# AN ECONOMIC PERSPECTIVE ON COSTS IN AUSTRALIAN CLASS ACTIONS

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*The Australian class action procedure has generated much controversy about how best to ensure that its costs do not outweigh its benefits. The increasing prevalence of litigation funding has further complicated the cost–benefit analysis. This article develops an economic framework for understanding the principal sources of costs in Australian class actions. In particular, information asymmetry among the key players in a class action generates agency costs, and the self-interested behaviours of these players may give rise to negative externalities on non-parties and the civil justice system. Yet measures to reduce agency costs and negative externalities may themselves give rise to costs, which we call preventive costs. These costs form part of our analysis. Our framework explains the core characteristics of Australian class action law and practice, and offers suggestions for ensuring that the costs of the class action procedure are fair and reasonable.*

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## I Introduction

The class action is based on the simple idea of pooling together numerous claims involving common issues.[1] Australia adopted a modern class action regime in 1991 with the stated purposes of facilitating access to justice, deterring wrongdoing and promoting the efficient use of court resources.[2] Three decades later, the Australian class action regimes continue to spark controversies among law reformers and others about how to ensure that their costs do not outweigh their benefits.[3] As Allsop CJ of the Federal Court has stated:

> One responsibility of the courts as a branch of government is to ensure … the scarce and valuable public resources that Parliament and the Executive devote to them are employed in a socially useful way.[4]

To help the courts discharge that responsibility and to inform ongoing law and policy reforms, this article offers an economic perspective on Australian class actions.

[1] See below Part II.

[2] Commonwealth, *Parliamentary Debates*, House of Representatives, 14 November 1991, 3174–6 (Michael Duffy, Attorney-General); Commonwealth, *Parliamentary Debates*, Senate, 13 November 1991, 3026 (Michael Tate, Minister for Justice and Consumer Affairs); Law Reform Commission, *Grouped Proceedings in the Federal Court* (Report No 46, October 1988) 8 [14] ('*ALRC 1988 Report*').

[3] See, eg, Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Litigation Funding and the Regulation of the Class Action Industry* (Report, December 2020) xiii–xiv ('*PJC Report*'); Australian Law Reform Commission, *Integrity, Fairness and Efficiency: An Inquiry into Class Action Proceedings and Third-Party Litigation Funders* (Final Report, December 2018) 25 [1.24] ('*ALRC 2018 Report*'); Victorian Law Reform Commission, *Access to Justice: Litigation Funding and Group Proceedings* (Report, March 2018) v–vi.

[4] Chief Justice Allsop, 'Class Actions' (Speech, Law Council of Australia Forum, 13 October 2016).

The main benefits of class actions are well known. First, class actions achieve economies of scale in civil litigation by resolving a large number of similar claims in one proceeding.[5] Secondly, class actions reduce the imbalance between small plaintiffs and a large defendant by allowing the plaintiffs to pool their resources into one proceeding against the defendant. Moreover, small plaintiffs are often dispersed and disorganised; voluntary organisation of collective action may be impossible and/or prohibitively costly. The class action mechanism mitigates this collective action problem by binding active and passive plaintiffs. In sum, through achieving economies of scale, reducing imbalance between the parties and facilitating collective action, class actions enhance access to justice and compensate plaintiffs who would otherwise not pursue their claims individually. For the same reasons, class actions assist to deter defendants who would otherwise not be sued individually for violating the substantive law.[6]

In this article, we explore ways to reduce the costs of the class action without undermining its benefits. Acceptance of the class action mechanism necessitates that some fair and reasonable level of costs must be incurred. These costs include the fair and reasonable costs of providing legal services and, increasingly, the costs of litigation funding.[7] Excessive or disproportionate levels of costs, however, are unnecessary and may undermine the benefits generated by class actions. The economic framework to be developed in this article focuses on three kinds of costs. The first kind is *agency costs*, meaning the costs that arise when a person (the principal) delegates some decision-making authority to another person (the agent) in situations involving conflicts of interest and information asymmetry.[8] The United States ('US') class action literature has analysed the agency costs that may arise in class actions.[9] This article adopts and builds upon that literature by applying it to the Australian class action regime, which has its own system of legal fees and costs that differs from the US.[10] Our close examination of third-party litigation funding of class actions,

[5] Edward Elgar, *Encyclopedia of Law and Economics*, vol 8 (at 2012) Procedural Law and Economics, '4 Class Action' 68 ('Encyclopedia of Law and Economics: Class Action').

[6] See generally ibid 68–72. See also below Part III(D), discussing the positive externalities of class actions.

[7] See *ALRC 2018 Report* (n 3), which found that the proportion of Federal Court class actions that 'received third-party litigation funding has grown overtime. … [W]ith funded class action proceedings filed in [2017–18] constituting 78% of all filed class actions': at 74 [3.19].

[8] See below Parts III(A)–(C). See Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305, 308.

[9] See, eg, Jensen and Meckling (n 8).

