the Game of Chess] in E W Hobson and A E H Love (eds), *Proceedings of the Fifth International Congress of Mathematicians (Cambridge 11–28 August 1912)* (Cambridge University Press, 1913) vol 2, 501–4.

8 J v Neumann, 'Zur Theorie der Gesellschaftsspiele' [On the Theory of Games and Strategy] (1928) 100 *Mathematische Annalen* 295. For a translation, see John von Neumann, 'On the Theory of Games and Strategy' in A W Tucker and R D Luce (eds), *Contributions to the Theory of Games* (Princeton University Press, 1959) vol 4, 13.

9 John Nash, 'Non-cooperative Games' (1951) 54 *Annals of Mathematics* 286.

10 Anthony Kelly, *Decision Making Using Game Theory: An Introduction for Managers* (Cambridge University Press, 2003) 13.

both if they did not give evidence, it was logical for each, given the risk of defection by the other, to give evidence against the other. The Nash equilibrium point therefore was both players choosing to defect and the outcome being the second worst outcome for both. The game illustrates a scenario where everyone suffers by acting selfishly though rationally.

A last relevant insight from game theory relates to coalition building in multi-party games (that is, a game involving more than two players) and has been applied in the field of political science. In these games, there may be more than one coalition of players that will provide the maximum payoff, but it is not clear which winning coalition will form. William Riker came up with the concept of the minimal winning coalition under which the coalition would seek to minimise its membership so as to avoid sharing the payoff.[11] This would suggest, inter alia, that a coalition of three could become unstable if two would suffice to win the game.

B Agency Theory

> In the race of life, always back self-interest; at least you know it's trying.[12]
>
> John Thomas (Jack) Lang

Agency theory developed out of research into risk sharing in the 1960s and 1970s.[13] In the late 1970s, Jensen and Meckling focused on what they referred to as the 'agency relationship', where a principal delegates work to an agent under a contract.[14] Their work attempted to solve the 'agency problem', which was the result of (a) the conflict between the desires and goals of principal and agent and (b) the cost and difficulty of the principal verifying that the agent is acting appropriately on his or her behalf. The focus of the theory was to determine the most efficient contract to govern the principal–agent relationship. This involved the principal establishing appropriate incentives for the agent and incurring bonding costs to stop the agent taking actions which would harm the principal (or to ensure that the principal would be compensated if he or she did take such actions).

Jensen later identified a division in agency theory into positivist theory and principal–agent theory.[15] The former focused on the governance mechanisms that sought to solve the agency problem between shareholders and managers in

11 William H Riker, 'The Entry of Game Theory into Political Science' in E Roy Weintraub (ed), *Toward a History of Game Theory* (Duke University Press, 1992) 207, 218.

12 Tony Wright, 'Labor Keeping an Eye Out for Goddess Fortuna', *Sydney Morning Herald* (Sydney), 10 June 2013, 7.

13 Kenneth J Arrow, *Essays in the Theory of Risk-Bearing* (Markham Publishing, 1971); Robert Wilson, 'The Theory of Syndicates' (1968) 36 *Econometrica* 119.

14 Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305. The economic concept of agency had elements of the legal concept but was not exactly coincident.

15 Michael C Jensen, 'Organization Theory and Methodology' (1983) 58 *Accounting Review* 319.

corporations.[16] It favoured greater manager ownership of the firm (such as stock options) to align the interests of principal and agent and encourage the agent to make choices which would maximise the principal's welfare. It also favoured better information systems so that the principal knew what the agent was doing. Principal–agent research, on the other hand, focused on a general theory of the principal–agent relationship that could be applied to other relationships: employer–employee, lawyer–client, buyer–supplier and so on.[17] The latter also focused on contract design and seeking to align the incentives of the principal and agent.

C Transaction Cost Economics

> Only free men can negotiate. A prisoner cannot enter into contracts.[18]
>
> Nelson Mandela (1985)

Transaction cost economics is principally associated with the economist Oliver E Williamson, though Williamson credits Ronald Coase's earlier work for some of his ideas.[19] It forms part of the so-called 'new institutional economics'. Although it focuses mainly on the behaviour of firms, it is also informed by contractual analysis. Transaction cost economics focuses on the transaction costs or 'friction' of contracting and the proposition that simple competitive market mechanisms may not work so effectively for complex contracting.

A number of key ideas and assumptions informed Williamson's work:

- unlike classical economists who assumed simple rationality and self-interest on the part of economic actors, Williamson noted at the outset Herbert Simon's insight that contractual humans were 'boundedly rational', meaning that they were 'intendedly rational, but only limitedly so'.[20] One of the results of this was that, despite the best intentions of the parties, contracts tended to be incomplete (as all eventualities could not be perfectly foreseen);[21]

16 In strict legal terms, of course, the corporation is interposed between the shareholders and the directors, so there is no legal agency between shareholders and directors.

17 Milton Harris and Artur Raviv, 'Some Results on Incentive Contracts with Applications to Education and Employment, Health Insurance, and Law Enforcement' (1978) 68 *American Economic Review* 20.

18 Zinzi Mandela, 'Statement by Nelson Mandela Read on His Behalf by His Daughter Zinzi at a UDF Rally To Celebrate Archbishop Tutu Receiving the Nobel Peace Prize' (Speech delivered at Jabulani Stadium, Soweto, 10 February 1985) <http://www.mandela.gov.za/mandela_speeches/before/850210_udf.htm>.

19 See especially R H Coase, 'The Nature of the Firm: Origin' (1988) 4 *Journal of Law, Economics, and Organization* 3.

20 That is, human intelligence is limited: see Oliver E Williamson, *The Economic Institutions of Capitalism* (Free Press, 1985) 5, 11, quoting Herbert A Simon, *Models of Man: Social and Rational* (John Wiley & Sons, 1957) 196 ff. See also Herbert A Simon, *Administrative Behaviour: A Study of Decision-Making Processes in Administrative Organization* (Macmillan, 2nd ed, 1957).

21 Oliver E Williamson, 'The Vertical Integration of Production: Market Failure Considerations' (1971) 61 *American Economic Review* 112.

- another of Williamson's assumptions about contractual humans was the existence of moral hazard,[22] or what Williamson preferred to refer to as 'opportunism'. This he defined as 'self-interest seeking with guile' and was said to include blatant forms such as lying, stealing and cheating as well as more subtle forms of deceit;[23] and
- a third observation about contracting was the existence of contracts involving specific rather than generic assets. This occurred because some assets were more unique than others and some transactions more idiosyncratic than others. Though there may be large numbers of qualified bidders at the outset, the winner of a contract could acquire an advantage through unique learning including the acquisition of undisclosed or proprietary technical or managerial procedures or task-specific labour skills.[24] Thus, transactions that were supported by 'durable, transaction specific assets' tended to experience 'lock-in' effects.[25] Such specialised assets could not be redeployed without sacrifice of productive value if contracts should be interrupted or prematurely terminated.[26] Williamson went so far as to describe such contracts as having the condition of 'bilateral monopoly'.[27]

Much of Williamson's theory was used to explain why some transactions were taken out of the realm of pure market contract and moved into hierarchies or governance structures such as vertically integrated firms. He noted, however, that 'credible commitments' to contracts can arise from mechanisms providing greater assurance or other governance mechanisms, such as post-contractual information disclosure and auditing mechanisms, specialised dispute settling mechanisms, shared ownership and sometimes the use of 'hostages' (forfeitable bonds, down payments and deposits) to support exchange.[28] In this, his work covers some of the same 'contract design' issues that agency theory looks at.

III TPLF IN AUSTRALIA

A The Basics

TPLF typically involves a funder meeting the legal costs and disbursements of a litigant (usually a claimant) in return for receiving a fixed percentage of any damages recovered by the litigant in a legal proceeding. Litigation funders also frequently provide an indemnity to cover the risk of adverse costs orders in the

22 Williamson, *The Economic Institutions of Capitalism*, above n 20, 3.
23 This might even include shirking or delivery of poor quality goods or services: ibid 47.
24 Ibid 53–4.
25 Ibid 53.
26 Ibid 53–4.
27 Ibid 32.
28 Oliver E Williamson, 'Transaction Cost Economics: The Natural Progression' (2010) 100 *American Economic Review* 673. See also Oliver E Williamson, 'Credible Commitments: Using Hostages To Support Exchange' (1983) 73 *American Economic Review* 519.

event that the proceeding is unsuccessful and also to cover orders made during the proceeding for security for adverse costs.[29] However, litigation funders do not act for the claimant as its legal representative so that lawyers will need to be instructed to act for the claimant in the proceeding. The lawyers may thus contract with the claimant litigant but may also contract with the funder. As such, TPLF usually involves tripartite contractual arrangements between funder, litigant and lawyer.[30]

B The Debate over TPLF

TPLF has been the subject of debate in Australia and in other jurisdictions where it has recently developed.[31] It has grown markedly in jurisdictions such as Australia which has historically prohibited US-style percentage-based contingency fees and operates under a 'loser pays' regime for the awarding of legal costs by courts.

Arguments for TPLF have generally focused on the merits of 'access to justice', which is said to be a 'fundamental human right which ought to be readily available to all'.[32] TPLF may also benefit small claimants who could not normally afford to litigate, usually provided that they are members of a class of victims of unlawful conduct and can use class action machinery in a group action organised by a funder.[33] Another advantage is that named plaintiffs will also generally be indemnified in respect of adverse costs that may be ordered by the court against them, benefiting both plaintiffs and defendants. Lastly, TPLF may assist in achieving public regulatory goals and deterrence of illegal conduct.[34] The term 'private attorney-general' has been applied to private persons pursuing

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29 Where the court orders the plaintiff claimant to put up monetary security to cover future costs that the plaintiff may be ordered to pay the defendant in the proceeding. See, eg, *Federal Court Rules 2011* (Cth) r 19.01.

30 In a class action, there is also likely to be a distinction between the representative party (or lead plaintiff) and the group members, so that the lawyers and funder may have different agreements with each of these. This may result in quadripartite contractual relations. Even this is a simplification, as it treats group members as one party. In reality, the group is unlikely to be completely homogenous. Contracts may be entered into with some or all of the class members, and conflicts within the class are possible.

31 Both sides of the debate in Australia are canvassed in Lee Aitken, '"Litigation Lending" after *Fostif*: An Advance in Consumer Protection, or a Licence to "Bottomfeeders"?' (2006) 28 *Sydney Law Review* 171. A good international summary is contained in Marco de Morpurgo, 'A Comparative Legal and Economic Approach to Third-Party Litigation Funding' (2011) 19 *Cardozo Journal of International and Comparative Law* 343. See also Jasminka Kalajdzic, Peter Cashman and Alana Longmoore, 'Justice for Profit: A Comparative Analysis of Australian, Canadian and US Third-Party Litigation Funding' (2013) 61 *American Journal of Comparative Law* 93.

32 *Thai Trading Co (a firm) v Taylor* [1998] QB 781, 786 (Lord Millett).

33 See, eg, *Federal Court of Australia Act 1976* (Cth) pt IVA.

34 The current chairperson of the Australian Securities and Investments Commission ('ASIC'), Greg Medcraft, has said class action litigation (which is often funded by TPLF) was 'very good at equalling up the tables', was 'a good market-driven solution' and 'they democratise access to the law': Alex Boxsell, 'Regulators Praise Private Court Actions', *The Australian Financial Review* (Sydney), 5 April 2012, 59. The current chairman of the Australian Competition and Consumer Commission, Rod Sims, has said: 'If companies feel aggrieved, the more they take the action themselves rather than through us, the better': at 59.

lawsuits that vindicate the public interest.[35] TPLF may even indirectly assist somewhat the achievement of some of the other goals of public law enforcement (deriving originally from the criminal law) such as punishment/retribution, denunciation and, to a lesser degree, prevention/incapacitation.[36]

The arguments against TPLF have generally focused upon the undesirability of 'stirring up' litigation and infringing the maxim *interest reipublicae ut sit finis litium*.[37] This argument asserts that civil courts are an arm of government charged with the quelling of controversies which actually exist between parties rather than controversies that have been brought into existence or inflamed by third parties.[38] It also is suggested that TPLF may encourage frivolous or unmeritorious claims,[39] and that funders who look for a sufficient scale of claims for their business models will not scrutinise the merits of individual claims which can be hidden within a large class action.[40] Shareholder class actions, a popular form of funded class action,[41] have also been criticised for targeting companies rather than their officers for damages so that settlements are paid from company (that is, shareholders') funds rather than directors' funds[42] – reducing the deterrent effect of such actions and leading to the plaintiff shareholders

35 See, eg, B Garth, Ilene H Nagel and S Jay Plager, 'The Institution of the Private Attorney General: Perspectives from an Empirical Study of Class Action Litigation' (1988) 61 *Southern California Law Review* 353. The argument has been analysed cogently in Australia: see Peta Spender, 'The Class Action as Sheriff: Private Law Enforcement and Remedial Roulette' in Jeff Berryman and Rick Bigwood (eds), *The Law of Remedies: New Directions in the Common Law* (Irwin Law, 2010) 695.

36 The aims of the criminal law are discussed in David Lanham et al, *Criminal Laws in Australia* (Federation Press, 2006) ch 1B <http://www.federationpress.com.au/pdf/Lanham%20Ch1B.pdf>. Unfortunately there is no space in this article to develop this argument though this will be a subject of further research by the author.

