ASIC
Australian Securities & Investments Commission

REPORT 338

Response to submissions on CP 185 Litigation schemes and proof of debt schemes: Managing conflicts of interest

April 2013

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 185 *Litigation schemes and proof of debt schemes: Managing conflicts of interest* (CP 185) and details our responses to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 248 *Litigation schemes and proof of debt schemes: Managing conflicts of interest* (RG 248).

Contents

A Overview/Consultation process

About our consultation

1 In Consultation Paper 185 *Litigation schemes and proof of debt schemes: Managing conflicts of interest* (CP 185), we consulted on proposals about how funders and lawyers can manage potential and actual conflicts of interest in litigation schemes and proof of debt schemes. CP 185 was released on 17 August 2012.

2 We were prompted to issue CP 185 because of the release of the Corporations Amendment Regulation 2012 (No. 6)—made on 12 July 2012. This regulation, which amended the Corporations Regulations 2001 (Corporations Regulations), was subsequently amended on 12 December 2012 by the Corporations Amendment Regulation 2012 (No. 6) Amendment Regulation 2012 (No. 1).

> Note: In this document, references to specific regulations (e.g. 'reg 7.6.01AB') are to the Corporations Amendment Regulation 2012 (No.6), as amended by the Corporations Amendment Regulation 2012 (No. 6) Amendment Regulation 2012 (No. 1) (Corporations Amendment Regulations).

3 Class action litigation has become an important feature of the corporate and legal landscape in Australia. A key factor in the increase in class action filings has been the emergence of commercial litigation funding. Litigation funding overcomes one of the major disincentives to filing a class action—namely, the risk of incurring significant costs.

4 Litigation funding has grown significantly in Australia, particularly since the High Court decision in *Campbells Cash and Carry Pty Limited v Fostif Pty Ltd* (2006) 229 CLR 386 (*Fostif*). In *Fostif*, the court considered the legality of litigation funding for the first time and held that it was not necessarily an abuse of process or against public policy for a funder to seek out claims that may be aggregated in class action proceedings and exercise a significant level of control over the conduct of the litigation.

5 From 12 July 2013, litigation schemes, litigation funding arrangements and proof of debt schemes as defined in the Corporations Amendment Regulations , will be exempt from:

(a) the definition of 'managed investment scheme' in s9 of the *Corporations Act 2001* (Corporations Act); and

(b) the licensing, conduct, anti-hawking and disclosure provisions in Ch 7 of the Corporations Act.

6 A litigation scheme is defined in the Corporations Amendment Regulations as a scheme that has all of the following features:

(a) the dominant purpose of the scheme is for each of its general members to seek remedies to which the general member may be legally entitled;

(b) the possible entitlement of each of the general members of the scheme to remedies arises out of:

(i) the same, similar or related transactions or circumstances that give rise to a common issue of law or fact; or

(ii) different transactions or circumstances, but the claims of the general members can be appropriately dealt with together;

(c) the possible entitlement of each of the general members of the scheme to remedies relates to transactions or circumstances that occurred before or after the first funding agreement (dealing with any issue of interests in the scheme) is finalised;

(d) the steps taken to seek remedies for each of the general members of the scheme include a lawyer providing services in relation to:

(i) making a demand for payment in relation to a claim;

(ii) lodging a proof of debt;

(iii) commencing or undertaking legal proceedings;

(iv) investigating a potential or actual claim;

(v) negotiating a settlement of a claim; or

(vi) administering a deed of settlement or scheme of settlement relating to a claim;

(e) a person (the funder) provides funds or indemnities, or both, under a funding agreement (including an agreement under which no fee is payable to the funder or lawyer if the scheme is not successful in seeking remedies) to enable the general members of the scheme to seek remedies; and

(f) the funder is not a lawyer or legal practice that provides a service for which some or all of the fees or disbursements, or both, are payable only on success.

7 The Corporations Amendment Regulations also define a litigation funding arrangement, which is similar to a litigation scheme but involves a single claimant.

8 A proof of debt scheme is defined in reg 5C.11.01(1)(c) as a scheme that has all the following features:

(a) the scheme relates to an externally administered body corporate;

(b) the creditors or members of the body corporate provide funds (including through a trust) or indemnities, or both, to the body corporate or external administrator;

(c) the funds or indemnities, or both, enable the external administrator or the body corporate to:

(i) conduct investigations;

(ii) seek or enforce a remedy against a third party; or

(iii) defend proceedings brought against the body corporate in relation to the external administration of the body corporate (other than in relation to allegations, made by creditors or members of the body corporate, of negligence or non-performance of duties by the external administrator).