[10] See especially below nn 62–6, 152 and accompanying text.

which is prevalent in Australia but not in the US, also adds to the existing law and economics literature.[11] Secondly, we consider *externalities*, meaning the costs and benefits that the self-interested players of a class action inflict on others.[12] Thirdly, the measures employed to reduce agency costs and manage externalities can themselves be costly to formulate and implement. The costs of these measures, which we label *preventive costs*, should ideally be smaller than the gains that they generate in terms of reducing agency costs and negative externalities.

The main claim we advance is that the core rules and principles of Australian class action law can be understood and utilised as a collection of tools to reduce overall agency costs, negative externalities and preventive costs. The economic framework to be developed not only explains the core of Australian class action law, it also generates normative suggestions for consideration by judges, law reformers and others. Our ultimate goal is to contribute to efforts to ensure that the overall costs arising from the class action mechanism are fair and reasonable. Achieving this goal 'is an important part of maintaining public confidence in the administration of justice'.[13]

Part II will introduce the core characteristics of Australian class action law and practice. Part III will offer an economic framework to analyse the sources of unfair or unreasonable costs in class actions. Part IV will apply this economic framework to explain and evaluate the main doctrines of Australian class action law, and will propose reform suggestions. Part V will conclude.

[11] See generally below Parts III(D), IV(B)(2). To our best knowledge, the existing law and economics literature on class actions typically ignores or skims over third-party litigation funding, in part because that literature has a strong US focus and third-party funding of class actions is rare in the US. Cf Michael Duffy, 'Two's Company, Three's A Crowd? Regulating Third-Party Litigation Funding, Claimant Protection in the Tripartite Contract, and the Lens of Theory' (2016) 39(1) *University of New South Wales Law Journal* 165; Tyler W Hill, 'Financing the Class: Strengthening the Class Action through Third-Party Investment' (2015) 125(2) *Yale Law Journal* 484, 528 n 155; Alon Klement, Zvika Neeman and Moran Ofir, 'Auctioning Class Action Representation' (2021) *Journal of Law, Economics, and Organization* (advance). For non-economic approaches to analysing litigation funding in US class actions, see, eg, Deborah R Hensler, 'Third-Party Financing of Class Action Litigation in the United States: Will the Sky Fall?' (2014) 63(2) *DePaul Law Review* 499; Jasminka Kalajdzic, Peter Cashman and Alana Longmoore, 'Justice for Profit: A Comparative Analysis of Australian, Canadian and US Third Party Litigation Funding' (2013) 61(1) *American Journal of Comparative Law* 93.

[12] See below Part III(D).

[13] Allsop (n 4).

## II Class Actions in Australia

Class actions were introduced into Australia through the enactment of the *Federal Court of Australia Amendment Act 1991* (Cth) which provided for 'representative proceedings' through the insertion of pt IVA into the *Federal Court of Australia Act 1976* (Cth) ('*FCA Act*'). Part IVA of the *FCA Act* commenced on 4 March 1992.[14] A number of Australian states followed with similar legislative regimes.[15]

The legislation deals with many of the issues essential to a modern class action regime, including: requirements for commencement (seven or more persons with claims which are connected through 'same, similar or related circumstances' and the existence of a 'substantial common issue of law or fact');[16] standing for the representative party;[17] the adoption of an opt-out procedure where a group member does not need to consent to inclusion, but is part of the class action if they fall within the pleaded group definition and are subsequently afforded an opportunity to affirmatively exclude themselves;[18] and court oversight, especially in relation to ordering discontinuance of proceedings as a class action,[19] notices,[20] approval of settlement[21] and a general power to 'make any order the Court thinks appropriate or necessary to ensure that justice is done in the proceeding'.[22]

The essence of the class action is that it provides 'a procedure whereby the claims of many individuals against the same defendant can be brought or conducted by a single representative'.[23] The class action involves both the aggregation of group members into a juridical unit, and the appointment of a representative of that unit, called the representative party (or named as an applicant/plaintiff). Of equal importance are the facilitators of the class action: the

[14] *Federal Court of Australia Amendment Act 1991* (Cth) s 2.

[15] See, eg, *Civil Procedure Act 2005* (NSW) pt 10; *Civil Proceedings Act 2011* (Qld) pt 13A; *Supreme Court Civil Procedure Act 1932* (Tas) pt VII; *Supreme Court Act 1986* (Vic) pt 4A.

[16] *Federal Court of Australia Act 1976* (Cth) ss 33C(1)(b)–(c) ('*FCA Act*'). Unlike the US or Canada there is no certification of the proceeding as a class action before it can proceed.

[17] Ibid s 33D.

[18] Ibid ss 33E (consent of group member not required), 33J (right to opt out), 33ZB (if a group member falling within the defined class does not opt out then they are bound by the outcome of the proceedings).

[19] Ibid s 33N.

[20] Ibid ss 33X–33Y.

[21] Ibid s 33V.

[22] Ibid s 33ZF.