37 That is, it is in the public interest that litigation comes to an end. It is arguable whether this maxim is directed to the *number* of cases (which TPLF will probably increase) or to the *length* of those cases (which litigation funders have no particular interest in protracting – indeed they have incentives to finish cases quickly).

38 Justice P A Keane, 'Access to Justice and Other Shibboleths' (Paper presented at Judicial Conference of Australia, Melbourne, 10 October 2009). See also the minority judgment of Callinan and Heydon JJ in *Fostif HC* (2006) 229 CLR 386.

39 Keane, above n 38, 8–23.

40 United States Chamber Institute for Legal Reform, *Third Party Litigation Financing in Australia: Class Actions, Conflicts and Controversy* (Publication, October 2013) 14 <http://www.instituteforlegal reform.com/uploads/sites/1/TPLF_in_Australia_page_web.pdf>.

41 Such as the Aristocrat and Centro class actions: *Dorajay Pty Ltd v Aristocrat Leisure Ltd* [2005] FCA 1483; *Kirby v Centro Properties Ltd* (2008) 253 ALR 65.

42 Angie Zandstra, Jason Harris and Anil Hargovan, 'Widening the Net: Accessorial Liability for Continuous Disclosure Contraventions' (2008) 22 *Australian Journal of Corporate Law* 51; Paul Miller, 'Shareholder Class Actions: Are They Good for Shareholders?' (2012) 86 *Australian Law Journal* 633, 635–8. Though, in Australia, research indicates that settlements appear to be coming out of a mixture of company funds and recoveries from other parties such as directors and officers, merchant bankers, auditors and their respective insurers. See Michael J Duffy, 'Protection of Companies from Shareholder Class Actions through Constitutional Amendment: Is This Possible or Desirable?' (2011) 23 *Bond Law Review* 69, 86–7. See also Michelle Welsh and Vince Morabito, 'Public v Private Enforcement of Securities Laws: An Australian Empirical Study' (2014) 14 *Journal of Corporate Law Studies* 39, 64.

benefiting at the expense of the company's other shareholders.[43] Also, though early class actions were 'open class',[44] there has been a move towards funded class actions being closed classes,[45] arguably weakening the 'access to justice' and 'public interest' arguments. Lastly, there may be also a move away from funding small retail plaintiffs to funding larger institutional plaintiffs, which weakens the 'good for small claimants' argument.[46]

The last criticism of TPLF is the question of conflicts of interest and control of the litigation.[47] This is a large part of the focus of this article. The potential for conflicts of interest between litigant, funder and lawyers has been widely commented upon.[48] In 2013, the corporate regulator Australian Securities and Investments Commission ('ASIC') was moved to set out the potential for conflicts of interest in TPLF as follows:

> The nature of the arrangements between the parties involved in a litigation scheme or a proof of debt scheme has the potential to lead to a divergence between the interests of the members and the interests of the funder and lawyers because:
>
> - the funder has an interest in minimising the legal and administrative costs associated with the scheme and maximising their return;
> - lawyers have an interest in receiving fees and costs associated with the provision of legal services; and
> - the members have an interest in minimising the legal and administrative costs associated with the scheme, minimising the remuneration paid to the funder and maximising the amounts recovered from the defendant or insolvent company.[49]

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43 Howell E Jackson and Mark J Roe, 'Public and Private Enforcement of Securities Laws: Resource-Based Evidence' (2009) 93 *Journal of Financial Economics* 207.

44 That is, covering all affected persons rather than just those who contracted with the funder. The first successful shareholder class action in Australia, *King v GIO Australia Holdings Ltd* (2000) 100 FCR 209, was open class: see generally Justice Michael Moore, 'Ten Years since *King v GIO*' (2009) 32 *University of New South Wales Law Journal* 883.

45 Where only those who have entered into fee agreements with lawyers will benefit. See Vince Morabito, 'Class Actions Instituted Only for the Benefit of the Clients of the Class Representative's Solicitors' (2007) 29 *Sydney Law Review* 5.

46 Michael Legg quotes the then Chairman of Maurice Blackburn Cashman, Mr Bernard Murphy, as saying that:

> I recall back in 1998 when [*King v*] *GIO* started, going around Sydney and seeing which of the institutions would join that case. Now, we had 22 000 clients but very few of the institutions joined in. In 2003 when I was starting the Aristocrat class action, the interest level from institutions was significantly greater and of that claim value which is $120 million, 94% comes from the institutions.

Michael Legg, 'Shareholder Class Actions in Australia – The Perfect Storm?' (2008) 31 *University of New South Wales Law Journal* 669, 675 n 34. See also United States Chamber Institute for Legal Reform, above n 40, 1. Though, it must be said that institutional plaintiffs may themselves represent groups of smaller claimants.

47 In relation to control, it has been suggested that, where the litigant has substantially contracted out of his or her ability to make decisions in the litigation, 'there will be a substantial risk that the funder's intervention will be inimical to the due administration of justice': *Clairs Keeley (a Firm) v Treacy* (2004) 29 WAR 479, 502 [125] (The Court). Of course, such a criticism could also be made of insurers' involvement in legal proceedings, yet the courts seem to accept this.

48 See the excellent analysis in Waye, 'Conflicts of Interests', above n 5.

49 Australian Securities and Investment Commission, *Regulatory Guide 248: Litigation Schemes and Proof of Debt Schemes: Managing Conflicts of Interest* (at April 2013) 7 [RG 248.11] ('*RG 248*')

C Australian Law and TPLF

In this Sub-part, I will look at the key cases affecting litigation funding and subsequent legislative responses. I will focus mainly on the issue of the governance of the tripartite arrangement rather than the public interest debate about litigation funding generally.

1 The Fostif Litigation

Though utilised for some time in the insolvency industry in Australia, the recent somewhat spectacular rise of TPLF is usually dated from the High Court's decision in *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* ('*Fostif HC*').[50]

In *Fostif*, both the New South Wales Court of Appeal and the High Court of Australia considered the law of maintenance and champerty and whether TPLF arrangements in a representative proceeding (class action) were a ground for a permanent stay of that proceeding as an abuse of process.

In the New South Wales Court of Appeal, Mason P (with Sheller and Hodgson JJA agreeing) held that representative actions were not an abuse of process and that a permanent stay of proceedings was not justified.[51] His Honour found that champerty or third-party assistance per se did not constitute abuse of process, nor did the funder's activities constitute 'trafficking in litigation'.[52]

His Honour noted that the perceived evil of maintenance at common law was in the act of 'officious intermeddling with litigation', rather than in supporting an unfounded claim or defence.[53] Champerty, on the other hand, was maintenance that involved a division of the spoils (or savings) derived from the litigation.[54] His Honour also noted the New South Wales Law Reform Commission's view that the considerations of public policy which once found maintenance and champerty repugnant had changed over time and that the social utility of assisted litigation was now recognised as a means of increasing access to justice.[55] This had been reinforced in New South Wales by the abolition of both the crime and tort of maintenance (including champerty).[56] Even in jurisdictions where the crime and tort had not been abolished, this was still reinforced by the trend of case law.[57]

In the course of his judgment, Mason P considered the tripartite arrangements under which the funder had responsibility for, inter alia, 'project management' as well as 'strategic and technical issues' and 'appointment of legal

50 (2006) 229 CLR 386.
51 *Fostif Pty Ltd v Campbells Cash & Carry Pty Ltd* (2005) 63 NSWLR 203 ('*Fostif NSWCA*').
52 Ibid 232 [122].
53 Ibid 224 [90].
54 Ibid.
55 Ibid 224 [91].
56 *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW) ss 3–4, as repealed by *Statute Law (Miscellaneous Provisions) Act 2011* (NSW) sch 4 cl 4.The current provision in force with respect to the tort of maintenance has been moved to the *Civil Liability Act 2002* (NSW) sch 2 cl 2, and the provision in force with respect to the crime of maintenance has been moved to the *Crimes Act 1900* (NSW) sch 3 cl 5.
57 *Fostif NSWCA* (2005) 63 NSWLR 203, 225 [94] (Mason P).

representatives'.[58] He noted that the funder had 'retained' the lawyer to 'advis[e]' the funder and 'represent' the litigants.[59] The funder would, 'together with the plaintiff's solicitor',[60] communicate with the litigants and conduct negotiations on their behalf.[61] The funder would receive a fee of 33 per cent of damages received.[62] Control over the litigation given to the funder included the right to give instructions as to how claims were to be moulded and what evidence to rely upon.[63] The trial judge had been concerned that the funder had not personally contacted the named litigants to advise them of the risk of adverse costs.[64] However, Mason P found that this was unproblematic, as the funder had indemnified the litigants against any costs liability and there was no ground for thinking that its capacity to meet the indemnity was at risk.[65]

President Mason also found that the trial judge's finding that the funder had 'a very clear opportunity … to abusively influence the conduct of the proceedings' was unsupported and ignored the presence of the solicitor and the control of the Court over the proceedings.[66]

In relation to the trial judge's concern that the funder's fee was 'inordinately high'[67] and the proposition that '[t]he greater the share of the spoils that the provider of legal services … will receive, the greater the temptation to stray from the path of rectitude',[68] his Honour noted a lack of reasons for this conclusion and noted the funder's arguments favouring the application of free market principles to the question subject to any 'genuine abuse of process factors'.[69] He stated that the Court should not lightly interfere with the autonomy of the funded clients, absent evidence of misleading or deceptive conduct by the funder or oppression or misuse of the powers conferred by contract on the funder.[70] This was said to have even greater force where the funder used a solicitor and submitted itself to judicial supervision under the *Supreme Court Rules 1970* (NSW) part 8 rule 13.[71]

In relation to the solicitor's role, the trial judge had found that there were irregularities in the retainer between the solicitor, the funder and the litigants, and this contributed to the conclusion that the proceedings were an abuse of process.[72]

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58 Ibid 216 [51].
59 Ibid 216 [54].
60 Ibid 216 [55].
61 Ibid 216–17 [55].
62 Ibid 218 [61].
63 Ibid 218 [63].
64 Though an employee of the funder 'had been advised to tell [the plaintiffs] what was involved as regards costs': ibid 219 [70].
65 Ibid.
66 Ibid 219 [71].
67 Ibid 220 [72].
68 Ibid.
69 Ibid 236 [145].
70 Ibid 236 [146].
71 The rule providing for orders that the proceedings continue as representative proceedings in respect of represented litigants. This rule has now been repealed, though a rough equivalent is now contained in *Civil Procedure Act 2005* (NSW) s 166.
72 Ibid 220–1 [76].

These included evidence as to lack of communication between the solicitors and the litigants and their 'tenuous relationship' (including the fact that the solicitor was engaged by the funder as a principal and not in his capacity as agent for the litigants).[73] There was evidence that communication between them could only take place through the 'conduit' of the funder.[74] In letters of retainer, the solicitor had required the funder to inform him of all 'material oral communications' between the funder and the litigants. On the other hand, the solicitor had stated that he would not directly liaise with the litigants, understanding that the funder had notified the litigants of his 'involvement' and that the litigants agreed to his 'representing them'.[75] The trial judge had stated that it was an 'extraordinary proposition' that in this situation, solicitors would accept a retainer upon the basis that they would not directly liaise with their clients. The trial judge noted various conflict of interest problems between the funder and the litigants including issues in relation to settlement offers (which I will examine further below). He rejected the funder's argument that the interests of the funder and litigants were 'exactly the same' or 'coincident'.[76]

President Mason found no undertaking by the solicitor not to directly liaise with litigants,[77] but in any event found nothing wrong in principle with such an arrangement if it had the informed consent of litigants. He noted similar arrangements between an insured motor vehicle owner litigant, insurer and lawyer, where the insured placed the matter in the hands of the insurer and the retained solicitor to do 'whatever is necessary, consistent with the ultimate recognition of the owner's position as client'.[78] As to the settlement conflict of interest scenarios, he considered these to be 'speculative' and 'far-fetched'.[79]

In the High Court, Gummow, Hayne and Crennan JJ found that the appellants' argument that the funder's conduct was a kind of trafficking in litigation conflated propositions that (a) the funding arrangements constituted maintenance and champerty and (b) maintaining the proceedings on behalf of the plaintiffs was an abuse of process which could only be avoided by ordering a stay.[80] They found that, in jurisdictions where maintenance and champerty had been abolished as crimes or torts (such as New South Wales, Victoria, South Australia and the Australian Capital Territory), the second proposition was not valid.[81] This was because the abolition meant that any wider rule of public policy 'lost whatever narrow and insecure footing remained for such a rule'.[82] Further, any asserted rule of public policy argued to survive the abolition would be too

73 Ibid.
74 Ibid 221 [76].
75 Ibid 222 [79].
76 Ibid 222 [80].
77 Ibid 223 [81].
78 Ibid 223 [82]. The 'insurance analogy' is discussed in more detail below.
79 Ibid 223 [83].
80 *Fostif HC* (2006) 229 CLR 386, 432 [84].
81 Ibid 432 [85].
82 Ibid 433 [86].

uncertain.[83] As to the funder's seeking out claimants and offering them terms that give the funder control of the litigation at a significant profit – their Honours found that none of these elements, alone or in combination, warranted condemnation as being contrary to public policy.[84]

In relation to fears about adverse effects on the processes of litigation and fears about the 'fairness' of the bargain struck between funder and litigant, their Honours found that neither consideration warranted formulation of an overarching rule that would bar the prosecution of an action where money was to be provided in return for a share of the proceeds of litigation.[85] Likewise, it should not be barred because the funding agreement fixed the nature or degree of control or reward the funder might have under the agreement. Their Honours observed that to meet these fears by adopting a rule in either form 'would take too broad an axe to the problems that may be seen to lie behind the fears'.[86] To ask whether the bargain was 'fair' assumed an ascertainable objective standard against which fairness was to be measured and required courts to exercise some unidentified power to relieve persons of full age and capacity from bargains otherwise untainted by infirmity.[87] As to the fear that the funder's intervention would be inimical to the due administration of justice (as there may be temptation to stray from the path of rectitude), it was not clear why that fear was not addressed by existing doctrines of abuse of process and other procedural and substantive elements of court processes.[88] It followed that the funding arrangements proposed by the funder did not constitute a ground to stay the proceedings.