9 To rely on the licensing exemption under reg 7.6.01AB(1), you must maintain adequate practices and follow certain procedures for managing any conflicts of interest that may arise in relation to activities undertaken by you, or your agent, in relation to the scheme. You must also be able to show through documentation that:

(a) you have conducted a review of your business operations that relate to the litigation scheme or proof of debt scheme to identify and assess potential conflicting interests;

(b) you have written procedures for identifying and managing conflicts of interest and have implemented the procedures;

(c) your written procedures are regularly reviewed, at intervals of not less than 12 months;

(d) your written procedures include procedures about:

(i) monitoring your operations to identify potential conflicting interests;

(ii) how to disclose conflicts of interest to members and prospective members;

(iii) managing situations in which interests may conflict;

(iv) protecting the interests of members and prospective 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 Div 2 of Pt 2 of the *Australian Securities and Investments Commission Act 2001* (ASIC Act); and

(viii) recruiting prospective members;

(e) the terms of the funding agreement are reviewed to ensure the terms are consistent with Div 2 of Pt 2 of the ASIC Act; and

(f) your procedures are implemented, monitored and managed by your senior management or partners.

10 Failure to maintain adequate arrangements and follow certain procedures for managing these conflicts is an offence under reg 7.6.01AB(3).

11 We proposed in CP 185 that if you rely on the exemptions or hold an Australian financial services (AFS) licence, you should:

(a) be responsible for determining your own practices to manage interests that may conflict with your duties; and

(b) be able to demonstrate that you maintain adequate practices and follow certain procedures for managing conflicts of interest, including documenting, implementing, monitoring and reviewing your practices.

12 We also proposed in CP 185 that if you rely on the exemptions or hold an AFS licence, you should be able to demonstrate that you formally reviewed areas where interests may diverge, and have, as a minimum, written processes and procedures for litigation funders and proof of debt funders that address the following:

(a) effective disclosure of conflicts of interest to members and prospective members;

(b) control of situations where interests may conflict;

(c) adequate protection of members' interests;

(d) recruitment of prospective members;

(e) review of the terms of the funding agreement, in light of the law on unfair contracts and unconscionability;

(f) the situation where the lawyer acts for both the funder and the members;

(g) the situation where there is a pre-existing relationship between the funder, lawyers and/or members; and

(h) approval by an independent panel or counsel of:

(i) any settlement offer made by, or accepted by, members; or

(ii) the terms of settlement of a litigation scheme.

13 This report highlights the key issues that arose out of the submissions received to CP 185 and our responses to those issues.

14 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 185. We have limited this report to the key issues.

15 For a list of the non-confidential respondents to CP 185, see the appendix. Copies of the submissions are on our website at www.asic.gov.au/cp under CP 185.

Responses to consultation

16 We received five responses to CP 185. These responses were from a variety of sources, including law firms, industry bodies and funders. We are grateful to respondents for taking the time to send us their comments.

17 The main issues raised by respondents related to:

(a) whether our proposed guidance should apply to both funders and lawyers;

(b) whether we should include guidance on the recruitment of prospective members;

(c) the method of disclosure to prospective members;

(d) whether specific terms should be included in the funding agreement; and

(e) whether any settlement offers or the terms of settlement agreements should be reviewed by counsel or an independent panel.

18 For our response to these issues, see Section B.

B Response to submissions on CP 185

Key points

This section outlines the key issues covered in submissions received on CP 185, and our responses to those issues.

It covers:

- our proposal that our guidance should apply to any person, including lawyers, who relies on the exemptions or conducts their activities under an AFS licence;
- our proposal to provide guidance on recruitment of prospective members;
- our guidance about the method of delivering disclosure to members for them to comply with our good practice guidance on online disclosure in RG 221;
- our proposal that we will not require the funding agreement contain particular terms, but that the funder and/or lawyers review the terms of agreements and use any funding agreement as a tool to meet their obligation to maintain adequate practices and follow certain procedures for managing conflicts of interest; and
- our adoption of Option 1(b)—specifically, that where proceedings have not been issued, the terms of any settlement agreement of a litigation scheme should be approved by counsel (or senior counsel if involved).

Application of our guidance

19 We proposed in CP 185 that our guidance should only apply to funders and lawyers involved in a litigation scheme or proof of debt scheme to the extent that they:

(a) rely on the exemptions in the Corporations Amendment Regulations for such activities; or

(b) conduct their activities under an AFS licence.

20 We recognised that lawyers are already subject to obligations to their clients relating to conflicts of interest. For example, lawyers are subject to fiduciary duties to their client, ethical duties to the court, statutory duties under state or territory legal profession legislation, and professional codes of conduct and practice rules. These obligations give rise to penalties for professional misconduct.

21 We received three submissions on this proposal. Two respondents supported our proposal, but considered that the existing obligations and duties of lawyers provided sufficient protection for members.

22 The other respondent did not support our proposal. This respondent was concerned that our guidance was not supported by the intention of the exemptions. The respondent noted that the purpose of the amendments was to ensure that funders had appropriate conflicts of interest arrangements in place because they are not subject to professional and ethical obligations.