[23] *ALRC 1988 Report* (n 2) 1 [2].

plaintiff lawyers, who have carriage of the class action,[24] and the litigation funder. The traditional lawyer–client relationship exists in relation to the representative party, and possibly with some or all of the group members, but it is also possible that it does not exist with those group members who are not the representative party.[25] Similarly, a litigation funder that pays the lawyer's fees,[26] and indemnifies the representative party against an adverse costs order should the case fail (the loser-pays approach),[27] contracts with the representative party, and depending on the funder's approach, none, some, or all of the other group members.[28] However, unlike traditional litigation, often the claims and the representative party are identified by the lawyers and/or funder. Further, it is axiomatic that the group members do not direct the conduct of the proceeding, that role falls to the representative party.[29]

[24] For simplicity, 'plaintiff lawyers' in this article refers to lawyers who bring or act in class actions.

[25] *Dyczynski v Gibson* (2020) 280 FCR 583, 672 [378] (Lee J) ('*Dyczynski*').

[26] Lawyers acting with litigation funding typically use time-based billing, but, when no funder exists, the lawyer will employ a conditional-fee arrangement where the lawyer's fee only becomes payable to the lawyer if a successful outcome is achieved. Conditional billing may also be combined with an uplift fee agreement where the lawyer takes his or her usual fee plus an agreed amount or percentage of this usual fee, the uplift, if the action succeeds. The uplift is limited to 25 per cent. See, eg, *Legal Profession Uniform Law 2014* (NSW) ss 181–2; *Legal Profession Uniform Law Application Act 2014* (Vic) ss 181–2.

[27] Only the representative party is typically liable for the costs of the defendant if the class action is unsuccessful: *FCA Act* (n 16) s 43(1A).

[28] The litigation funders' approach has developed over time, from contracting with the representative party and as many group members as they could (book building), to seeking to limit the class action's membership to those who had contracted (a closed class), to then including all potential group members (an open class), and seeking orders from the court that those group members who had not contracted with the funder nonetheless be required to contribute to the cost of litigation funding. The High Court's rejection of common fund orders at the beginning of proceedings in *BMW Australia Ltd v Brewster* (2019) 269 CLR 574 ('*BMW*') may incentivise litigation funders to engage in more book building, combined with a closed class or a funding equalisation/common fund order at the end of proceedings. *Brewster v BMW Australia Ltd* [2020] NSWCA 272, [41]–[43] (Bell P, Bathurst CJ agreeing at [1], Payne JA agreeing at [49]) and *Davaria Pty Ltd v 7-Eleven Stores Pty Ltd* (2020) 281 FCR 501, 511–12 [49] (Lee J, Middleton J agreeing at 502 [1], Moshinsky J agreeing at 503 [4]), both held that the High Court had not determined that the courts lacked power to make common fund orders as part of a settlement or judgment at the end of proceedings. See generally Michael Legg, 'Litigation Funding of Australian Class Actions after the High Court Rejection of Common Fund Orders: BMW Australia Ltd v Brewster; Westpac Banking Corporation v Lenthall [2019] HCA 45' (2020) 39(4) *Civil Justice Quarterly* 305.

[29] *Mobil Oil Australia Pty Ltd v Victoria* (2002) 211 CLR 1, 31 [37]–[38] (Gaudron, Gummow and Hayne JJ) ('*Mobil Oil*'); *Dyczynski* (n 25) 600 [60] (Murphy and Colvin JJ).

In summary, the class actions regime and funding mechanisms give rise to a number of relationships among the representative party, group members, lawyers and any litigation funder. The next Part will develop an economic framework for understanding the dynamics of these relationships.

## III Economic Costs in Class Actions

This Part introduces an economic framework for understanding information asymmetry and externalities in class actions. Part IV below will explore how the Australian law of class actions may function to reduce the resulting agency costs and other costs.

### A *Moral Hazard on the Part of the Plaintiff Lawyers*

This Part introduces the concept of moral hazard, which is a well-known problem in principal–agent theory.[30] It is convenient first to consider an ordinary lawyer–client relationship. In this relationship, the lawyer (the agent) often has some discretionary decision-making authority, and their exercise of discretion may affect the interests of the client (the principal). The existence of such discretion means that the lawyer is unlikely to be bound by comprehensive, rule-like instructions that account for every eventuality. This may be due to the inability of the drafter of the retainer (or of the statutory or general law governing the lawyer–client relationship) to anticipate all contingencies that may arise. It may also be impractical or prohibitively costly to account for all possible anticipated contingencies. Thus lawyers who have a discretionary decision-making authority may exercise such discretion to respond to any unaccounted-for contingencies.

The lawyer is also typically subject to limited or no monitoring by the client.[31] First, that the client lacks the necessary skills and resources to undertake

[30] Jensen and Meckling (n 8) 308. See Bengt Holmström, 'Moral Hazard and Observability' (1979) 10(1) *Bell Journal of Economics* 74; Paul R Milgrom, 'Good News and Bad News: Representation Theorems and Applications' (1981) 12(2) *Bell Journal of Economics* 380, 385–6.

