YELDHAM PRICE O'BRIEN LUSK

LITIGATION FUNDING

The second endorsement of litigation funders – no liability for costs

Introduction

In *Campbells Cash and Carry Pty Ltd v Fostif Pty Limited*,[1] the High Court declined to formulate a general rule of public policy that would prevent the practice of funding a party to institute or prosecute litigation in return for a share of the proceeds of the litigation.

On 13 October 2009, the High Court delivered its second endorsement of litigation funding in *Jeffery & Katauskas Pty Limited v SST Consulting Pty Limited; Jeffery & Katauskas Pty Limited v Rickard Constructions Pty Limited*.[2]

In *Jeffery & Katauskas*, the Court held (by a 4-1 majority) that a successful defendant could not recover its costs from a non-party who funded the plaintiff without indemnifying it for any adverse costs orders that may be made against it. The majority did not consider that the funder had been shown to have committed an abuse of process which would enliven the power of the Supreme Court of New South Wales to order costs against it or its directors pursuant to Rule 42.3(2)(c) of the *Uniform Civil Procedure Rules* 2005 (NSW) (**UCPR**).

The High Court has reinforced the limited basis on which New South Wales courts can make orders for costs against non-parties pursuant to Rule 42.3 of the UCPR. The categories under that rule do not currently include litigation funders. Commentary in response to this decision echoes concern for some time that this seeming anomaly should be rectified, so that all parties who have a stake in the proceeds of litigation also have a share of the risk.

This decision will be important for all parties (and their insurers) involved in litigation in which the moving party is funded by a litigation funder, and in particular where the moving party has limited or no real assets against which a costs order could be enforced.

Outline of facts

The case concerned the construction of a pavement at a container terminal at Port Botany. The pavement was constructed pursuant to a contract between Rickard Constructions Pty Limited (**Rickard**) and SST Consulting Services Pty Limited (**SST**).

The pavement failed three days after practical completion. Rickard subsequently commenced proceedings in the Supreme Court of New South Wales against a number of parties, including the engineers who had provided geotechnical services in connection with the pavement (**Jeffery & Katauskas**).

After commencing the proceedings, Rickard entered into a deed of charge with SST which recited a debt of $200,000 owed by Rickard to SST "arising from a loan to fund litigation concerning failed pavement and working capital". The charge secured payment to SST of $930,000 plus interest. Six days later, Rickard went into administration by resolution of its directors.

Rickard subsequently entered into a deed of company arrangement (**DOCA**), the other parties to which were Rickard's director Mr Charles Rickard, the administrator and two companies designated "the Secured Creditor", namely SST and SST Services Pty Limited. The DOCA established a fund to which was appropriated, among other things, a sum advanced by Mr Rickard and the Secured Creditor. The DOCA provided that Mr Rickard and SST would "jointly covenant and agree to pay all legal fees incurred in the conduct of [the proceedings] by [Rickard]", up to certain limits. In the event of the limits being exceeded, the administrator could decide, in his complete discretion, whether or not to accept litigation insurance to fund

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[1] [2006] HCA 41; (2006) 229 CLR 386.

[2] [2009] HCA 43.

the proceedings further. Any net amount recovered by way of settlement or verdict in the proceedings (after specified deductions) was to be paid into the fund.

SST was prohibited from enforcing its charge during the currency of the DOCA. It was to surrender its security, on the basis that it would receive payment of $350,000 in priority to Rickard's unsecured creditors but after payment, *inter alia*, of fees and expenses incurred in the conduct of the proceedings and the administrator's fees and expenses. Payment of a further $300,000 to SST was to rank equally with other creditors, and payment of the balance of SST's charge was to be deferred until after payment of other creditors.

In substance, therefore, SST undertook to fund the proceedings in return for a financial benefit (albeit one which would only be realised if the proceedings succeeded). SST did not indemnify Rickard for any adverse costs orders that may be made against it.