ASIC's response

We remain of the view that our guidance should apply to any person who relies on the exemptions or conducts their activities under an AFS licence.

We acknowledge that the Explanatory Statement to the Corporations Amendment Regulation 2012 (No. 6) stated that a purpose of the regulation was to addresses potential conflicts between the interests of funders and their clients in certain situations. However, we note that the Explanatory Statement states that, by making the litigation funding schemes and arrangements financial products, it subjects them to conflict of interest obligations. In these circumstances, we consider that the intention of the amendments was not to restrict the conflict management obligation to funders. We consider that the exemptions can apply to lawyers to the extent they rely on them.

We took into account the submissions that the existing obligations and duties of lawyers provided sufficient protection for members. However, we have not changed our guidance because of them. This is because:

- we did not receive any submissions that our proposals would conflict with the fiduciary, ethical or professional obligations of lawyers, or that lawyers would be unable to comply, or have difficulty complying, with our proposal; and
- we consider that our guidance provides sufficient flexibility so that lawyers could establish and maintain procedures to manage conflicts of interest, taking into account their fiduciary and ethical duties and professional responsibilities.

Recruitment of prospective members

23 In CP 185 we proposed that the funder and/or lawyers recruiting prospective members for a litigation scheme or proof of debt scheme should have arrangements to ensure that conflicts do not result in misleading or deceptive conduct, including having a senior person with designated responsibility to oversee recruitment practices.

24 We received three submissions on this proposal. One respondent supported our proposal on the basis that it will assist prospective members to understand the different significant interests between the different parties and how conflicts may arise.

25 The other two submissions did not support our proposal because it has not been an area of significant concern to date.

ASIC's response

We remain of the view that our guidance should include the recruitment of prospective members.

We note that reg 7.6.01AB(4)(d)(viii) provides that the written procedures for identifying and managing conflicts include procedures about managing situations in which interests may conflict and so will involve the recruitment of prospective members. In these circumstances, we consider that a person relying on the exemption or holding an AFS licence may benefit from our guidance on how they can manage potential and actual conflicts of interest in this situation.

We acknowledge that this has not traditionally been an area where a significant number of complaints about conflicts have arisen. However, we did not receive any submissions that identified any burdens with compliance if the proposal were to be adopted. In addition, the Australian class action sector is an emerging sector and we note that the overseas experience has been that recruitment practices of prospective members have proved to be an area where the interests between funders, lawyers and members can diverge and conflict.

For example, in *Jarra Creek Central Packing Shed Pty Ltd v Amcor Limited* [2008] FCA 575, after a notice to opt out of a class action proceeding was given to group members, the solicitor for the plaintiffs made representations concerning the anticipated amount of damages the court might award. The court held that the statements were misleading because the solicitor incorrectly attributed them to the Australian Competition and Consumer Commission and that the statements could have a significant impact on a group member's opt-out decision because the inaccurate statements artificially inflated the member's expectations of potential compensation.

With the growth of the Australian class action sector, we consider this could prove to be an area for increased divergence of interests causing conflict.

Method of disclosure to prospective members

26 We proposed in CP 185 that the funder should provide prospective members with:

(a) information that is likely to assist them to understand the different significant interests of the funder, lawyers and members, and how they may conflict; and

(b) details of any dispute resolution options that are available to a member who has a dispute with the funder.

27 We did not include any proposals about the method of delivering disclosure to members or prospective members.

28 We received three submissions on this proposal. All respondents supported this proposal. In addition, one respondent noted that in some cases the only practical option for disclosing information would be on a website.

ASIC's response

We took into account the submissions made on the delivery of disclosure. We have provided further guidance about the method of delivering disclosure to members. We consider that online disclosure of information should comply with our good practice guidance in RG 221.

We consider this will help ensure that any online disclosures are more transparent and will encourage delivery of disclosure in a way that is consistent with best practice, while ensuring that members receive clear, concise and effective information for online communications.

Terms of funding agreement

29 We proposed in CP 185 that we would not require particular terms to be contained in the funding agreement relating to a litigation scheme or proof of debt scheme. We also proposed that the funder and/or lawyers should review the terms of agreements to which they are party in light of the existing body of law on unfair contracts and unconscionability.

30 We received two submissions on this proposal. One respondent supported our proposal on the basis that in the majority of cases lawyers do not act for the funder and so it is preferred that the lawyers not be engaged in a substantive review of the funding agreement. This respondent also submitted that it should be for the funder to determine what would be appropriate in terms of content for the funding agreement because the terms of a funding agreement will change depending on the circumstances and nature of the claims.

31 The other respondent did not agree with our proposal, and was in favour of a requirement that the funding agreements include particular terms. This is because this respondent believed the interests of members would be better protected if arrangements to manage conflicts of interest were incorporated in the funding agreement.