[31] The client's ability and willingness to monitor the lawyer will depend to a significant degree on the client's characteristics. For example, are they well-resourced, sophisticated, repeat players, such as a large corporation or bank with an in-house legal counsel/department, or are they an individual that is a one-shot litigant with limited funds who is generally unfamiliar with legal matters? See *P Dawson Nominees Pty Ltd v Brookfield Multiplex Ltd [No 4]* [2010] FCA 1029, [23] (Finkelstein J), referring to group members who were institutional investors and noting that '[m]ost, if not all, have in-house legal departments'. But see *Tredrea v KPMG Financial Advisory Services (Australia) Pty Ltd [No 3]* [2019] NSWSC 871, [101]–[102] (Parker J) ('*Tredrea*'), explaining that institutional investors might not challenge the fees sought by a litigation

the relevant legal tasks without assistance is usually the reason for engaging the lawyer; the same reason prevents the client from effectively monitoring the lawyer. Secondly, extensive monitoring can be very costly to the client. Thirdly, any observable and verifiable evidence of the lawyer's unmonitored behaviour tends to be imperfectly probative. For example, the client may inspect the lawyer's bills and timesheets, but these are imperfect records of the legal services actually rendered. In particular, the lawyer may not self-report shirking, unnecessary or excessive work, or wrongdoing.[32]

The combination of discretion and ineffective monitoring gives the lawyer opportunities to take hidden actions that benefit themselves at the expense of the client or of the lawyer–client relationship as a whole. The lawyer has an incentive to exploit such opportunities if their interests do not align perfectly with the client's. This problem is commonly called moral hazard. The resulting costs to the lawyer–client relationship are a source of agency costs.[33]

While moral hazard may affect any lawyer–client relationship, it tends to be particularly problematic when the lawyer acts for a representative party in a class action.[34] First, in many class actions, the aggregate claim of the plaintiff class is large, but the plaintiffs' individual stakes are generally small.[35] Thus the

funder because 'the marginal benefit from reducing the commission that [the funder] seeks would scarcely justify the effort and expense (potentially involving a costs liability should their opposition fail) of resisting the application'.

[32] See, eg, *Bolitho v Banksia Securities Ltd [No 6]* (2019) 63 VR 291, 325–31 [124]–[147] (John Dixon J) ('*Banksia [No 6]*'); *Bolitho v Banksia Securities Ltd [No 16]* [2021] VSC 9, [5], [8], [10] (John Dixon J) ('*Banksia [No 16]*'); *Bolitho v Banksia Securities Ltd [No 18]* [2021] VSC 666, [761], [1694], [2021]–[2122] (John Dixon J) ('*Banksia [No 18]*'), which concerned a dishonest and fraudulent scheme by the representative party's legal representatives, including both his counsel and solicitors, as well as the litigation funder, which the court-appointed contradictor successfully argued should result in the court exercising its jurisdiction to disallow the funder's claimed commission and legal costs. See also Simone Degeling and Michael Legg, 'Class Action Settlements, Opt-Out and Class Closure: Fiduciary Conflicts' (2017) 11(3) *Journal of Equity* 319, 338–9 ('Class Action Settlements, Opt-Out and Class Closure').

[33] Jensen and Meckling (n 8) 308–9.

[34] See, eg, John C Coffee Jr, 'The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action' (1987) 54(3) *University of Chicago Law Review* 877, 883–4 ('The Regulation of Entrepreneurial Litigation'); Michael Legg, 'Judge's Role in Settlement of Representative Proceedings: Lessons from United States Class Actions' (2004) 78(1) *Australian Law Journal* 58, 68, 70 ('Judge's Role in Settlement of Representative Proceedings').

[35] The size of a representative party's stake, and that of group members, may vary depending on the type of class action. For example, shareholder class actions may include institutional shareholders (who suffered large losses) or small shareholders. See, eg, Michael Legg, 'Institutional Investors and Shareholder Class Actions: The Law and Economics of Participation' (2007) 81(7) *Australian Law Journal* 478, 480, 489–90 ('Institutional Investors').

representative party often does not have enough at stake to justify the cost of extensive monitoring. Secondly, the representative party is often chosen by the plaintiff lawyers and they may well choose someone who is compliant.[36] Indeed the practice of making payments to the representative party to reimburse them for their efforts[37] may encourage compliance, particularly in relation to settlement. In addition, class actions tend to be more complex than individual actions,[38] and thereby render monitoring more costly. Thus, the plaintiff lawyers may take hidden actions that adversely affect the interests of the representative party.