The effect of the decision was that, at least in the jurisdictions where maintenance and champerty had been abolished as crimes and torts[89] – maintenance and champerty could not be used to challenge proceedings funded by a litigation funder.

2 The Multiplex Litigation

The next decisive step by the courts was, however, arguably a step back for TPLF, as funded class actions were found to constitute 'managed investment schemes' within the meaning of section 9 of the *Corporations Act 2001* (Cth) ('the Act'). In *Brookfield Multiplex Funds Ltd v International Litigation Funding Partners Pte Ltd* ('*Multiplex*'),[90] the defendants sought to halt two class action proceedings, in which breaches of continuous disclosure provisions of the Act were alleged. They did this by arguing that the TPLF agreements and solicitors'

83 It would yield a rule no more certain than the 'patchwork of exceptions and qualifications that could be observed to exist in the law of maintenance and champerty at the start of the twentieth century': ibid.

84 Ibid 433–4 [88].

85 Ibid 434 [90]–[91].

86 Ibid 434 [91].

87 Ibid 434–5 [92].

88 Ibid 435 [93].

89 *Civil Law (Wrongs) Act 2002* (ACT) s 221; *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW) ss 3–4; *Criminal Law Consolidation Act 1935* (SA) sch 11 item 3; *Wrongs Act 1958* (Vic) s 32.

90 (2009) 180 FCR 11.

retainers entered into together constituted a 'managed investment scheme' within the meaning of the Act,[91] and that the Act required such schemes to be registered which the class actions were not. The trial judge, Finkelstein J, rejected this argument, taking a purposive approach to the Act. However, the argument met with more favour on appeal.

In their joint judgment, Sundberg and Dowsett JJ were satisfied that the TPLF arrangements were a scheme in terms of the statutory definition, but did not engage in a detailed consideration of the regulatory policy issues.[92] Their Honours did, however, disagree with the finding of the trial judge that the obligations, which would come into existence if the TPLF was a managed investment scheme, would afford group members little protection.[93] In this regard, they noted the Australian Law Reform Commission's identification of risks against which any regulatory system would guard. These were said to be:

- investment or market risk – the risk that the investment will decline in value …
- institution risk – the risk that the institution which operates the scheme will collapse
- compliance risk – the risk that the operator of a scheme will not follow the rules set out in the scheme's constitution or the laws governing the scheme, or will act fraudulently or dishonestly.[94]

Their Honours suggested that a decline in the value of the investment could be caused by a decline in the fortunes or asset position of the defendant, the funder or the solicitors, or by the likely occurrence of previously unexpected costs necessitating some action to protect the group members' interests.[95]

Their Honours also suggested that it was not difficult to imagine circumstances in which there could be institutional or compliance risk, and that compliance plans required for managed investment schemes were designed to minimise such risk.[96] Their Honours also observed that it was no answer to say that a solicitor's professional duty would sufficiently safeguard the interests of group members against misconduct by the solicitors.[97]

3 Government Action Following the Multiplex Decision

The implications of *Multiplex* were that funded class actions would be subject to the significant regulation of managed investment schemes. This would require, inter alia, the registration of the litigation as a scheme, the appointment of a corporate responsible entity holding an Australian Financial Services Licence ('AFSL'), and the preparation of a constitution and compliance plan. In

91 The lengthy definition is contained in the *Corporations Act 2001* (Cth) s 9.

92 It was a 'scheme' as constituting some 'programme, or plan of action': *Multiplex* (2009) 180 FCR 11, 23 [37]. As to the satisfaction of remaining elements of the s 9 definition, see 27 [51], 28–9 [59], 31–2 [70]–[71], 35 [89]–[90], 35–6 [92], 36–7 [97], 37 [101].

93 Ibid 21 [30].

94 Ibid 21 [31], quoting Law Reform Commission, *Collective Investments: Other People's Money*, Report No 65 (1993) 2 [5].

95 Ibid 22 [32].

96 Ibid.

97 Ibid.

response, the federal government made it known that it was concerned about consumers losing access to the courts, and that it supported class actions and litigation funders as providing access to justice for those who would not otherwise have their claims heard and assessed.[98] In announcing that it would reverse *Multiplex* by exempting funded class actions from the managed investment provisions in the Act, the Government declared that it had decided not to impose a 'heavy compliance burden' on funded class actions.[99] As a result, the *Corporations Amendment Regulation (No 6) 2012* (Cth)[100] excluded TPLF in relation to class actions or insolvency scheme actions from managed investment regulation.[101] However, the same legislation also imposed on litigation funders substantial new rules in relation to the management of conflicts of interest (see below).

In the meantime, ASIC had granted in 2009 transitional relief from the managed investment provisions to lawyers and litigation funders involved in class actions commenced before 4 November 2009.[102] ASIC subsequently extended this relief on a number of occasions.[103]

4 The Chameleon Mining Litigation

TPLF had a further brush with regulation in *International Litigation Partners Pty Ltd v Chameleon Mining NL (recs & mgrs apptd)*.[104] The litigant had entered into a TPLF agreement with a funder to enable it to pursue a piece of litigation, which was not a class action. Disagreements developed between the litigant and the funder. The litigant purported to withdraw the funder's authority to instruct the engaged lawyers, while the funder argued that the litigant was in breach of the funding agreement. Later, when the litigant signed an agreement with another company triggering a 'change in control' of the litigant,[105] the funder argued that

98 Treasury (Cth), *Explanatory Commentary: Exclusion of Class Actions/Litigation Funding Schemes from Managed Investment Schemes* (Publication, 27 July 2011) 1 <http://archive.treasury.gov.au/documents/2104/RTF/Explanatory%20Commentary%20Draft%20Regulations%20Class%20actions.rtf>.

99 Chris Bowen, 'Government Acts To Ensure Access to Justice for Class Action Member' (Media Release, No 039, 4 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/039.htm&pageID=&min=ceba&Year=&DocType=0>.

100 *Corporations Amendment Regulation (No 6) 2012* (Cth) sch 1 item 1, inserting *Corporations Regulations 2001* (Cth) reg 5C.11.01.

101 Insolvency scheme actions are effectively class action claims that do not result in court proceedings due to the insolvency of the defendant.

102 Applications in respect of class actions to be commenced after that date would be considered separately, and ASIC would assess whether and on what terms it would grant transitional relief. See Australian Securities and Investments Commission, 'ASIC Grants Transitional Relief from Regulation for Funded Class Actions' (Media Release, 09–118MR, 4 November 2009).

103 See Australian Securities and Investments Commission, *ASIC Class Order*, CO 10/333, 11 January 2013; Australian Securities and Investments Commission, *ASIC Class Order*, CO11/555, 23 June 2011; Australian Securities and Investments Commission, *ASIC Class Order*, CO12/158, 21 February 2015; Australian Securities and Investments Commission, *ASIC Class Order*, CO13/19, 9 January 2013; Australian Securities and Investments Commission, *ASIC Class Order*, CO13/897, 11 July 2013; Australian Securities and Investments Commission, *ASIC Class Order*, CO14/571, 1 July 2014.

104 (2012) 246 CLR 455 ('*Chameleon Mining*').

105 Ibid 466 [40] (Heydon J).

under the terms of the funding agreement it was entitled to a substantial 'funding fee'[106] and 'early termination fee'.[107] The litigant then took action to rescind the TPLF agreement, arguing that the agreement was a 'financial product' under the Act. It argued that it was entitled to rescind under section 925A of the Act, as the funder did not hold an AFSL.[108]

In the New South Wales Court of Appeal,[109] Giles, Young and Hodgson JJA found that the agreement was a 'financial product' as it was a facility through which the litigant managed financial risk.[110] On appeal to the High Court,[111] the main focus was on the question of whether the TPLF agreement was in fact a 'credit facility' under the Act and therefore excluded from the definition of financial product by section 765A(1)(h)(i) of the Act.[112] Applying the definition of 'credit' in regulation 7.1.06(3)(a) of the *Corporations Regulations 2001* (Cth), the Court found that a contract, arrangement or understanding that is any form of financial accommodation is 'credit', and its provision 'for any period' would be a 'credit facility'.[113] The majority (French CJ, Gummow, Crennan and Bell JJ) noted the obligation undertaken by the funder in the funding deed to pay the litigant's legal costs[114] and concluded that the funding deed was a 'credit facility'[115] and therefore the funder did not need an AFSL.

5 Government Response to Chameleon Mining

If litigation funders were required to hold an AFSL, this would import obligations of capital adequacy,[116] risk-management systems[117] and internal and external dispute resolution procedures for 'retail client' litigants.[118] If litigation amounted to providing a credit facility then funders would be subject to the requirements of the *National Consumer Credit Protection Act 2009* (Cth) schedule 1 ('*National Credit Code')*, including holding an Australian credit licence and complying with the conduct, disclosure and responsible lending requirements of that *Code*.

On 23 June 2011, class orders issued by ASIC in relation to exempting TPLF from the managed investment provisions were extended to exempt TPLF from

106 Ibid 464 [29] (French CJ, Gummow, Crennan and Bell JJ).
107 Ibid 466 [40] (Heydon J).
108 Section 925A provides a right of rescission to the client of an unlicensed financial services provider.
109 *International Litigation Partners Pte Ltd v Chameleon Mining NL* (2011) 276 ALR 138.
110 Under s 763A(1) of the Act, a 'financial product' includes a facility which, or through the acquisition of which, a person manages financial risk. Section 763C provides that a person manages financial risk if they manage the financial consequences to them of particular circumstances happening.
111 *Chameleon Mining* (2012) 246 CLR 455.
112 This set out specific things that were not financial products.
113 Ibid 463–4 [26] (French CJ, Gummow, Crennan and Bell JJ).
114 Ibid 464 [29].
115 Ibid 465 [33].
116 *Corporations Act 2001* (Cth) s 912A(d).
117 *Corporations Act 2001* (Cth) s 912A(h).
118 *Corporations Act 2001* (Cth) ss 912A(2), 1017G(2).

financial product regulation[119] and also to relieve it of the requirements of the *National Credit Code*.[120]

6 Regulation of Conflicts of Interest

As noted above, the Australian Government has brought in some level of regulation for litigation funders. This relates essentially to the issue of potential conflicts of interest between funder, lawyers and client. The rule inserted by *Corporations Amendment Regulation (No 6) 2012* (Cth) relevantly requires in essence that a funder has adequate practices for managing conflict of interests if it can show, through documentation, that it has written procedures for identifying, managing, monitoring, disclosing and otherwise dealing with the conflict to protect claimants.[121]

ASIC's identification of potential conflicts of interest has been noted in Part III(B). In April 2013, it released a regulatory guide setting out its approach on

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119 See the relevant class orders promulgated by ASIC above at n 103.

120 Australian Securities and Investments Commission, 'ASIC Extends Relief from Regulation for All Funded Representative Actions and Funded Proof of Debt Arrangements' (Media Release, 13–003MR, 11 January 2015).

121 The provisions provide that a person (the funder) has adequate practices for managing a conflict of interest that may arise if they can show, through documentation, that:

- (a) the person has conducted a review of the person's business operations that relate to the scheme or arrangement to identify and assess potential conflicting interests; and
- (b) the person:
  - (i) has written procedures for identifying and managing conflicts of interest; and
  - (ii) has implemented the procedures; and
- (c) the written procedures are reviewed at intervals no greater than 12 months; and
- (d) the written procedures include procedures about the following:
  - (i) monitoring the person's operations to identify potential conflicting interests;
  - (ii) how to disclose conflicts of interest to general members and prospective general members;
  - (iii) managing situations in which interests may conflict;
  - (iv) protecting the interests of general members and prospective general members;
  - (v) how to deal with situations in which a lawyer acts for both the funder and general members;
  - (vi) how to deal with a situation in which there is a pre-existing relationship between any of a funder, a lawyer and a general member;
  - (vii) reviewing the terms of a funding agreement to ensure the terms are consistent with *Australian Securities and Investments Commission Act 2001* (Cth) pt 2 div 2;
  - (viii) recruiting prospective general members; and
- (e) the terms of the funding agreement are reviewed to ensure the terms are consistent with *Australian Securities and Investments Commission Act 2001* (Cth) pt 2 div 2; and
- (f) the matters mentioned in paragraphs (a)–(e) are implemented, monitored and managed by:
  - (i) if the person is an entity other than an individual – the senior management or partners of the person; or
  - (ii) if the person is an individual that represents an entity – the senior management or partners of the entity.