The defendants, including Jeffery & Katauskas, succeeded at a trial which ran for 19 days. Jeffery & Katauskas incurred costs which exceeded, by more than $450,000, the security for costs which had been ordered in its favour prior to and during the trial. Jeffery & Katauskas and other successful defendants sought orders from the trial judge for costs against SST and its directors under Rule 42.3(2)(c) of the UCPR.

Rule 42.3(2)(c)

Pursuant to section 98(1)(b) of the *Civil Procedure Act* 2005 (NSW), the Supreme Court has a general discretion to determine by whom costs are to be paid. That discretion is limited, however, by Rule 42.3 of the UCPR, which provides that the Court may not make any order for costs against a person who is not a party, except in certain circumstances.

One such circumstance, found in Rule 42.3(2)(c), is that the Court can order a person "who has committed contempt of court or an abuse of process of the court" to pay the whole or part of the costs of a party occasioned by the contempt or abuse of process.

Rule 42.3 has displaced the line of cases in which courts have exercised a general discretion to award costs against non-parties.[3]

First instance and Court of Appeal decisions

The trial judge, McDougall J, noted that there was some evidence that the sum actually advanced to Rickard by SST was $300,000, rather than the $200,000 recited in the deed of charge. In any case, a proportion of at least $630,000 of the charge in SST's favour was not explained by any advance. This was characterised before McDougall J as a "success fee".

McDougall J found that Mr Rickard and SST funded the litigation until 31 March 2001, and that SST funded the litigation thereafter. Mr Rickard gave instructions on behalf of Rickard in relation to the litigation, and there was no evidence that SST was involved in the decision-making, nor that Mr Rickard was trammelled in giving instructions by any agreement with SST. SST could, however, have brought the litigation to an end at any time after 31 March 2001 by ceasing to provide further funding. These findings were not challenged on appeal.

McDougall J declined to order SST or its directors to pay the costs of Jeffery & Katauskas and other successful defendants. Those parties appealed to the NSW Court of Appeal.

The primary submission put before the Court of Appeal by Jeffery & Katauskas and the other defendants was that:

> "... an abuse of process would occur where a non-party with a commercial interest in the fruits of the litigation funds proceedings by an insolvent plaintiff without providing the plaintiff with an indemnity against costs orders in favour of successful defendants."

This proposition was rejected by all three members of the Court of Appeal bench (Gyles AJA, with Giles and Tobias JJA agreeing).

High Court decision

Jeffery & Katauskas sought and was granted special leave to appeal to the High Court.

The abuse of process relied on was formulated, in submissions before the Court, by reference to two elements:

- The success fee arrangement.

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[3] See *Knight v FP Special Assets Ltd* [1992] HCA 28; (1992) 174 CLR 178

- The failure by SST and its directors to provide Rickard with an indemnity for the costs of any successful defendants.

To put it simply, SST stood to gain from the litigation but did not assume an obligation to bear the costs consequences if the litigation failed.

It could not be argued that it would, of itself, constitute an abuse of process for a non-party to agree, for reward, to pay or contribute to the costs of a party in instituting and conducting proceedings. As the majority (French CJ, Gummow, Hayne and Crennan JJ) pointed out, that proposition could not stand with the High Court's decision in *Fostif*. The absence of an indemnity for the costs of successful defendants was accordingly a crucial element of the alleged abuse.

The funding arrangement did not bear on the merits of the proceedings, nor on the way in which they were conducted. Rickard was not a nominal plaintiff and it was not suggested that the proceedings were conducted by or in the name of Rickard for any improper purpose.

The alleged unfairness occasioned to Jeffery & Katauskas arose because Rickard was impecunious and would not be able to meet a costs order against it, and had been placed in funds to litigate by a person who would not be liable to meet an adverse costs order. The latter aspect, the majority noted, is a product of the rules of court cutting down the otherwise general power given to courts in New South Wales.

The majority held that Jeffery & Katauskas' contention depended on one of two propositions:

- A general proposition condemning the funding for reward of another's litigation; or
- A proposition that, despite the provisions and principles governing security for costs, and despite the UCPR's general prohibition against ordering costs against non-parties, those who fund another's litigation for reward must agree to put the party who is funded in a position to meet any adverse costs order.