Moral hazard also affects the relationship between the plaintiff lawyers and the passive group members. These group members are not known to the lawyers, or are prohibitively costly for the lawyers to consult.[39] They usually have small individual stakes, and do no more than collect their share of any judgment or settlement. Indeed, the class action is designed to facilitate passivity.[40] Passive group members engage in no monitoring, even though their interests are affected by the plaintiff lawyers' hidden actions. Thus, the plaintiff lawyers may act against the interests of the passive group members without detection.

Moral hazard in class actions not only hurts the representative and passive group members, but also undermines the benefits of the class action mechanism. For instance, without effective monitoring (including by the courts, as Part IV(B)(1) below will explain), the plaintiff lawyers may negotiate a 'sweetheart' settlement with the defendant, under which the plaintiff lawyers receive a large fee but the group members obtain a small benefit.[41] Through enriching the plaintiff lawyers at the expense of the group members, 'sweetheart' settlements impair the compensatory role of the class action mechanism. By

[36] 'Encyclopedia of Law and Economics: Class Action' (n 5) 73; Michael J Legg, 'Shareholder Class Actions in Australia — The Perfect Storm?' (2008) 31(3) *University of New South Wales Law Journal* 669, 697.

[37] See generally Vince Morabito, 'An Empirical and Comparative Study of Reimbursement Payments to Australia's Class Representatives and Active Class Members' (2014) 33(2) *Civil Justice Quarterly* 175.

[38] Michael Legg, 'Class Action Settlements in Australia: The Need for Greater Scrutiny' (2014) 38(2) *Melbourne University Law Review* 590, 591 ('Class Action Settlements in Australia').

[39] Passive group members are frequently, but not always, lay persons. See below n 159 and accompanying text.

[40] See *Mobil Oil* (n 29) 32 [40] (Gaudron, Gummow and Hayne JJ), stating that '[g]roup members, however, need take no positive step in the prosecution of the proceeding to judgment to gain whatever benefit its prosecution may bring'; *Melbourne City Investments Pty Ltd v Treasury Wine Estates Ltd* (2017) 252 FCR 1, 21 [73] (Jagot, Yates and Murphy JJ).

[41] See, eg, Bruce Hay and David Rosenberg, 'Sweetheart and Blackmail Settlements in Class Actions: Reality and Remedy' (2000) 75(4) *Notre Dame Law Review* 1377; 'Encyclopedia of Law and Economics: Class Action' (n 5) 73.

imposing a small liability on the defendant, 'sweetheart' settlements also undermine the deterrence effect of class actions.[42]

Moreover, free riding by some group members may exacerbate the moral hazard problem. In a class action, to the extent that the representative party monitors the plaintiff lawyers, they benefit not just themselves, but the passive group members as well. The passive group members enjoy the benefits of monitoring but may not contribute to its costs.[43] At the same time, the representative party is not enjoying all the fruits of their labour. This dampens their incentive to engage in extensive monitoring, assuming that high transaction costs preclude the formation of a contract among all members of the plaintiff class to share the monitoring costs.[44] While the practice of reimbursing a representative party for their costs, raised above, may offset the disincentives of monitoring due to free riding, reimbursement is conditional on a successful outcome and is limited to out-of-pocket expenses incurred in prosecuting the proceeding.[45]

### B *Moral Hazard and Adverse Selection in the Plaintiff Class*

The relationship between the representative party and the other group members gives rise to two kinds of agency problems. First, moral hazard may arise when the representative party makes trial or settlement decisions that affect the passive group members. Subject to limited or no monitoring by the passive group members, the representative party may participate in trial preparation, settlement negotiation and other activities that affect the outcome of the class

[42] See 'Encyclopedia of Law and Economics: Class Action' (n 5) 74 and the literature surveyed therein.

[43] See, eg, ibid 73; Coffee, 'The Regulation of Entrepreneurial Litigation' (n 34) 884. In the Australian context, free riding has also arisen in the form of some group members enjoying a share of any settlement or other benefits of legal representation without contributing to costs, particularly where those costs were initially met by litigation funders. See, eg, *BMW* (n 28) 626–7 [131]–[132], 637 [167]–[169] (Gordon J); *Perera v GetSwift Ltd* (2018) 263 FCR 1, 14 [25] (Lee J); *Botsman v Bolitho [No 1]* (2018) 57 VR 68, 113–14 [214]–[216] (Tate, Whelan and Niall JJA) ('*Botsman*'); Samuel Issacharoff and Thad Eagles, 'The Australian Alternative: A View from Abroad of Recent Developments in Securities Class Actions' (2015) 38(1) *University of New South Wales Law Journal* 179, 197–8, 203; Michael Legg, 'Ramifications of the Recognition of a Common Fund in Australian Class Actions: An Early Appraisal' (2017) 91(8) *Australian Law Journal* 655, 657, 659; *ALRC 2018 Report* (n 3) 67 [2.73]; *PJC Report* (n 3) 96 [9.9].

[44] See generally RH Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1.