These requirements are paraphrased from *Corporations Regulations 2001* (Cth) reg 7.6.01AB(4), as inserted by *Corporations Amendment Regulation (No 6) 2012* (Cth) sch 1 cl 6.

how funders could satisfy the obligation to maintain practices and procedures to manage conflicts of interest in a litigation scheme or proof of debt scheme.[122]

IV CAUTIONARY INSIGHTS FROM THEORY

As appears from the above, TPLF will involve tripartite contractual relationships (which may be extended to quadripartite or more numerous relations in class actions). The potential for conflicts of interest between these multiple parties has been noted by academics [123] and recognised by the legislature[124] and regulator.[125] It is also the case that these contractual relations will be of some complexity, involving uncertainties of litigation, ongoing decision-making by the parties, strategising, asymmetric information as to facts and law and uncertainties of outcome. Some theoretical ideas on these issues were reviewed at the start of this article. I now will seek to make some points from the application of those ideas to the TPLF context.

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122 *RG 248*. A litigation scheme is defined at some length at 4 [RG 248.2], but is in essence a representative proceeding (class action) funded by a non-lawyer funder. A proof of debt scheme is said to often have a similar structure to a litigation scheme, the key difference being that the company against which remedies are sought has become insolvent so that legal proceedings cannot be issued or continued against it without the permission of the liquidator: at 6 [RG 248.5]. The key practices to satisfy the obligation are set out by ASIC in summary at 11 [RG 248.26]. They include procedures for managing situations in which interests may conflict. This involves showing, through documentation, that there has been a review of business operations, that there are written procedures for identifying and managing conflicts of interest, that these have been effectively implemented and are regularly reviewed every 12 months and they are monitored and managed by senior management or partners (set out in Section B). There are also to be written procedures:

- (a) for protecting the interests of members of the claimant group (set out in Section B);
- (b) for effective disclosure of conflicts of interest to the claimant group (set out in Section C);
- (c) about recruiting prospective members to the claimant group (set out in Section D);
- (d) including procedures about reviewing the terms of the funding agreement to ensure the terms are consistent with *Australian Securities and Investments Commission 2001* (Cth) pt 2 div 2 (provisions providing various consumer protections against unconscionable conduct, unfair terms and misleading conduct in relation to the provision of financial services) (set out in Section D);
- (e) including procedures about dealing with situations in which the lawyer acts for both the funder and members (set out in Section D);
- (f) including procedures about how to deal with situations in which there is a pre-existing relationship between any of the funder, lawyer and members (set out in Section D).

If the litigation settles without a proceeding being issued, the terms of any settlement agreement must be approved by counsel (or senior counsel if involved) (set out in Section E).

123 See, eg, Waye, 'Conflicts of Interests', above n 5. See also United States Chamber Institute for Legal Reform, above n 40. Michael Legg has pointed to even further complexities and conflicts that may arise where there are multiple competing class actions arising out of the same facts: Michael Legg, 'Entrepreneurs and Figureheads – Addressing Multiple Class Actions and Conflicts of Interest' (2009) 32 *University of New South Wales Law Journal* 909.

124 Explanatory Statement, *Corporations Amendment Regulation (No 6) 2012* (Cth) <https://www.comlaw.gov.au/Details/F2012L01549/Explanatory%20Statement/Text>.

125 See above n 122.

A Game Theory

Insofar as third party-funded litigation can be characterised as a rule-based game involving three or more players, the 'prisoner's dilemma' from game theory opens up the possibility that each party (litigant, funder and lawyer) acting rationally in their own self-interest will not necessarily produce the best outcome for all. The Nash equilibrium point[126] may be the worst outcome for all players though other outcomes are possible. This might be another way of saying that unregulated market forces may not ensure the best outcome for all players.[127] This may suggest that regulation is needed to change the rules of the game. It may also suggest that optimum communication between the parties (including full disclosure) is something that regulation should mandate (in the 'prisoner's dilemma' scenario, the lack of ability to communicate and then cooperate is argued by some to play a part in the sub-optimal outcome).[128]

To the extent that the alliance between claimant litigant, funder, and lawyer seeks a winning outcome against the defendant in litigation, the theory of winning coalitions[129] may also provide insights into possible behaviour of the parties. There may be a temptation for funder and lawyer to collude at the expense of the litigant. Other alliances are possible, such as between lawyer and litigant against the funder or between funder and litigant against the lawyer. The three-way (or four-way) alliance may therefore be inherently unstable. Disclosure as between all parties may minimise opportunities for such collusion, but bounded rationality (see below) will limit the complete effectiveness of this.

B Agency Theory

Economic agency is not the same as legal agency though there are many elements of commonality. Agency theory also has parallels in the law's concept of the fiduciary (the latter in fact substantially predating the former) where the fiduciary must put the principal's interests ahead of the fiduciary's interests. Fiduciary law does not, however, make prescriptions for seeking to align interests of principal and agent in contract design (though it does not generally prevent this).[130] This may be because the two concepts have

126 Nash, above n 9, 286.

127 In conventional economics, a 'market failure'.

128 See Daniel Balliet, 'Communication and Cooperation in Social Dilemmas: A Meta-Analytic Review' (2010) 54 *Journal of Conflict Resolution* 39, 41.

129 Riker, above n 11, 218.

130 Otherwise, most managing directors would be in breach of their fiduciary duties in receiving stock options.

substantially different origins.[131] Agency theory can be applied to the key relationships in TPLF.

1 Litigant and Lawyer

Where litigants are represented by lawyers, agency theory has some application to the relationship, as the litigant as principal delegates work to the lawyer as agent.

(a) Lawyer's Remuneration

Agency theory suggests that the contract between lawyer and litigant should be designed to align their interests in the same way that giving share options to a director is supposed to align his or her interest with the corporation.[132] Yet allowing the lawyer to share the risk and reward of litigation through pure percentage contingency fees has historically been opposed in Australia and in many common law countries – apart from the United States ('US')[133] – and remains unlawful.[134] Various reasons have been offered for this,[135] including the potential for an increase in unmeritorious claims, negative community perceptions of the professional role of contingency fee motivated lawyers, driving up of the value of settlements or judgments,[136] asserted superiority of fee for service in professional services, clarity to the client of actual work performed, potential for more lawyer advertising[137] and 'cherry picking' by lawyers of high value cases.

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131 The fiduciary concept was mainly developed in the English Court of Chancery where the focus was on *duty* (rather than self-interest) and the related and *quasi-religious* concept of acting in good conscience to another. In medieval times, this was 'conscience' according to the laws of God. This later became 'conscience' according to the laws of England: see Timothy A O Endicott, 'The Conscience of the King: Christopher St German and Thomas Moore and the Development of English Equity' (1989) 47 *University of Toronto Faculty of Law Review* 549, 559. Agency theory, by contrast, seems to be built upon the more modern economic view of humans as *rationally self-interested*, and hence, the focus on incentives to act in the other's interest.

132 Samuel Issacharoff, 'Litigation Funding and the Problem of Agency Cost in Representative Actions' (2014) 63 *DePaul Law Review* 561, 576. See also Winand Emons and Nuno Garoupa, 'US-Style Contingent Fees and UK-Style Conditional Fees: Agency Problems and the Supply of Legal Services' (2006) 27 *Managerial and Decision Economics* 379.

133 See Nina C Ayoub, 'Risks, Reputations, and Rewards: Contingency Fee Legal Practice in the United States' (2004) 51 *Chronicle of Higher Education* 20.

134 See, eg, *Legal Profession Uniform Law 2015* (NSW) s 183; *Legal Profession Act 2004* (Vic) s 3.4.29. Though contingency fees that are not calculated as a percentage of damages – success fees and uplift fees – have been widely tolerated in Australia in more recent times. See Vince Morabito, 'Contingency Fee Agreements with Represented Persons in Class Actions – An Undesirable Australian Phenomenon' (2005) 34 *Common Law World Review* 201, 204. See also Productivity Commission, 'Access to Justice Arrangements' (Inquiry Report No 72, 5 September 2014) 603–4.

135 The arguments set out come from the Victorian Law Reform Commission, *Civil Justice Review Report*, Report No 14 (2008) 684–5.

136 Notwithstanding that this is clearly in a claimant litigant's interests.

137 Notwithstanding that competition theory suggests that more advertising will be good for consumers of legal services. See John R Schroeter, Scott L Smith and Steven R Cox, 'Advertising and Competition in Routine Legal Service Markets: An Empirical Investigation' (1987) 36 *Journal of Industrial Economics* 49.

In agency terms, however, there are at least two arguments against contingency fees, particularly if they are to be coupled with a no adverse costs regime[138] or an adverse costs indemnity from a litigation funder.

The first arises because lawyers are in the unique position of holding other duties that will override their agent duties to their client principal. Lawyers hold paramount duties to the court and the law, which override duties to the client (in agency terms, the lawyer is an agent of the court as well as of the litigant – lawyers are referred to as 'officers of the court').[139] It is suggested that percentage contingency fees may create a conflict between the duty to the court and the duty to the client. That is, the lawyer's personal interest in the outcome may tempt them to prefer the obligation to the client to the obligation to the court. In the words of the Victorian Law Reform Commission, ethical standards in a case may be 'undermined with a view to achieving a favourable outcome'.[140]

A second argument in agency terms against percentage contingency fees is that they do not exactly align the interests of lawyer and litigant. This is because, although the potential rewards of the litigation are reasonably well aligned between litigant and lawyer,[141] the potential economic losses are less perfectly aligned, particularly if the contingency fee is coupled with a no adverse costs regime (as occurs in the US)[142] or an adverse costs indemnity from a litigation funder (as now often occurs in Australia). In these situations, the lawyer has a greater incentive to compromise the claim before trial for a 'sub-optimal' amount[143] or 'cheaply'[144] to avoid the risk of his or her investment in the case (unbilled time and disbursements) being lost in the event of an unfavourable outcome.[145] Though the litigant also invests some unpaid time in the case, this will generally be less than the lawyer's economic investment. Further, in a no adverse costs regime (or a regime where adverse costs are indemnified by a litigation funder), the litigant has no risk of an adverse costs order. Therefore,

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138 As has been discussed in the past as a law reform option for class actions: Australian Law Reform Commission, *Grouped Proceedings in the Federal Court*, Report No 46 (1988) 111 [266].

139 Chief Justice Marilyn Warren, 'The Duty Owed to the Court – Sometimes Forgotten' (Speech delivered at the Judicial Conference of Australia Colloquium, Melbourne, 9 October 2009). See also *Giannarelli v Wraith* (1988) 165 CLR 543, 555–6 (Mason CJ).

140 Victorian Law Reform Commission, above n 135, 685. It should be noted that this agency argument applies not just to percentage contingency fees but to any contingency fee including (a) a speculative 'no win no pay' fee (involving the payment of normal fee in the event of success and no fee in the event of loss) and (b) an uplift fee (involving the payment of a greater fee on success than on loss). The conflict will be less in these cases, however, as the fee is usually less than a percentage contingency fee. The Productivity Commission appears to have noted this point and has recommended that percentage contingency fees be permitted: Productivity Commission, above n 134, 614.

141 Though perhaps not perfectly aligned as this may require a fifty-fifty split which is uncommon (I am not advocating that there should be a fifty-fifty split but merely considering a theoretical approach – obviously, in cases with large economies of scale, a fifty-fifty split would produce rewards to lawyers that may be considered excessive by other objective standards).

142 Geoffrey P Miller, 'Some Agency Problems in Settlement' (1987) 16 *Journal of Legal Studies* 189, 190.

143 Vince Morabito, 'Federal Class Actions, Contingency Fees, and the Rules Governing Litigation Costs' (1995) 21 *Monash University Law Review* 231, 246.

144 Waye, 'Conflicts of Interests', above n 5, 260.

145 Ibid.

there will be less incentive for the litigant to compromise the claim and more incentive to take the matter to trial. A somewhat surprising conclusion from this analysis is that US-style percentage-based contingency fees may work better in agency terms when combined with English-style awarding of costs against unsuccessful litigants, at least insofar as this would reduce agency conflicts between lawyer and litigant when a settlement offer is made.[146]

In fact, the popular prescriptions of agency theory for incentive alignment are not applied to the lawyer–litigant relationship in the TPLF context as, under these arrangements, lawyers are typically paid a fee for service by the litigation funder rather than a percentage or success fee from damages received in the litigation.[147] Fee for service has its own problems. As I have done in relation to the analysis of contingency fees, I will for the moment put aside professionalism,[148] ethics, reputation,[149] overriding duties to the court and other factors. Shorn of these factors, the lawyer appears to have incentives to maximise his or her fees by protracting litigation and disputation and over-servicing[150] (assuming of course that the client has a continuing ability to pay such fees).[151] This will conflict with the lawyer's duties to the litigant and to the court (in wasting its time). The

146 Another conclusion is that there is an argument that an indemnity against adverse costs given by a lawyer or a third-party litigation funder should be subject to some compulsory nominal excess. This would have the effect of spreading a small part of the risk of going to trial (from the litigation funder and indemnifying lawyer to the litigant), which thereby better aligns interests and reduces conflicts. It would also provide some disincentive to litigants bringing unmeritorious litigation. The amount of such a compulsory excess should be enough to spread some risk to the litigant without unduly penalising the litigant, his or her lawyers or the defendant's ability to recover costs. How much this would be would depend upon the size of the litigation, the resources of the litigant and other factors, but a nominal sum of $10 000 might be suitable in some cases.

