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legal update

LITIGATION FUNDING REGULATIONS

How do the recent amendments to the regulation of litigation funders impact funding for insolvency matters?

Class actions and litigation funders have been the subject of significant media, parliamentary and judicial attention in recent times. In particular, the *Corporations Amendment (Litigation Funding) Regulations 2020* (new regulations) which were published in July 2020 seem to have raised more questions than they've answered.

While apparently intended to regulate the conduct of professionally funded class actions, the new regulations may have had the effect of disturbing the previously uncontroversial position of funded insolvency actions and potentially imposing financial services licensing and associated requirements on those arrangements.

There are a number of options available to insolvency practitioners and funders to address these issues and the industry is working to get some answers. In the meantime, the current state of play is set out below.

A BRIEF HISTORY OF LITIGATION FUNDING

The practice of commercial litigation funding in Australia was born out of the insolvency industry in the late 1990s, prior to which it was effectively banned under the doctrines of maintenance and champerty. At that time, a series of decisions confirmed liquidators' powers to assign the fruits of litigation[1] and certain causes of action [2] to third party funders, which allowed insolvency practitioners to explore previously inaccessible recovery routes.

Some 10 years later, the High Court upheld the broader validity of litigation funding, recognising its role in promoting access to the civil justice system,[3] and funders began expanding their scope to non-insolvency commercial claims and class actions. Nevertheless, the vast majority of funded claims over the last 24 years have involved insolvency proceedings.

To put that in context, my company, Litigation Lending Services, has been in operation for 21 years and has funded 144 litigated cases to completion in Australian and New Zealand courts. Of those cases, 115 were actions for insolvency claims.

OLD REGULATIONS

The definition of 'managed investment scheme' (MIS) in s 9 of the Corporations Act covers schemes in which people contribute and pool together money (or money's worth) to acquire benefits produced by the scheme – in circumstances where those people don't have day-to-day control over the operation of the scheme.

Since the Full Federal Court's decision in *Brookfield Multiplex Limited v International Litigation Funding Partners Pty Ltd* (2009) 260 ALR 643, class actions (through which multiple claimants' rights are litigated in the same proceeding) funded by third parties have generally been understood to fall within the definition of an MIS.

Left unaddressed, this precedent would have had the effect of imposing the wide range of MIS requirements (relating to registration, licensing, conduct and disclosure) on litigation funders. It was accepted, shortly after Brookfield, that it would be neither effective nor necessary to regulate litigation funding arrangements under the MIS regime.

Accordingly, by 2013 (after some years of temporary relief by ASIC), the Corporations Act was amended by the 'old regulations'[4] with the effect that litigation funders were:

- taken to provide 'financial products' but were expressly exempt from the requirement to hold an Australian Financial Services Licence (AFSL) as long as they had appropriate processes in place to manage conflicts of interest, and
- exempt from compliance with the MIS regime.

1 *Movitor Pty Ltd (rec and mgr apptd) (in liq) v Sims (Re Movitor)* (1996) 64 FCR 380. **2** *Ultra Tune Australia Pty Ltd v UTSA Pty Ltd* (1996) 14 ACLC 1610. **3** *Campbells Cash and Carry Pty Ltd v Fostif Pty Limited* [2006] HCA 41. **4** *Corporations Amendment Regulation 2012 (No.6)* (Cth).

The relevant amended provisions of the Corporations Act set out categories of funding which were expressly exempt from the various Chapter 5C and 7 requirements. Those exemptions, in one way or another, appeared to cover the primary areas which utilised litigation funding (including funding for insolvency proceedings) namely:

Class actions – these were captured by the definition of 'litigation funding scheme'[5] which, broadly, applied to funding which enabled more than one claimant to 'seek remedies' arising out of similar or related circumstances:

Non-class actions – which fall into two categories:

- Single-party claims – single-party claims were covered by the definition of 'litigation funding arrangement'[6] which included funding provided to single claimants in order to seek remedies to which they were entitled. Accordingly, funding for ordinary commercial claims, as well as claims brought solely in the name of an externally administered body corporate, would have been captured by the associated exemption.
- Multiple-party claims – as litigation funding schemes were not expressed as being limited to class actions, funding for other multiple-party claims (such as those brought in the name of a liquidator and company together, or by joint and several liquidators together, or by groups of companies in liquidation) would likely also fall within the definition to which this exemption applied.

In addition, the old regulations expressly exempted funding made by 'the creditors or members' of an externally administered company 'to the body corporate or external administrator.' Such funding arrangements (Creditor/Member Funding) were also separately defined as litigation funding schemes[7] and therefore exempted under the old regulations.