[45] See, eg, *Darwalla Milling Co Pty Ltd v F Hoffman-La Roche Ltd [No 2]* (2006) 236 ALR 322, 346–55 [74]–[93] (Jessup J); *Endeavour River Pty Ltd v MG Responsible Entity Ltd* [2019] FCA 1719, [19] (Murphy J) ('*Endeavour*').

action. These unmonitored activities may affect the evidence and arguments put forward on the common questions that are presented for judicial resolution. They may also affect the terms of a settlement that is presented for judicial approval. The 'statutory estoppel' that arises from the determination of the common questions or approval of the settlement binds the passive group members.[46] As previous work has recognised, 'it should not be assumed, even in the case where class members have *claims which are* congruent, that their *interests* align'.[47] The fact that the representative party may make unmonitored decisions affecting the interests of the group members is a source of moral hazard. By the same token, moral hazard also arises when the representative party shirks decision-making or fails to monitor the plaintiff lawyers to the detriment of group members.

For example, in *Kelly v Willmott Forests Ltd (in liq) [No 4]* ('*Kelly*'), several investors in some failed forestry plantation managed investment schemes brought class actions against, inter alia, the responsible entities in the schemes and the lenders who provided finance to some of the investors.[48] The claims centred on alleged omissions and misleading statements in the product disclosure statements.[49] One of the defendants proposed a settlement that provided modest benefits to the representative parties and those group members who elected to make a claim and contribute to security for costs. Such modest benefits essentially covered the legal costs incurred by the plaintiff class, monies paid as security for costs, and any costs of after-the-event insurance taken out.[50] However, the proposed settlement provided no benefit to the passive group members who took no action, yet obliged all members to give up their claims. Moreover, the proposed settlement included binding admissions that the group members' loan agreements with the lenders were valid and enforceable, which would cause 'significant detriment' to some members by precluding them from defending loan enforcement proceedings by the lenders.[51] While the representative parties sought judicial approval of the proposed settlement, the subset of group members who would be disadvantaged by the binding admissions and other passive group members had an interest in letting the class action

[46] *Dyczynski* (n 25) 665 [339], [342] (Lee J), discussing *FCA Act* (n 16) s 33ZB.

[47] Degeling and Legg, 'Class Action Settlements, Opt-Out and Class Closure' (n 32) 322 (emphasis in original).

[48] (2016) 335 ALR 439, 443 [2] (Murphy J) ('*Kelly*').

[49] Ibid 445–6 [14]–[16] (Murphy J).

[50] Ibid 459 [97] (Murphy J).

[51] Ibid 444 [6] (Murphy J).

continue.[52] This was an example of moral hazard on the part of the representative parties, in the form of acceding to and supporting a settlement that benefits themselves but adversely affects the interests of the passive group members.

Secondly, the relationship between the representative party and the other group members is affected by adverse selection — another well-known problem in principal–agent theory.[53] Australian class actions are defined by reference to 'claims' which are linked through 'same, similar or related circumstances' and the existence of 'a substantial common issue of law or fact'.[54] The ensuing focus on the common questions presented in the plaintiffs' claims necessarily disregards heterogeneous characteristics that could be legally relevant if those claims were pursued individually. The plaintiffs' heterogeneous characteristics are hidden from the court and the plaintiff lawyers.[55] Moreover, any judgment or settlement may be calculated on an average basis, disregarding these hidden characteristics.[56] As a result, some plaintiffs with above-average individual claims may prefer to opt out of the class action and sue individually, while some plaintiffs with below-average individual claims may prefer to stay in the action. Any judgment or settlement will then be calculated on the basis of a low or moderate average. This is the problem of adverse selection in class actions.[57]

[52] Ibid 444 [9] (Murphy J), discussed in Degeling and Legg, 'Class Action Settlements, Opt-Out and Class Closure' (n 32) 337.

[53] See, eg, George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84(3) *Quarterly Journal of Economics* 488, 493.

[54] *FCA Act* (n 16) ss 33C(1)(b)–(c).

[55] Simone Degeling and Michael Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions: Conflict between Duties' (2014) 37(3) *University of New South Wales Law Journal* 914, 917, 923 ('Fiduciary Obligations of Lawyers in Australian Class Actions'), describing group members as 'known unknowns'.

[56] Rony Kishinevsky, 'Damage Averaging: How the System Harms High-Value Claims' (2017) 95(5) *Texas Law Review* 1143, 1145–7; Michael Legg, 'Class Action Settlement Distribution in Australia: Compensation on the Merits or Rough Justice?' (2016) 16 *Macquarie Law Journal* 89, 97–9, 101; Rebecca Gilsenan and Michael Legg, 'Australian Class Action Settlement Distribution Scheme Design — Deciding Who Gets What' (2019) 38(1) *University of Queensland Law Journal* 15, 26–8; The American Law Institute, *Principles of the Law* (online at 23 May 2022) Aggregate Litigation, '1 Definitions and General Principles' § 1.04.