147 Though 'fee for service' is not a straightforward concept. There are numerous ways fees can be calculated, particularly in a class action, and it has been noted that any alignment of interests between litigant, lawyer and funder tends to end when there is a settlement discussion in which legal fees have to be agreed. See the excellent analysis in Michael Legg, 'Class Action Settlements in Australia – The Need for Greater Scrutiny' (2014) 38 *Melbourne University Law Review* 590, 600.

148 See, eg, Vivien Holmes et al, 'Practising Professionalism: Observations from an Empirical Study of New Australian Lawyers' (2012) 15 *Legal Ethics* 29.

149 Reputational disciplines may be problematic. Asymmetric information can cause adverse selection where the client, lacking sufficient information to judge the quality of legal services, uses price per hour or overall price as an indicator of this. In this scenario, the lawyer who charges more per hour or more overall is adjudged to be better than the lawyer who charges less. If this occurs, over-servicing may enhance rather than reduce the lawyer's reputation.

150 There is not a great deal of research on this issue, perhaps due to client confidentiality issues and difficulties in identifying when a lawyer has actually over-serviced. There is some literature on the phenomenon in the medical profession however: see Kate J Brameld and C D'Arcy J Holman, 'The Use of End-Quintile Comparisons To Identify Under-servicing of the Poor and Over-servicing of the Rich: A Longitudinal Study Describing the Effect of Socioeconomic Status on Healthcare' (2005) 5 *BMC Health Services Research* article 61 <http://bmchealthservres.biomedcentral.com/track/pdf/10.1186/1472-6963-5-61?site=bmchealthservres.biomedcentral.com>. See also Suzanne Le Mire and Christine Parker, 'Keeping It In-House: Ethics in the Relationship between Large Law Firm Lawyers and Their Corporate Clients through the Eyes of In-House Counsel' (2008) 11 *Legal Ethics* 201, which deals with legal ethics and the involvement of in-house counsel in the monitoring of these.

151 A client's ability and willingness to pay ongoing lawyer's fees obviously has limitations, especially for clients of limited means.

lawyer will also have no direct financial interest in a successful outcome to the case. Based on economic assumptions about human motivation (which obviously have their limitations), this means the lawyer may be less motivated to achieve success for the litigant. This will also conflict with the duty to the client. On the other hand, such a fee structure will incentivise the lawyer to spend as much time as possible to fully investigate and prepare the case. The litigant will also be able to see the tasks undertaken, the time spent, the personnel involved and the hourly rate.[152] TPLF may curb some of the problems of fee for service as the litigation funder will have an incentive to minimise legal costs (which it pays), and, as a repeat player with some legal expertise, will have some ability to monitor the quality of legal services and to identify, and take action against, over-servicing.

(b) Dual Agency and Conflict

A litigant's lawyer is paid by the litigation funder and may have an agreement with the litigation funder under which the funder has the right to give the lawyer instructions. For this reason, the question may arise whether the lawyer may find him or herself to be the agent of two parties whose interests conflict. This would cause both an agency dilemma and a professional conflict of interest. As fiduciaries, lawyers are required to avoid conflicts,[153] though liability may be avoided in equity if the conflict is fully disclosed to the client and fully informed consent is obtained.[154] What is required for a fully informed consent will depend on the circumstances of the case[155] but may extend to independent legal or other advice.[156] Disclosure and consent will absolve the lawyer as a fiduciary but will not remove the agency dilemma. This issue is discussed again below.

(c) Asymmetric Information

Other insights from agency theory also have some relevance to these relationships, principally the problem of asymmetric information.[157] Differing knowledge between lawyer and litigant (the lawyer having more information about the law and litigation procedure) means that the litigant as principal cannot directly ensure that the lawyer agent is always acting in the litigant's best

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152 Michael Legg, 'Contingency Fees – Antidote or Poison for Australian Civil Justice?' (2015) 39 *Australian Bar Review* 244, 251.

153 This is confirmed by Law Council of Australia, *Model Rules of Professional Conduct and Practice* (at March 2002) r 8.2, which provides that a practitioner must avoid conflicts of interest between two or more clients of the practitioner or of the practitioner's firm.

154 *Parker v McKenna* (1874) LR 10 Ch App 96; *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390. Fiduciary duty may thus be attenuated in equity but it appears that it may be more difficult for the lawyer to contract out of other duties that could still be breached, at least in Victoria: see *Legal Profession Act 2004* (Vic) s 7.2.11. There does not appear to be an equivalent provision in NSW.

155 *Maguire v Makaronis* (1997) 188 CLR 449, 466–7 (Brennan CJ, Gaudron J, McHugh J and Gummow J). See also *DPC Estates Pty Ltd v Grey* [1974] 1 NSWLR 443; *Chan v Zacharia* (1984) 154 CLR 178.

156 *Woods v Legal Ombudsman (Vic)* [2004] VSCA 247.

157 See George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488, 490–1.

interests.[158] The solution to this is better information systems and communication between litigant and lawyer which obviously encompasses (though is not limited to) better disclosure. However, there are limits to the extent to which better disclosure can improve the agency relationship between the lawyer and litigant client. This is because of the complexity of the law and of evidence.[159] TPLF arrangements do provide some assistance here as funders become repeat players in litigation (unlike many claimants who have suffered a one-off injury), tending to learn about the process and can better monitor lawyers for quality and value.

Lastly, it should be noted that simple applications of agency theory to the lawyer–client relationship have been criticised as not taking into account the roles of professionalism, reputational issues and ethics and the detailed external legal structures that govern such relationships.[160]

2 Litigant and Funder

The application of agency theory to the relationship between litigant and funder is less clear. The definition of an 'economic' agent (meaning an agent in the context of agency theory – a theory that comes from economics) in this context is not entirely coextensive with the definition of a 'legal' agent, though there are some similarities. Where some decision-making in the litigation is delegated to the funder, the funder may have some of the elements of an economic agent of the litigant. This delegation may be slight or substantial. Litigation agreements may provide that the litigation funder is providing 'project investigation' and 'project management' services which have some agency aspects,[161] and the funder or persons from the funder may be specifically appointed attorneys for certain purposes (such as signing documents).[162] An agreement may specifically provide that the funder is not the litigant's legal agent.[163] Yet conversely, it has been suggested that a fiduciary duty to the litigant may exist (depending upon the circumstances)[164] or should be imposed on

158 Likewise, the litigant may have more knowledge of the some of the facts of the case in which the litigant was more personally involved than the lawyer, which may affect the way the lawyer runs the case and the appropriateness of this.

159 Richard Moorhead, Avrom Sherr and Alan Paterson, 'What Clients Know: Client Perspectives and Legal Competence' (2003) 10 *International Journal of the Legal Profession* 5, 8.

160 Waye, 'Conflicts of Interests', above n 5, 229. For a discussion where agency theory is characterised as being limited by its 'parsimonious' foundations of rationality, self-interest and wealth maximisation, see Edgar Kiser, 'Comparing Varieties of Agency Theory in Economics, Political Science, and Sociology: An Illustration from State Policy Implementation' (1999) 17 *Sociological Theory* 146, 150.

161 The author has on file a number of non-public TPLF fee agreements and parts of fee agreements that contain the types of clauses referred to. The author has agreed to refer to these generally without identifying specific funders' funding agreements.

162 Ibid.

163 Ibid

164 Waye, 'Conflicts of Interests', above n 5, 255. See also Legg, 'Entrepreneurs and Figureheads', above n 123, 926.

funders[165] or that that funders ought to be subject to an implied duty of good faith in the same manner as insurers.[166]

(a) Funder's Remuneration and Potential Economic Losses

Many similar considerations therefore apply to the relationship between litigant and funder as between litigant and lawyer. A litigant may therefore be well served by agency theory's prescriptions for incentive alignment in contracts which is usually achieved by provision for the funder to take a percentage of the claimant's damages. The amount of that percentage will presumably be determined by competitive market forces. Unlike the position of lawyers, funders do not generally have duties to the court that may conflict with duties to the litigant (though some commentators have argued that they should have such duties).[167] Thus the litigant may be well served by such a contract, though conversely, it could be argued on this analysis that there is no incentive structure to guarantee that the courts will be so well served (that is, the funder is not an agent of the court).

The comments above in relation to the lawyers' incentives to settle also apply to funders, particularly as they usually provide an indemnity. Again, though the potential rewards of the litigation are reasonably well aligned between litigant and funder, the potential economic losses are poorly aligned because the indemnifying funder will both lose its investment in the case and will have to pay an adverse costs order from an unsuccessful trial. In comparison, the litigant will not. The funder may therefore want to settle while the litigant may want to go to trial.[168] The possibility of a compulsory nominal excess to better align interests arises. The question of whether a settlement offer is sub-optimal or reasonable will also need to be decided. How this might occur is discussed below.

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165 Maya Steinitz, 'Whose Claim Is This Anyway? Third-Party Litigation Funding' (2011) 95 *Minnesota Law Review* 1268, 1333.

166 Waye, 'Conflicts of Interests', above n 5, 257. See also *Project 28 Pty Ltd v Barr* [2005] NSWCA 240, [70] (Ipp JA) ('*Project 28*').

167 Steve Mark, *The Regulation of Third-Party Litigation Funding in Australia* (Discussion Paper, March 2012) 24. Others have argued that the funders' position is more analogous to an insurer which does not have such a duty to the court. See generally John Walker, 'Policy and Regulatory Issues in Litigation Funding Revisited' (2014) 55 *Canadian Business Law Journal* 85. In Victoria, both funders and insurers now have certain overarching duties to the court set out in the *Civil Procedure Act 2010* (Vic) ss 10–27. In NSW, funders and insurers must not by their conduct cause parties to breach the parties' duty to assist the court to further the overriding purpose of facilitating the just, quick and cheap resolution of the real issues in the proceedings: see *Civil Procedure Act 2005* (NSW) s 56. The WA Supreme Court has also introduced rules requiring 'interested non-parties', such as litigation funders, to be identified to the court, and to be subject to duties in relation to the conduct of the case, including a duty to cooperate with the parties and the Court and not engage in misleading or deceptive conduct: see *Supreme Court Amendment Rules 2012* (WA), inserting *Rules of the Supreme Court 1971* (WA) O 9A.

168 Although the indemnity given to the litigant reduces the alignment of interests between litigant and funder in going to trial, there does not seem to be much criticism of such indemnities from any side of the debate. This may be because the indemnity is seen as benefiting both the plaintiff and the defendant, as well as their respective lawyers.

(b) Funder's Indemnity

Clearly then, the funder's indemnity raises agency conflicts. Despite this, there does not seem to be much criticism of such indemnities from any side of the debate. This may be because the indemnity is seen as benefiting both the plaintiff and the defendant (and their respective lawyers). In fact, the issue with indemnities has rather been a concern as to their quality and/or financial backing, which raises another agency dilemma. It has been noted that an entity with insufficient capital is not currently prohibited from being a litigation funder so that, were it to fund too many unsuccessful cases, it may find itself insolvent.[169] This has been noted as a potential regulatory concern as the representative party/lead plaintiff would then be liable to meet adverse costs and the successful defendant may not recover those costs.[170] There is also seemingly nothing to stop a funder incorporating a subsidiary with limited capital to provide that indemnity to protect the parent company from liability.[171] Special purpose subsidiaries might even be incorporated for each case. A funder will of course have interests in providing an adequate indemnity, as inadequate indemnities will be bad for its reputation and future business. It also has obvious interests in avoiding insolvency (though perhaps a lesser concern about the insolvency of its subsidiary). Nevertheless the conflict between these interests and the interest to safeguard the parent company from undue liabilities creates a possible agency conflict that may need to be resolved by prudential regulation of funders and any subsidiaries they may utilise to pay indemnities.[172]

(c) Asymmetric Information

Agency theory's concern with asymmetric information between such parties will also remain (though as we have seen, the funder's assistance may reduce asymmetric information in the litigant–lawyer relationship). The litigant claimant

169 Michael Legg et al, 'Litigation Funding in Australia' (Research Paper No 2010–12, UNSW Law, 27 March 2010) 42.

170 Vince Morabito and Vicki Waye, 'Reining in Litigation Entrepreneurs: A New Zealand Proposal' (2011) *New Zealand Law Review* 323, 348. See also Kalajdzic, Cashman and Longmoore, above n 31, 109.

171 A court might, depending on the circumstances, consider ordering the parent company to pay the costs if the subsidiary was insolvent. However, prima facie, this would infringe the principles of limited liability and constitute a lifting of the corporate veil. This issue did not, however, prevent such an order being made against the parent company of a funder in the recent United Kingdom ('UK') case of *Excalibur Ventures LLC v Texas Keystone Inc* [2014] EWHC 3436 (Comm). As to courts ordering funders to pay costs, see generally Morabito and Waye, above n 170, 353.