NEW REGULATIONS

The new regulations – *Corporations Amendment (Litigation Funding) Regulations 2020* (Cth) – were introduced off the back of two recent inquiries (by the Australian Law Reform Commission in 2018 and then a parliamentary inquiry this year) into litigation funding in the class action industry.

The stated purpose of the new regulations was to achieve 'greater transparency for class action group members and greater accountability for third party litigation funders'.[8]

Funding of insolvency actions or single-party claims did not form part of the dialogue leading to the reforms and the Explanatory Statement says that the new regulations 'do not remove the effect of other exemptions that currently apply to certain litigation funding schemes in the insolvency context and litigation funding arrangements (which are used in actions involving a single plaintiff)'.

At first glance, it looked as though the new regulations had just rearranged and renamed some of the existing definitions to facilitate the intended removal of exemptions relating to class action funding. The changes include that:

- Creditor/Member Funding is no longer caught in the definition of litigation funding scheme – it has a new name, 'insolvency litigation funding scheme.' These arrangements remain exempt from AFSL and MIS requirements.[9]
- Litigation funding schemes (as re-defined) have been removed from the earlier AFSL and MIS exemptions.

The definition and treatment of litigation funding arrangements remain largely unchanged.

The new regulations apply in relation to litigation funding schemes, insolvency litigation funding schemes and litigation funding arrangements entered into on or after 22 August 2020[10] (presumably relating to the timing of the entry into the relevant contractual arrangements, rather than the commencement of any associated proceeding).

THE MIS-TAKE?

Insolvency litigation funding schemes under the new regulations do not refer to funding by third parties (only to funding by creditors or members of the relevant body corporate). As such, ordinary professional funding arrangements do not appear to be captured by any express exemption under the new regulations.

On the other hand, it may be that funding for certain insolvency actions (such as liquidators' causes of action, which are ordinarily run in the name of the appointee as well as the company) is treated as falling within the litigation funding scheme due to the existence of more than one plaintiff. This would have the seemingly unintended effect of requiring that action to be registered and treated as an MIS.

In addition to the onerous procedural requirements, including requiring a PDS and periodic statements to be provided to the appointee, such a course would add significantly to the total costs of funding insolvency claims.

Creditor/Member Funding arrangements no doubt play an important role in insolvency administrations and there is no reason to unfairly restrict those stakeholders from supporting the recovery work of appointees.

However, it would be an odd result if commercially funded insolvency claims were treated differently, requiring the implementation of protectionist measures for the benefit of sophisticated insolvency professionals (who themselves remain adequately regulated in respect of their own duties to stakeholders).

Of course, there are arguments that commercial insolvency funding agreements are not MIS (and so the exemptions are not needed, and the regulation does not apply).

5 *Corporations Amendment Regulation 2012 (No.6)* (Cth) reg 5C.11.01(1)(b). **6** Ibid reg 5C.11.01(1)(d). **7** Ibid reg 5C.11.01(1)(c). **8** Explanatory statement, *Corporations Amendment (Litigation Funding) Regulations 2020* (Cth). **9** *Corporations Amendment (Litigation Funding) Regulations 2020* (Cth) regs 5C.11.01(3); 7.1.04N(2); 7.6.01(1)(x). **10** Ibid reg 10.38.01.

Litigation funding

That's on the basis that the members of the 'scheme' (i.e. the appointees and/or the body corporate) have day-to-day control over the conduct of the litigation and funding (unlike, for example, individual members of a large 'open' class action) or that there is not, in effect, any real 'pooling' of distinct rights and remedies available to the appointee versus the body corporate.

These arguments are untested, and it would be preferable to obtain statutory clarifications rather than descending into interlocutory disputes on the issue.

WHAT NOW?

ARITA and the Association of Litigation Funders of Australia (ALFA) have each written to the Treasury to explain these issues and seek clarifying amendments to the new regulations (including to expressly include third-party funding of insolvency claims within the insolvency litigation funding scheme exemption).

The new regulations are also now subject to a disallowance motion which is scheduled for 10 November 2020 – if that motion succeeds, then the new regulations will cease to have effect and the old state of affairs will be restored.

In the meantime, it remains open to insolvency practitioners to:

- apply to ASIC for bespoke relief from compliance in respect of a specific external administration (or a broader class order concerning the issue generally)
- seek directions from the court (including under s 90-15 of the Insolvency Practice Schedule) regarding the application of the regime to a particular external administration (which would probably also necessitate notification to ASIC)
- consider assigning causes of action, or
- talk to funders regarding further solutions.

The litigation funding space will continue to evolve and adapt and sooner or later the path forward will become clear.