[57] Coffee, 'The Regulation of Entrepreneurial Litigation' (n 34) 906–7; 'Encyclopedia of Law and Economics: Class Action' (n 5) 75–6. The adverse selection problem does not necessarily discourage all plaintiffs with strong claims to opt out, nor does it encourage all plaintiffs with weak claims to stay in: see Yeon-Koo Che, 'Equilibrium Formation of Class Action Suits' (1996) 62(3) *Journal of Public Economics* 339; Yeon-Koo Che, 'The Economics of Collective Negotiation in Pretrial Bargaining' (2002) 43(2) *International Economic Review* 549, 570.

For an example of adverse selection in Australian class actions, consider the class action against packaging groups Amcor and Visy over their price-fixing cartel, which ran for five years and resulted in a total settlement sum of $120 million.[58] Cadbury opted out of the class action and brought its own action. According to its legal representative, Cadbury did so in part to ensure that its case 'was not tarnished by the weaknesses in other class members' claims'.[59] The legal representative further stated that Cadbury's own action settled two to three years quicker than the class action and obtained a financial benefit that was about 20 times greater than what it would have obtained if it had stayed in the class action.[60] If such anecdotal evidence is correct, then this case provides an example of adverse selection in the form of an above-average plaintiff opting out of the class action and reducing the average strength of the remaining claims.

As Robert Bone wrote in respect of US class actions:

> Adverse selection is costly for two reasons. First, it undermines the efficiency of the class device by encouraging class members to litigate separately and by diverting social resources to compensate low value claims. Second, adverse selection exacerbates agency problems by driving high value plaintiffs out of the class and making it even less likely that the remaining class members will have enough at stake to monitor the class attorney.[61]

Adverse selection may be less problematic in Australia than in the US. Unlike prevailing American law, Australian law generally allows the winners of litigation to recover some or all of their legal costs from the losers. This loser-pays rule applies by default in both individual litigation and class actions.[62] An implication of this rule is that plaintiffs are unlikely to sue if their prospects of success are low; they are likely to lose and become liable to pay the defendants' costs.[63] As a result, weak claims are unlikely to proceed to litigation individually.

[58] *Jarra Creek Central Packing Shed Pty Ltd v Amcor Ltd* [2011] FCA 671, [4], [9] (Jacobson J) ('*Jarra Creek*').

[59] Interview with Domenic Gatto, 'A Case for Independent Action Rather than Class Action Participation — Cadbury v Amcor' (King & Wood Mallesons, 15 September 2015) 00:00:57–00:00:59 <https://cmkwmlive.kwm.com/en/au/knowledge/insights/independent-or-class-action-cadbury-amcor-20150915>.

[60] Ibid 00:01:07–00:01:23.

[61] 'Encyclopedia of Law and Economics: Class Action' (n 5) 76–7.

[62] Legg, 'Institutional Investors' (n 35) 482–3. See also *Northern Territory v Sangare* (2019) 265 CLR 164, 172–3 [24]–[25] (Kiefel CJ, Bell, Gageler, Keane and Nettle JJ).

[63] See generally Edward Elgar, *Encyclopedia of Law and Economics*, vol 8 (at 2012) Procedural Law and Economics, '10 Fee Shifting' 279–80 ('Encyclopedia of Law and Economics: Fee Shifting').

Similarly, the loser-pays rule may also deter those class actions that have been weakened by the inclusion of too many weak claims. This is in part because litigation funders usually provide an indemnity against the risk of becoming liable to pay the defendant's costs. Funders may be reluctant to fund class actions that carry a high risk of liability for costs. Moreover, the financial reward for plaintiff lawyers is usually tied to the outcome for the group.[64] On one view, this may encourage the inclusion of any viable claim in an effort to increase recovery for the group as a whole. However, too many weak claims may be counterproductive. Weak claims may arm defendants with arguments for reducing global settlement offers, assuming they have information about group member claims.[65] Equally, group members with strong claims may have an incentive to opt out due to concerns about damages averaging, as explained above. Knowing this, the plaintiff lawyers may not want to include too many weak claims. Overall, the loser-pays rule and the incentives of funders and plaintiff lawyers may mitigate the adverse selection problem in Australia.[66]

### C *Moral Hazard and Litigation Funders*

Litigation funding is increasingly common in Australian class actions, especially in shareholder class actions.[67] As explained in Part II, a litigation funding arrangement is typically a contract between a funder and some or all members of the plaintiff class, but always including the representative party. The funder is usually a profit-oriented entity that funds a portfolio of cases to further their commercial interests.[68] The litigation funding contract obliges the funder to pay the group members' legal costs and, usually, indemnify the group members in the event that they become liable to pay the defendant's costs. In return, if the proceedings are successful, the group members will typically pay the funder a percentage (usually 20–30 per cent) of any recovery received by way of

[64] See below Part IV(B)(4).

[65] David Taylor and Annie Leeks, 'Mediation in Shareholder Class Actions: A Defendant's Perspective' [2015] (May) *Australian Alternative Dispute Resolution Bulletin* 34, 34–5.