172 Prudential regulation would, however, be a significant step, as it is the exception rather than the rule for corporations. Only banks, credit unions, building societies, friendly societies, insurers and superannuation funds are prudentially regulated in Australia. See Australian Prudential Regulatory Authority, *Homepage* <http://www.apra.gov.au/Pages/default.aspx>. See also *Australian Prudential Regulation Authority Act 1998* (Cth) s 9 (APRA to have functions conferred on it by an Act) and *Banking Act 1959* (Cth) pt II div IA (prudential supervision and monitoring of ADIs and authorised NOHCs). A lesser type of prudential regulation applies to Australian Financial Services Licensees who are required to have adequate available resources (including 'financial, technological and human resources') to provide the financial services covered by the licence: *Corporations Act 2001* (Cth) s 912A(1)(d); and to have compensation arrangements in place approved by ASIC: *Corporations Act 2001* (Cth) s 912B.

is more likely to be a one-off player unfamiliar with the complexities of TPLF arrangements and the quality of the funding service. On the other hand, the simple 'percentage take' of the funder is a relatively simple concept for the litigant to understand (and compare with other funders in the market).[173] It might also be observed that the funding contract's incentive structure provides a substantial motive for the funder to fully investigate the strengths and weaknesses of the case which may reduce information asymmetry on these issues between funder and litigant. Again, on the other hand, though the funder may become aware of factual weaknesses in the case, it could be argued that the funder may have similar incentives, as the litigant has to avoid disclosing factual weaknesses in the case to the lawyer and to the court which may not be in the interests of either.[174]

3 Lawyer and Funder

If the lawyer represents the funder as well as the litigant, then the lawyer will be the funder's economic and legal agent. This however is said to be unusual[175] and against ASIC guidance.[176] However, it does occur.[177] The starting point for any such contract would be a presumption that the lawyer has a fiduciary duty and a duty of care to the funder. In some cases, this is specifically stated.[178] There may, however, be a funder–lawyer contract which states that, in a situation of conflict, the litigant's instructions to the lawyer override the funder's instructions to the lawyer.[179] This, however, may be subject to the litigant's obligation to act consistently with his or her agreement with the funder which includes the obligation to follow all reasonable legal advice and fully cooperate with the

173 This moves us into economics and competition theory, a detailed examination of which goes beyond the scope of this article.

174 Obviously, this is partly regulated by detailed rules as to discovery of documents by litigants, their agents and non-parties. As a repeat player, the funder will be aware of the tactical disadvantage and possible harm to credibility that may result from late or non-disclosure of documentary weaknesses in the case if these subsequently become known.

175 Wayne Attrill, 'The Regulation of Conflicts of Interest in Australian Litigation Funding' (Paper presented at the UNSW Class Actions: Securities and Investor Cases Seminar, Sydney, 29 August 2013) 8 <https://www.imf.com.au/docs/default-source/site-documents/the-regulation-of-conflicts-of-interest-in-australian-litigation-funding---wayne-attrill-19-aug-13>.

176 ASIC says that '[i]t is appropriate for the funder to give instructions to the lawyers and for the lawyers to consider these instructions in light of their obligation to the members. However, we do not think that having the lawyers act solely for the members will impede this occurring': *RG 248* 23 [RG 248.79].

177 For example, in the *Fostif* proceeding, the funder's agreement with the lawyers stated '[w]hilst you are acting for your client [the litigant] you have engaged me [the funder] as principal and not as agent for your clients': *Fostif HC* (2006) 229 CLR 386, 478 [243] (Gleeson CJ). See also above n 161.

178 Bruce MacDermott, 'Litigation Funding Risks' (2006) 44 *Law Society Journal* 40, 40.

179 See above n 161.

funder and lawyer.[180] There may also be agreement between the lawyer and funder that the lawyer–funder agreement overrides any lawyer–litigant agreement which may cause uncertainty.[181]

There may be a lesser contract between the funder and lawyer where it is agreed that the relationship is not that of lawyer–client, the lawyer is not a fiduciary and no duties of care and diligence apply. However, lawyers are not always permitted to contract out of such duties.[182] Even if there is no contract, there may still be a relationship between the funder and the lawyer,[183] and in agency terms, the lawyer may have incentives or interests in 'pleasing' the funder as the funder will be a source of work.[184] Thus, the lawyer may be tempted to act in the funder's interests which may conflict with the litigant's interests.

Agency theory has little application to this relationship as it would seemingly be against the litigant's interests to positively incentivise the lawyer to act in the funder's interests (by aligning the interests of the lawyer as an agent of the funder) unless the litigant's and funder's interests are completely harmonised which, for reasons stated, they will not always be.[185] Otherwise the lawyer has an obligation as a fiduciary to avoid conflicts with the litigant's interests.[186] It probably follows therefore that lawyers and funders owning substantial or material interests in each other by way of equity or otherwise would not generally be in the litigant's interest. They will also require the litigant's

180 See above n 161. It should also be noted that in a class action group, members may have no say at all on the conduct of the proceeding as regards the common or group issues, as lawyers typically take instructions from the representative party or lead plaintiff and not from group members on these matters. Members may only have a say on their individual issues. This practice has been criticised, as it ignores the fact that group members' interests are affected by the outcome of the case through *res judicata* or issue estoppel: see Simone Degeling and Michael Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions: Conflicts between Duties' (2014) 37 *University of New South Wales Law Journal* 914, 925 n 58.

181 See above n 161.

182 See, eg, *Legal Profession Act 2004* (Vic) s 7.2.11 which provides that a lawyer must not make any agreement or arrangement with a client to the effect that the lawyer will not be liable to the client for any loss or damage caused to the client in connection with legal services to the client, and that any such agreement is void. Waye suggests that lawyers contracting out of such duties may be contrary to public policy, and further that a funder who directs a lawyer to act in a manner deleterious to the litigant's interests may infringe express or implied duties of good faith between the funder and the litigant. See Waye, 'Conflicts of Interests', above n 5, 240–1.

183 United States Chamber Institute for Legal Reform, above n 40, 16.

184 Though interestingly, it has also been argued that lawyers have incentives to give over-optimistic advice to funders about the merits of a case with the objective of being appointed to act as lawyers in running the case (suggesting that lawyers who have advised the funder should be prohibited [banned] from running the case). See Keane, above n 38, 31. See also Robert Baxt, 'Litigation Funding: Crossing the "Cross Roads"' (2010) 28 *Company and Securities Law Journal* 54, 57. While these incentives undoubtedly exist, it is not clear why this argument could not be made about any lawyer–litigant relationship so that the problem does not seem to be specific to funders and their lawyers.

185 As stated, they would be seemingly be harmonised if both had fiduciary duties to the litigant.

186 Law Council of Australia, *Model Rules of Professional Conduct and Practice* (at March 2002) r 8.2.

informed consent, including possible independent legal advice on the issue.[187] If the latter occurs it will satisfy the requirements of the law of equity, but the agency dilemma will seemingly remain.[188]

(a) Insurance Analogy

A similar situation does however arise in the insurance context where solicitors may represent both the insured and the insurer notwithstanding the conflict that might arise.[189] In the latter case both the insurer and the insured are

187 See above n 154. ASIC suggests that disclosure may solve the dilemma and does not go so far as fully informed consent and/or independent legal advice. ASIC expects that there will be either: (a) independence between the funder, lawyers and members; or (b) if there is no such independence, the relationship will be disclosed to members: *RG 248* 23 [RG 248.81]. Interestingly the same analysis could be made about relations between lawyers and insurers but there does not appear to be similar regulation of this relationship. As noted above it is likely that equity would require more than disclosure by the lawyer and that fully informed consent of the litigant would be needed to avoid the lawyer breaching his or her fiduciary duties.

188 In agency terms it does not eliminate the problem but merely makes it known. It is suggested therefore that ultimately, there is nothing that can save the principal from having to assess the 'moral quality of the agent in the particular case at hand': Antonio Argandoña, 'Conflicts of Interest: The Ethical Viewpoint' (Working Paper No 552, IESE Business School, University of Navarra, March 2004) 10. Nor does anything save the principal from having to assess 'how the fiduciary's conflict might compromise the fiduciary's judgment': Robert H Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 *Boston University Law Review* 1039, 1043.

189 Waye notes President Mason's citing of the insurance analogy in *Fostif NSWCA* (2005) 63 NSWLR 203, 225 [82] and Justice Ipp's approach in *Project 28* [2005] NSWCA 240, [70]–[72]: 'Conflicts of Interests', above n 5, 242. In the latter case, his Honour noted that the law had already countenanced insurers' absolute control over proceedings on the ground that that control was tempered by a duty on the part of the solicitors and the insurers to conduct the proceedings with due regard to the nominal claim holder's interests. See generally Sandro Goubran, 'Conflicts of Duty: The Perennial Lawyers' Tale – A Comparative Study of the Law in England and Australia' (2006) 30 *Melbourne University Law Review* 88. The insurance analogy is quite compelling in many respects. Both enter into tripartite relations with litigant and lawyer, both assume day to day responsibility for provision of instructions to lawyers, both pay for the conduct of the litigation, both assume some liability for adverse costs: Walker, above n 167, 86. Certainly the funder has interests in maximising the verdict for the litigant to achieve gain for the funder and its shareholders. The insurer has interests in minimising the verdict against the litigant to minimise loss to the insurer and its shareholders. Whether or not the distinction between litigating to minimise loss and litigating to maximise gain creates a fundamental philosophical or other difference is unclear. Yet it probably goes to the heart of the TPLF debate. Certainly, in terms of President Mason's analysis of maintenance and champerty in *Fostif NSWCA* (2005) 63 NSWLR 203, 224 [90], insurers may also be guilty of both 'the perceived evil … of officious intermeddling with litigation' (maintenance) and the 'division of the spoils (or savings) derived from the litigation' (champerty), as insurers may divide 'savings' where they partially indemnify or indemnify subject to an excess. It might be argued that insurers do not cause matters to come before the courts in the way that funders do, though even this is doubtful, as an insurer's resistance to paying a claim clearly does 'stir up a controversy' that may end in litigation. Grave, Adams and Betts point to differences in that (a) insurers are usually totally indemnifying or seeking to recover an indemnified loss through subrogation rights so that in general their financial interest in the litigation is greater than a funder; (b) funders typically exercise greater control of litigation than insurers; and (c) funders usually have rights to terminate the agreement at will whereas insurers usually do not: see Damian Grave, Ken Adams and Jason Betts, *Class Actions in Australia* (Thomson Reuters, 2nd ed, 2012) 860–1.

clients but this may alter when a conflict of interest arises between them.[190] When such a conflict of interest arises, the lawyer owes an undivided duty of loyalty to the insured (although this can be modified by agreement between the insured and the insurer).[191] There is also said to be a duty on both the insurers and the solicitors they appoint to conduct the proceedings with due regard to the insured's interests and an action for damages will lie for breach of that duty.[192] However it is not clear why the latter common law duty might not also be modified or contracted out of. There can be no contracting out of the insurer's duty of utmost good faith towards the insured (which is a reciprocal duty) however, as this is a statutory duty.[193] This duty has been developed somewhat in Australia to include having regard to the legitimate interests of the insured and the insurer, fairness, decency and honesty and full and frank disclosure.[194] Nevertheless the duty does not require the insurer to prefer the interest of the litigant to its own and thus falls short of a fiduciary duty to the insured.[195]

Given the ability of contracts between the insurer and the litigant to modify or negate duties (including the lawyer's duty to the insured) it is not clear that the insurance analogy currently provides great comfort as to protection of the litigant's interests in the TPLF context.[196] It is arguable therefore that some overriding statutory duty (a fiduciary duty or at least a duty of utmost good faith and fair dealing) should be created as between litigants and funders. This may assist the lawyer's dealings with the funder as the lawyer would be comfortable that, in fearlessly representing the litigant, the lawyer is also helping the funder meet the funder's duties to the litigant. In agency terms, this would be a move towards harmonising the position of the funder and the lawyer.

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190 *Mercantile Mutual Insurance (NSW Workers Compensation) Ltd v Murray* (2004) 13 ANZ Ins Cas ¶61-612, 77 419–20 [50]–[57] (Mason P).

191 Ibid.

192 *Project 28* [2005] NSWCA 240; *Groom v Crocker* [1939] 1 KB 194. See also Walker, above n 167, 107..

193 *Insurance Contracts Act 1984* (Cth) ss 13–14. It appears though that there is no tortious duty of good faith in Australia in insurance contracts where that Act does not apply: *CGU Workers Compensation (NSW) Ltd (ACN 003 181 002) v Garcia* (2007) 69 NSWLR 680.

194 See *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1. For other relevant case law and commentary see Michael Gill et al, LexisNexis Butterworths, *Australian Insurance Law*, vol 1 (at Service 3) [10,305.10]–[10,305.20].

195 The good faith duty has also been criticised as a 'foreign' (coming from the US) and 'problematic' doctrine. See Angelo Capuano, 'Not Keeping the Faith: A Critique of Good Faith in Contract Law in Australia and United States' (2005) 17 *Bond Law Review* 29, 48.

196 In Australia, insurers are not fiduciaries of their clients. However, the courts may be more prepared to find fiduciary relationships generally than they have in the past. See, eg, *Bathurst Regional Council v Local Government Financial Services Pty Ltd [No 5]* [2012] FCA 1200. In the US, there have been some judicial suggestions of a fiduciary duty of insurers to insured. However, this seems to be limited to special circumstances so that the general duty of insurers is limited to good faith and fair dealing. See William T Barker, Paul E B Glad and Steven M Levy, 'Is an Insurer a Fiduciary to Its Insureds?' (1989–1990) 25 *Tort & Insurance Law Journal* 1; Douglas R Richmond, 'Trust Me: Insurers Are Not Fiduciaries to Their Insureds' (1999–2000) 88 *Kentucky Law Journal* 1.