ASIC's response

We remain of the view that we should not require any funding agreement contain particular terms. This is because we consider that:

- conflicts management practices should be tailored to the nature, scale and complexity of the scheme or arrangement, and mandating the inclusion of specific terms in the funding agreement would be inconsistent with this; and
- mandating the inclusion of specific terms may not provide appropriate flexibility for the parties to include terms that are both practical and would optimally manage any conflicts that are unique to the circumstances or the nature of the claim.

However, we recognise that the inclusion of specific terms in a funding agreement is an important tool that a funder and/or lawyer should use to meet its obligation and will provide greater protection for members. Specifically, members will have recourse to contractual remedies for a breach.

In considering the appropriate terms that may assist in managing conflicts of interest, the funder and/or lawyer will need to consider the interests of each person or group of people and where interests may actually or potentially diverge in the scheme. We expect that the funder and/or lawyer will consider including the following terms in the funding agreement:

- an obligation to comply with and implement procedures to meet the requirements of the Corporations Amendment Regulations;
- a cooling-off period which would provide 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 of 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;
- an obligation to provide clear and full disclosure to members of the terms of the agreement between the funder and the lawyers; and
- an obligation to provide timely and clear disclosure to members of any breach of the Corporations Amendment Regulations and a right to terminate the agreement if the funder does not comply with the regulations.

> We also remain of the view that the funder and/or lawyers should review the terms of agreements to which they are party in light of the existing body of law on unfair contracts and unconscionability.

Independent review of settlement

32 We proposed the following options in CP 185:

Option 1: the terms of any settlement agreement of a litigation scheme should be approved by either:

(a) a panel comprising at least one independent person; or

(b) counsel (or senior counsel if involved).

Option 2: any settlement offer in a litigation scheme to be made by the members, or the acceptance of any settlement offer received by the members, should be approved by either:

(a) a panel comprising at least one independent person; or

(b) counsel (or senior counsel if involved).

33 All submissions addressed this proposal. Two respondents supported either Option 1(b) or 2(b), with reasons including:

(a) counsel would already have intimate knowledge on the matter and would adopt an extremely cautious, careful and conservative approach to signing off on whether or not a settlement in a proceeding is fair and reasonable;

(b) there would be cost savings from having counsel review and sign off on any settlement due to their close knowledge of the matter;

(c) Options 1(a) or 2(a) were impractical and would likely be costly and cause delays; and

(d) Options 1(a) or 2(a) have a greater potential to cause delays and may result in a larger number of claims being filed in court.

34 One respondent supported independent review of any settlement agreement, but did not specify which option they preferred. This was on the basis that most funding agreements currently included a clause of similar effect.

35 Another respondent did not directly support either Option 1 or 2, but agreed that any settlement before the issue of proceedings not occur without the advice of counsel or senior counsel. This was on the basis that most funding agreements currently included a clause to the effect that a claim cannot be settled unless 50% of members vote in favour of settlement and senior counsel opines that the terms of the settlement are reasonable.

36 The final respondent did not support our proposal or Option 1 or 2. This was because they believe it is beyond the scope of reg 7.6.01AB(4). This respondent also believed that such a requirement might curtail early settlement of claims.

ASIC's response

We considered whether our guidance was beyond the scope of reg 7.6.01AB(4). However, we do not consider that reg 7.6.01AB(4) is an exhaustive list of requirements that a person must have in written procedures to rely on the exemptions. We consider that the submissions and Australian case law recognise that settlement is a key area for a potential or actual conflict of interest to occur.

Having taken into account all of the submissions, we consider that where proceedings have not been issued, the terms of any settlement agreement of a litigation scheme should be approved by counsel (or senior counsel if involved).

We note that the majority of respondents supported this option.

We consider that any settlement agreement should be reviewed rather than any settlement offer, or the acceptance of such an offer, because it will impose less of a regulatory burden. While the requirement for counsel to review every offer affords greater protection for members, we have taken into account submissions that it would add to the cost of settlement negotiations, and potentially curtail early settlement of claims.

We recognise that the review of any settlement agreement could affect the timing of settlement. However, we understand that current standard industry practice is that any funding agreement contains a clause to the effect that counsel is to review a settlement offer and state whether it is reasonable.

We consider that requiring a review by an independent panel may increase the probability of additional cost and delay associated with briefing the panel on the complexities of the claim. In our view, it is likely that counsel will have accrued significant knowledge of the claims and is likely to be in the best position to assess the settlement. We consider this approach will minimise costs associated with the claim.

Appendix: List of non-confidential respondents

- Australian Institute of Company Directors
- IMF (Australia) Limited
- Law Council of Australia
- Maurice Blackburn Lawyers
- US Chamber Institute for Legal Reform