The first proposition is not consistent with the decision in *Fostif*.

The second proposition, in the majority's view, is too broad to be accepted. As stated, it would apply also to shareholders who support a company's claim, relatives who support an individual plaintiff's claim and banks who extend overdraft accommodation to a corporate plaintiff. Moreover, the majority considered that the proposition has no doctrinal root, and that it depends on circular reasoning.

Heydon J gave a detailed dissenting judgment in which each of the funder's arguments was considered and rejected. Perhaps at the heart of his Honour's reasoning was the argument which is apparent in the following passage at [61]:

> "If the court system is "primarily there" to enable to rights to be vindicated rather than to enable commercial profits to be made, it follows that a non-plaintiff who funds the plaintiff with the primary purpose of making commercial profits out of the litigation is behaving extraneously to the proper function of litigation, at least where the funder avoids responsibility for the costs of the defendant. It is behaviour outside the purpose which the process is supplied to serve. It is not making a legitimate use of that process. Rather it abuses that process."

Commentary

The decision in *Jeffery & Katauskas* supports the view that the rules of court set a high bar for obtaining a costs order against a third party, and cannot be invoked merely because the proceedings were funded by a litigation funder. The High Court's acknowledgment of this, in this context, will be welcome news to litigation funders because it confirms that, at least under the UCPR (and assuming the facts are the same as or similar to those in this case), they will be insulated from any liability to pay the costs of successful defendants.

Heydon J's dissenting remarks will no doubt resonate with successful defendants (and their insurers) in cases where litigation funding has been involved. A common feeling in such cases is that the funder has, to adopt an expression used by Heydon J, backed a horse to win without being responsible for paying a component of the sum wagered if the horse lost.

The reasons for this feeling are perhaps illustrated by observing that there is a qualitative difference between a non-party investing in litigation with the goal of obtaining access to the fruits of the litigation (whether it be a commercial litigation funder in the generally understood sense, or an entity with some connection to the parties who has identified an opportunity, as

seems to have been the case in *Jeffery & Katauskas*) and the actions of others mentioned in the majority judgment such as shareholders and banks, whose motivation is not necessarily the same.

Nevertheless, the High Court has held by a clear majority that Rule 42.3(2)(c) will not provide an avenue for a successful defendant to recover its costs from a litigation funder.

There remains a possible argument based on the Court's general power under section 14 of the *Civil Procedure Act* to dispense with any requirement of rules of court if satisfied that it is appropriate to do so in the circumstances of the case. Jeffery & Katauskas disavowed any reliance on this argument, and the High Court therefore did not need to consider it, but it is problematic. The majority observed that the section arguably limits its application to rules imposing some duty on parties and does not extend it to a rule imposing limitations on the power to order costs, a telling observation in a case where the issue did not have to be decided.

The decision in *Jeffery & Katauskas* has immediately prompted calls for legislative reform.[4] In the absence of reform, litigation funders will be encouraged by the High Court's position, and those funders who currently assume some risk by providing indemnities for adverse costs orders may in future be less inclined to do so.

The most obvious reason why a plaintiff would seek litigation funding is because the plaintiff lacks sufficient assets to fund the litigation itself, but that may not always be the case. There are other potential reasons why a plaintiff would consider seeking funding. Commercial litigation funders seek to offer products which attract litigants, and in the current economic climate there is likely to be an increase in proceedings being funded.

Where a claim is brought by a corporate plaintiff with limited assets and a litigation funder is involved, one way for the defendants to protect their position is by seeking security for costs. This was acknowledged in the majority judgment in *Jeffery & Katauskas*, and the involvement of a litigation funder may be a factor which the court takes into account in awarding security for costs, or awarding a higher amount of security than it would otherwise have done. This is an important issue to be considered when bringing and preparing for applications for security for costs.

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[4] "Review call for funded litigation", Australian Financial Review, 16 October 2009