(b) Agency Theory and Dispute Resolution

A funding agreement may provide that some issues (mainly whether or not to accept an offer of settlement) may be referred to counsel (a barrister) for an opinion if the funder and litigant cannot agree.[197] Counsel will be briefed by the solicitors[198] for the litigant and counsel's opinion will usually be contractually binding upon the litigant. In agency terms, the barrister is an agent of the solicitor who is an agent of the litigant. Despite this double agency arrangement and the fact that the solicitor engages and pays the barrister, it is generally accepted at law that the litigant is usually the barrister's client, rather than the solicitor being the barrister's client.[199] Nevertheless, if the solicitor has a conflict in relation to his or her client, such as a conflict between the litigant's interests and the funder's interests, it is not entirely clear that briefing a barrister relieves this conflict. Despite the concept of the independence of the Bar,[200] some elements of the solicitor's conflict may transfer to the barrister so that the barrister becomes conflicted as well. If the solicitor directly acts for both funder and litigant and is conflicted, then the barrister similarly directly acts for both funder and litigant and is similarly conflicted. In terms of incentives, the barrister also has an interest in pleasing the solicitor, as the solicitor may be a source of future work. This may therefore involve an element of pleasing the funder as discussed above. The solicitor's conflict may therefore be transferred to the barrister.

The barrister has an obligation to avoid conflicts as well. In giving the advice, the barrister will therefore have to disclose the conflict and obtain the

197 Walker, above n 167, 101. See above n 161.

198 I will use the term 'solicitor' rather than 'lawyer' in this section for clarity, given that barristers are also 'lawyers'.

199 See, eg, *Legal Profession Uniform Conduct (Barristers) Rules 2015* (NSW) r 120; Róisín Annesley, *Good Conduct Guide: Professional Standards for Victorian Barristers* (Victorian Bar, 2006) 77–9 [5.23]–[5.24]. If there is a conflict between the litigant's interests and the instructing lawyer's interests, the barrister must advise the client of this in writing: Victorian Bar Inc, *Practice Rules: Rules of Conduct and Compulsory Continuing Professional Development Rules* (at 22 September 2009) r 73 (even though, in agency terms, the incentive structure is such that the barrister may be tempted to have regard to the lawyer's interest). An alternate view might be a 'stakeholder' approach where in some cases the barrister acts for the solicitor but the client is a 'stakeholder'.

200 Although it is a popular principle, independence of the Bar is not simply or precisely defined. In NSW, it is provided inter alia that '[a] barrister must not act as the mere mouthpiece of the client or of the instructing solicitor and must exercise the forensic judgments called for during the case independently, after the appropriate consideration of the client's and the instructing solicitor's wishes where practicable': *Legal Profession Uniform Conduct (Barristers) Rules 2015* (NSW) r 42. According to Annesley,

> [w]hen applied to barristers in Victoria, the term independence connotes a variety of ideas: autonomy, in the sense of being a sole practitioner owing no commercial allegiance to any other practitioner; individual and collective separation from the role of being a solicitor; and a certain detachment, even from the particular cause of the client, so as to ensure that the barrister observes the paramount duty owed to the court. In each case that independence plays a vital role in enabling the barrister to serve the ends of justice in an adversarial system - that is, by fearlessly pursuing the client's interest to the exclusion of any other within the boundaries circumscribed by the duty owed to the court, professional ethics and the law.

Annesley, above n 199, 4 [1.7].

informed consent of the litigant and funder to the conflict as discussed above.[201] This will meet legal requirements though not remove agency dilemmas.

The author submits that a better approach is to obtain counsel's opinion as a de facto adjudication, arbitration or 'expert determination'[202] of the question[203] rather than as purported advice to one or two conflicted parties. This could be done by briefing fresh counsel to arbitrate the issue pursuant to commercial arbitration legislation[204] (under which the barrister has no particular duties to any one party but a general duty to treat the parties with equality)[205] and to decide the issue in accordance with relevant rules of law,[206] and/or as an expert determination. The funder could put its arguments about the settlement offer (for example, that the litigant should settle), and the solicitor would be obliged to put the litigant's arguments about the settlement offer (for example, that the litigant should not settle). Counsel would then decide the issue based upon the arguments, facts and law. Solicitors may object that there is unlikely to be time for full arbitration – in which case an 'expert determination' might be a quicker option.

It is notable that some litigation agreements seem to acknowledge the issue of conflict in that they provide for mediation and arbitration of other conflicts between the funder and litigant (but not on the critical issue of agreeing on a settlement offer).[207] The point seems also partly acknowledged in the UK where the voluntary *Code of Conduct of Litigation Funders*[208] of the Association of Litigation Funders of England and Wales[209] provides that, where there is a dispute about termination or settlement, a binding opinion must be obtained from an independent QC, who has been either instructed 'jointly'[210] or appointed by the Bar Council.[211]

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201 This might go so far as having an independent solicitor explain the conflict to the litigant: see above nn 155–6.

202 Some barristers provide alternative dispute resolution services allowing for an 'expert determination' but there is little public guidance on the ethical framework or duties of counsel under this regime. See, eg, New South Wales Bar Association, *BARADR* <http://www.nswbar.asn.au/briefing-barristers/adr/baradr>; Victorian Bar, *Alternative Dispute Resolution* <http://www.vicbar.com.au/using-a-barrister/alternative-dispute-resolution/expert-determination>.

203 The question will presumably be whether the settlement offer is reasonable and should be accepted.

204 See, eg, *Commercial Arbitration Act 2010* (NSW); *Commercial Arbitration Act 2011* (Vic).

205 See, eg, *Commercial Arbitration Act 2010* (NSW) s 18; *Commercial Arbitration Act 2011* (Vic) s 18.

206 See, eg, *Commercial Arbitration Act 2010* (NSW) s 28(1); *Commercial Arbitration Act 2011* (Vic) s 28(1). Though the parties have the option of agreeing and choosing what the relevant rules of law are.

207 See n 161.

208 Association of Litigation Funders of England and Wales, *Code of Conduct for Litigation Funders* (at 14 January 2014), which it is stated was published by the United Kingdom Civil Justice Council.

209 An association of seven UK litigation funders, being Burford Capital, Calunius Capital LLP, Harbour TPLF Ltd, Redress Solutions LLP, Therium Capital Management Ltd, Vannin Capital PCC Ltd and Woodsford TPLF Ltd. See Association of Litigation Funders of England and Wales, *Welcome* (2015) <http://associationoflitigationfunders.com/>.

210 Under which counsel would admittedly have conflicting duties to all parties and be likely conflicted.

211 Association of Litigation Funders of England and Wales, *Code of Conduct for Litigation Funders* (at 14 January 2014) cls 11.2, 13.2.

C Transaction Cost Economics

The insights of transaction cost economics also have some application to TPLF.

1 Opportunism

First, the existence of opportunism means that there will be various temptations to act in ways that may not be in all parties' interests. In a tripartite arrangement, the temptation of two parties to collude to the detriment of the third is an obvious moral hazard. As has been seen, this is a prediction of game theory as well.

2 Bilateral Monopoly and Termination

Second, there is the problem of bilateral monopoly. Conventional or textbook market economics and competition theory suggest that a competitive market of litigation funders will provide considerable protection to the litigant consumer and maximise efficiency.[212] Transaction cost economics, however, suggests that a consumer choice to terminate a funding agreement and recontract with a new funder may not be completely efficient and may lead to a loss of economic value. This is because TPLF contracts involve the funder investing time and money in acquiring unique knowledge of the case. This is 'transaction-specific' intellectual property, the value of which will be largely lost by the funder if the funding contract is terminated. Likewise, the litigant, if he or she can find another funder, will need to reinvest time in the new funder acquiring these intellectual property assets. There may be further delays in the litigation to all parties' (and to the court's) detriment. Thus, transaction cost theory notes that there will be a loss of productive value if such contracts are interrupted or prematurely terminated.[213]

Because of the potential costs of premature termination, funding contracts tend to limit the litigant's contractual rights to terminate the funding agreement at will and move to a new funder (for example, by providing that the litigant can only terminate if there is a breach of contract by the funder).[214] This leads to 'lock-in' effects, reduced competition and the problem of 'bilateral monopoly'.[215] Bilateral monopoly can enhance the ability of the seller (funder) to dictate to the buyer (litigant) in any bargaining that occurs during the contract ('*ex post*'). Most litigation contracts set the price (usually a percentage of the litigation damages) in advance ('*ex ante*') so this will not be subject to bargaining. There is, however, considerable scope for differences of opinion and disputation in the course of the contract (notably in relation to whether a settlement offer should or should not be

212 The 'free market principles' referred to by Mason P in *Fostif NSWCA* (2005) 63 NSWLR 203, 236 [145].

213 Williamson, *The Economic Institutions of Capitalism*, above n 20, 53–4.

214 See above n 161.

215 Another way of looking at this phenomenon might be through the economic theory of barriers to entry. The existing funder will have investments in the case that new funders will have to duplicate before they can compete on a level playing field. See R Preston McAfee, Hugo M Mialon and Michael A Williams, 'What Is a Barrier to Entry?' (2004) 94 *American Economic Review* 461.

accepted). The funder will be at an advantage in any dispute as the litigant will not have the option of going to another funder.

This may suggest that the legislature should mandate a right of litigants to terminate at any time to increase competition. This may, however, lead to loss of economic value to all parties, disrupt proceedings, and may even be ineffective at increasing competition, as the associated economic costs to the funder may result in a diminution in the supply of funders in the market.

3 Bounded Rationality and Governance Mechanisms

The last insight of transaction cost economics that I shall examine is the effect of bounded rationality. Limits on the cognitive power of the parties combined with the complexity of litigation means that contracts between parties will not be sufficiently complex to govern all possible eventualities and will necessarily be incomplete. This means that a 'governance mechanism' will be required to deal with the relationship '*ex post*'. Williamson refers to arbitration as a possible type of trilateral (that is, the two parties in dispute and the third-party arbitrator) governance in this situation.[216] This is exemplified in practice by the existence of mediation clauses in some TPLF agreements. Mediation may be superior in this context to arbitration as arbitration tends to look for a solution based on a finding of fact and agreed rules of law, whereas mediation allows solutions beyond such an approach (lateral thinking) if the parties are agreeable. This may also necessarily be superior if the contract is indeed 'incomplete' in Williamson's terms and therefore possibly silent on important questions. There is also clearly a role for the court in governance of the funding arrangements so that filing of funding agreements with the court to facilitate this has been convincingly argued for[217] and recently implemented (at least in class actions) via court practice notes in a number of jurisdictions.[218]

In terms of a mechanism to govern disputes about whether a settlement offer is adequate I have already noted above the relative merits of advice from counsel and adjudication/arbitration or expert determination by counsel.

D Some Conclusions from the Above Theoretical Insights

Some tentative conclusions can be drawn out from the above theoretical approaches.

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216 Williamson, *The Economic Institutions of Capitalism*, above n 20, 74–5.

217 Peta Spender, 'After Fostif: Lingering Uncertainties and Controversies about Litigation Funding' (2008) 18 *Journal of Judicial Administration* 101, 114.

218 At or prior to the initial case management conference each party will be expected to disclose any agreement by which a litigation funder is to pay or contribute to the costs of the proceeding, any security for costs or any adverse costs order. Any funding agreement disclosed may be redacted to conceal information which might reasonably be expected to confer a tactical advantage on the other party.

Federal Court of Australia, *Practice Note No CM 17 – Representative Proceedings Commenced Under Part IVA of the Federal Court of Australia Act 1976 (Cth)*, 9 October 2013, [3.6]. See also Supreme Court of New South Wales, *Practice Note SC No Gen 17 – Supreme Court Representative Proceedings, 12 August 2014*, [7.2]; Supreme Court of Victoria, *Practice Note No 10 of 2015 – Conduct of Group Proceedings (Common Law Division)*, 28 November 2014, [3.6].

1. From game theory comes the suggestion that a Nash equilibrium may not automatically ensure the best outcome for all parties (litigant, funder, lawyer and, in the extended model, the court) and that there may therefore need to be regulation to change the rules of the game.
2. Game theory also suggests the possibility of collusion between two parties to the detriment of the third in a tripartite relationship. The assumption of the existence of 'opportunism' in transaction cost analysis can lead to a similar conclusion. Better disclosure as between all parties will go some way to reducing this possibility. This should include all relevant contractual and financial arrangements between the three parties. Agency theory also suggests that better information systems and communication will go some way to reduce agency conflicts between lawyer and litigant and funder and litigant. There may therefore be a role for regulation to mandate better disclosure.[219]
3. Despite some incentive alignment arguments, agency theory does not appear to support lawyers' contingency fees, particularly when the model is expanded to bring the lawyer's duty to the court into the analysis (which clearly must occur). By the same token, it also finds significant incentive problems in the fee for service approach. Agency theory does suggest that the funder will play a useful role in monitoring the lawyer's fees.
4. The litigant's interests may be reasonably well aligned with the funder by the latter's remuneration being based upon a percentage of damages obtained, though this may break down on the question of whether to accept a settlement offer or go to trial. Again expanding the model, these arrangements do not necessarily serve the court's interests, with neither the litigant nor the funder generally owing duties to the court.[220] Imposing on the funder a fiduciary duty to the litigant and an overriding duty to the court may address this, but funders may characterise this as discriminatory, as no such regulation has been placed on insurers in similar circumstances.[221]

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219 It is less clear how regulation could mandate better 'communication'. See Steven M Davidoff and Claire A Hill, 'Limits of Disclosure' (2013) 36 *Seattle University Law Review* 599. On the other hand, there is a vast amount of law in Australia directed at ensuring disclosure is not misleading or deceptive or likely to mislead or deceive. See, eg, *Competition and Consumer Act 2010* (Cth) sch 2 s 18 ('*Australian Consumer Law*'), originally enacted as *Trade Practices Act 1974* (Cth) s 52. The original provision has extensive progeny in the *Australian Consumer Law*, *Corporations Act 2001* (Cth), *Australian Securities and Investments Commission Act 2001* (Cth) and elsewhere.

220 Though as noted, in Victoria, they will be subject to the overarching obligations to the court set out in the *Civil Procedure Act 2010* (Vic). See above n 167.

221 Insurers are only subject to the lesser duty of utmost good faith to the insured and generally have no duties to the court: see above n 167. Another approach would be to impose such duties on both insurers and litigation funders. This would show admirable consistency but may be resisted by the insurance industry.

5. There may also be an agency conflict between the litigant and the funder on the question of the funder's adverse costs indemnity to the litigant so that some prudential regulation of this may be warranted. There may also be an argument for a nominal compulsory excess[222] on the indemnity which would have the effect of better aligning the litigant and funder's interests (especially by sharing the potential downside of going to trial and losing) and also provide some disincentive to litigants pursuing unmeritorious claims.
6. The relationship between the funder and the lawyer can potentially create a conflict for the lawyer's duty to the litigant. This could be overcome by imposing a fiduciary duty on the funder to the litigant. However, as noted, this goes beyond the way insurers are regulated. As noted above, a duty of utmost good faith could be imposed on funders as a lesser obligation, but this would not completely remove the agency dilemma.
7. Incentivising lawyers and funders to act in each other's interests through material ownership interests in each other by way of equity or otherwise is also likely not to be in the litigant's interest. Full disclosure of the disadvantages of such arrangements to the litigant and the obtaining of a fully informed consent (possibly including independent advice) would be required by equity though this does not eliminate the agency dilemma. Another option is to prohibit such arrangements. However, this may be considered extreme and not required by fiduciary law.[223]
8. Agency theory suggests that counsel's advice to the litigant is an inadequate means of resolving disputes between the funder, solicitor and litigant about whether to accept a settlement offer. This is because counsel's advice does not relieve the solicitor's potential conflict but merely transfers some or all of the conflict to counsel. Counsel must then obtain informed consent of the parties to the conflict. A better approach is to brief new counsel to formally arbitrate/adjudicate the conflicting views (or provide an 'expert determination') so that it is clear that counsel is not acting for (nor the agent of) any of the parties.
9. Transaction cost economics notes the 'bilateral monopoly' aspects of funding agreements between litigant and funder but stops short of suggesting that termination at will is a viable solution to enhance competition, as the latter will lead to a loss of productive value by all parties (though mostly by the funder). Instead, it suggests a governance mechanism through a dispute resolution process such as mediation or arbitration and supervision by the court. This will also be necessary due to the incompleteness of such contracts caused by the factual complexity

222 The amount of this excess should be significant enough to give the litigant pause in going to trial after a reasonable offer is made, though small enough not to seriously penalise the general benefit of the indemnity to the plaintiff or defendant.

223 Again, to be consistent, such a prohibition may have to be placed upon similar relationships between lawyers and insurers.

and the bounded rationality of the parties. Though many funding agreements already have dispute resolution clauses, this is arguably something that should be mandated.

V OPTIONS FOR REFORM

What does the theoretical analysis above mean for the options to reform TPLF? It is now possible to briefly consider the five main types of approaches to TPLF that have been discussed in Australia and the implications of the above discussion in relation thereto. The five options to regulate TPLF are: (1) no change to current laws; (2) self-regulation; (3) regulation as a financial product, scheme or credit facility; (4) regulation as a legal service; and (5) regulation analogous to insurers.

A No Change to Current Law

Game theory suggests that equilibrium outcomes in a tripartite arrangement may not ensure the best outcome for all parties nor adequate disclosure, and that the 'rules of the game' (that is, the law) may therefore need to be reviewed. Agency theory identifies similar problems with disclosure and also notes conflict of interest problems. Current regulation by ASIC goes some way to addressing conflicts by requiring them to be disclosed and for written procedures to be established to deal with them. The guidance does not, however, say much about what those procedures might be other than certain suggestions as to what the lawyer and/or funder should 'consider including' in agreements[224] and certain matters that ASIC 'expects' in regard to their relations (including procedures for settling differences on settlement offers).[225] The analysis above suggests that these protections could be strengthened. ASIC's guidance also does not extend to prudential regulation of funders and there is a reasonably strong argument that this is necessary.[226]

224 These include a cooling-off period which provides an opportunity for members to seek legal advice; an obligation for the lawyer to give priority to the instructions given by the member over those given by the funder; the procedure that will be applied in reviewing and deciding whether to accept any settlement offer, including the factors that will and will not be taken into account in deciding to settle; an obligation to provide clear and full disclosure of any terms of settlement to all members and to the court (where applicable); how disputes in relation to the scheme will be resolved; and an obligation to provide clear and full disclosure to members of the terms of the agreement between the funder and the lawyers. See *RG 248* 21 [RG 248.71].

225 See above n 187. Further ASIC expects that, if the litigation scheme settles without a proceeding being issued, the terms of any settlement agreement should also be approved by counsel (or senior counsel if involved): *RG 248* 25 [RG 248.88].

226 This would again parallel the regulation of insurers who are regulated by the Australian Prudential Regulation Authority.

B Self-regulation

The above analyses do not touch on the debate between government regulation and self-regulation. This is a complex topic which I will not attempt to deal with here. A movement away from simple government regulation as a solution has been observed[227] and self-regulation will have certain benefits,[228] though the debate can be clouded by political ideology. Self-regulation can be seen as a form of private ordering. Clearly there will be both advantages and disadvantages of self-regulation for all stakeholders.[229] Self-regulation might take the form of an industry code and/or membership of a professional organisation.[230] Appropriate self-regulation may indeed be in the interests of litigation funders as well as the public as it may see demand for TPLF increase.[231] Self-regulation would need to cover the issues referred to above. It is less clear how prudential issues could be self-regulated other than through possible insurance requirements. An example of self-regulation of TPLF is the UK voluntary *Code for Conduct of Litigation Funders* released in November 2011 by the Association of Litigation Funders of England and Wales.[232]

227 Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-regulation in a "Post-regulatory" World' (2001) 54 *Current Legal Problems* 103.

228 See, eg, Christine Parker, *The Open Corporation: Effective Self-regulation and Democracy* (Cambridge University Press, 2002).

229 For a good summary of the arguments, see Anthony Ogus, 'Rethinking Self-regulation' (1995) 15 *Oxford Journal of Legal Studies* 97.

230 The Australian Productivity Commission has come out against self-regulation of litigation funders. The Commission has stated that it considers that regulation is more appropriately set out explicitly in court rules and through licensing under enforceable legislation (in relation to capital adequacy), rather than by a self–regulatory industry code: see Productivity Commission, above n 134, 631.

231 Indeed, some litigation funders have suggested that regulation in the form of possession of an AFSL should be required. See Kate Richie, Interview with Clive Bowman and Steven Glass (Television Interview, 27 July 2012) <http://www.brrmedia.com/event/99728/steven-glass-gilbert--tobin-and-clive-bowman-imf-australia>.

232 See above n 208. The code is relatively short (five pages) but includes certain key aspects such as:

(a) Control by litigants – funders are prevented from (i) seeking to influence the funded party's lawyers to cede control or conduct of the dispute to the funder and (ii) causing the litigant's lawyers to act in breach of their professional duties.

(b) Capital adequacy of funders – it requires funders to maintain adequate financial resources at all times in order to meet their obligations to fund all of the disputes they have agreed to fund, and to cover aggregate funding liabilities under all of their funding agreements for a minimum period of 36 months.

(c) Termination and approval of settlements – it provides that funders may only withdraw from funding where they reasonably cease to be satisfied about the merits of the dispute, believe it to be no longer commercially viable, or believe that there has been a material breach of the agreement by the funded party. Where there is a dispute about termination or settlement, a binding opinion must be obtained from an independent QC, who has been either instructed jointly or appointed by the Bar Council.

Association of Litigation Funders of England and Wales, *Code of Conduct for Litigation Funders* (at 14 January 2014).

C Regulation as a Scheme, Financial Product or Credit Facility

Regulation as a managed investment scheme seems particularly inapt for TPLF. The requirements of a constitution, compliance plan and a responsible entity seem to be ill fitted to the arrangements between lawyers, funders and litigants. At a stretch, the funder might perform some of the functions of the responsible entity and the agreements between the parties may have some aspects of a constitution and compliance plan (possibly enhancing disclosure between the parties) but this seems to be a severe straining of the regulatory regime.[233]

As noted above, the characterisation of TPLF as a financial product would mean that litigation funders would be required to hold an AFSL. This would import requirements of conflicts management procedures,[234] de facto capital adequacy,[235] training of staff,[236] risk management systems,[237] and, where financial services were provided to litigants as retail clients, internal and external dispute resolution procedures.[238] There would also need to be compensation arrangements for retail clients[239] and compliance with the extensive, complex (and arguably prolix) provisions of the Act (and regulations) dealing with disclosure.[240] This type of regulation would thus address a number of the points raised above though is still perhaps not completely apt for the special circumstances of litigation funders and their relations with lawyers and courts. Licensing is probably desirable as a general principle. The question is whether this should be AFS licensing or special purpose licensing.[241]

If litigation amounted to providing a credit facility then funders would be subject to the requirements of the *National Credit Code* including that they hold an Australian credit licence and comply with the conduct, disclosure and responsible lending requirements of that *Code*. Again, this type of regulation would address certain issues (and credit regulation is the only type of regulation that has any sort of structure to determine unfair 'credit pricing' – that is, the percentage charged by the funder) but may not be a perfect fit for the services provided by litigation funders.

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233 Notwithstanding the observations of their Honours in *Multiplex* about investment or market risk, institution risk, compliance risk and a decline in the value of the investment which could be caused by a decline in the fortunes or asset position of the defendant, the funder or the solicitors, or by the likely occurrence of previously unexpected costs necessitating some action to protect the group members' interests: see *Multiplex* (2009) 180 FCR 11, 21–2 [32] (Sundberg and Dowsett JJ).

234 *Corporations Act 2001* (Cth) s 912A(aa).

235 *Corporations Act 2001* (Cth) s 912A(d).

236 *Corporations Act 2001* (Cth) s 912A(f).

237 *Corporations Act 2001* (Cth) s 912A(h).

238 *Corporations Act 2001* (Cth) ss 912A(2), 1017G(2).

239 *Corporations Act 2001* (Cth) s 912B.

240 *Corporations Act 2001* (Cth) pts 7.7, 7.9.

241 AFSL licensing may be more efficient from the taxpayers' point of view if the alternative is setting up a separate bureaucracy to administer special purpose licensing. On the other hand, the relevant provisions are lengthy and complicated, which would create a more heavy compliance burden and possibly reduce the number of funders in the market.

D Regulation as a Legal Service Provider (Lawyer)

This is probably inappropriate. Litigation funders do not act as legal representatives in the litigation process. Despite many litigation funders being staffed by legally qualified persons and having a role in assessing the legal and factual merits of claims, funders are not strictly providing legal services to litigants. Lawyers are generally involved in a funded proceeding and these are already regulated. Admittedly, imposing on funders fiduciary duties to litigants and duties to the court would solve many agency dilemmas. However, this has not been done to insurers which are the entities that are arguably most analogous to litigation funders.[242]

Clearly many of the issues that arise in relation to funders and litigants relate to lawyers acting in accordance with their obligations to litigants and acting partly as gatekeepers. Lawyers are already highly regulated through fiduciary and common law duties, statute, licensing to practise by the courts, professional codes of conduct and compulsory insurance arrangements. Nevertheless, there may be scope for focusing and developing compulsory continuing legal education on the particular conflicts problems that arise in TPLF and how these should be dealt with. There is also scope for strengthening legal complaints bodies, their disciplinary powers and ability to give redress.[243]

E Regulation Analogous to Insurers

From what has been said above, it appears that any extra special purpose regulation (in addition to a slight strengthening of current ASIC regulation and possible licensing) would have aspects in common with the regulation of insurers. This would include the imposition of a statutory obligation of utmost good faith in TPLF contracts (which would be mutual), consideration of nominal excesses on indemnities as well as prudential regulation through either Australian Prudential Regulation Authority, or possibly by ASIC under section 912A(d) of the *Corporations Act 2001* (Cth) or laws analogous thereto.

VI CONCLUSION

Despite the sometimes fierce debate as to its merits in our justice system, TPLF has become a part of the Australian legal landscape following the High Court's decision in *Fostif HC*. Meanwhile, decisions by the courts as to the applicability of various forms of regulation to funders have been partially wound back by the legislature and by ASIC. An application of the theoretical insights of game theory, agency theory and transaction cost economics leads to a number of important conclusions about the problems of such complex multi-party

242 Subject to the question noted above as to whether there is a fundamental difference between the funder seeking to maximise a verdict for the funded litigant (to achieve gain for the funder) and the insurer seeking to minimise the verdict against the insured litigant (to minimise loss to the insurer).

243 Productivity Commission, above n 134, 187.

contractual arrangements, particularly as they affect the rights of the litigant. The analysis also gives guidance as to possible areas for reform through regulation including licensing, some prudential supervision and the introduction of a statutory implied term of good faith in TPLF agreements.