[66] In fact, some American scholars have raised the possibility of adopting the loser-pays rule in the US: see, eg, Deborah R Hensler and Thomas D Rowe Jr, 'Beyond "It Just Ain't Worth It": Alternative Strategies for Damage Class Action Reform' (2001) 64(2–3) *Law and Contemporary Problems* 137, 147–60.

[67] *ALRC 2018 Report* (n 3) 74–7 [3.18]–[3.24].

[68] Legg, 'Class Action Settlements in Australia' (n 38) 602–3.

settlement or judgment, reimburse the funder for the legal fees it incurs, and assign to the funder the benefit of any costs order.[69]

The advent of litigation funding adds to, or alters, the agency analysis in Australian class actions.[70] The funder is usually sufficiently well resourced to monitor the plaintiff lawyers, and its monitoring efforts may mitigate (but not eliminate) the moral hazard problem in the relationship between the representative party/passive group members and the plaintiff lawyers.[71] However, the funder's interests are not perfectly aligned with the representative party/passive group members' interests. While both the funder and the representative party/passive group members benefit from maximisation of the expected settlement sum, the repayment of legal fees by group members from any settlement does not reduce the funder's fee but does reduce the group members' recovery. Moreover, the ongoing or repeat business relationship between the litigation funder and the plaintiff lawyers may undermine effective monitoring of the plaintiff lawyers.[72] Overall, the funder is unlikely to exert enough monitoring efforts to eliminate moral hazard in the relationship between the representative party/passive group members and the plaintiff lawyer.

A new moral hazard problem also arises when there is a conflict of interest between the funder and the representative party/passive group members. Through the lens of principal–agent theory, the funder is the agent while the representative party/passive group members are the principal. While the litigation funding contract may have conflict resolution provisions covering select instances,[73] it is unlikely to account for every eventuality. The funder is usually subject to limited or no monitoring by the representative party/passive group members.[74] Thus, the funder has opportunities to take hidden actions that benefit itself at the expense of the representative party/passive group members, or at the expense of the contractual relationship as a whole.[75] Indeed, an obvious

[69] Michael Legg, 'The Rise and Regulation of Litigation Funding in Australian Class Actions' (2021) 14(4) *Erasmus Law Review* 221, 223; *ALRC 2018 Report* (n 3) 49 [2.10].

[70] Legg, 'Class Action Settlements in Australia' (n 38) 593.

[71] Duffy (n 11) 187–8; Legg, 'Institutional Investors' (n 35) 485; Kalajdzic, Cashman and Longmoore (n 11) 101; *QPSX Ltd v Ericsson Australia Pty Ltd [No 3]* (2005) 219 ALR 1, 13–14 [54] (French J).

[72] *Tredrea* (n 31) [134]–[135] (Parker J).

[73] For example, many funding agreements require the plaintiff lawyers to prioritise the representative party's instructions over the funder's except in relation to settlement. See *PJC Report* (n 3) 261–3 [15.25]–[15.30].

[74] *Botsman* (n 43) 136 [335] (Tate, Whelan and Niall JJA).

[75] See generally Simone Degeling and Michael Legg, 'Fiduciaries and Funders: Litigation Funders in Australian Class Actions' (2017) 36(2) *Civil Justice Quarterly* 244, 247 ('Fiduciaries and Funders').

potential conflict between the funder and the representative party/passive group members is in relation to the size of any commission that is payable to the funder.[76] Further, the funder may pressure the plaintiff lawyers to facilitate acceptance of a small settlement in order to avoid the risk of trial, even though the settlement insufficiently compensates some or all of the group members.[77] The plaintiff lawyers may well assist the funder rather than the group members because their relationship with the funder is more lucrative and ongoing.[78]

Finally, unlike the plaintiff lawyers, the funder is not an officer of the court, and its contractual arrangement with the group members is not subject to the taxation of costs process.[79] The courts, referring to s 33V of the *FCA Act*, have reviewed the funder's fee in some cases but the power to alter that fee is unclear.[80] As a result, the moral hazard problem in the relationship between the representative party/passive group members and the funder may be more severe than that between the representative party/passive group members and the plaintiff lawyers.

### D *Externalities: Costs and Benefits to Non-Parties*

The analysis so far concerns the agency costs arising from the principal–agent relationships among the key players of a particular class action. A class action can also generate costs and benefits to other persons external to the class action. These costs and benefits are called externalities,[81] which the self-interested players in a class action have no incentive to consider.

First, just like individual actions, class actions can give the courts opportunities to reduce uncertainty in the law and generate precedent. These opportunities are particularly valuable in relation to consumer law and other areas of law that usually do not attract individual actions given the small size of individual claims. Reduction in legal uncertainty and the generation of precedent can benefit non-parties by making it easier and less costly to comply with the

[76] *Botsman* (n 43) 135 [330] (Tate, Whelan and Niall JJA).

[77] Legg, 'Class Action Settlements in Australia' (n 38) 593–4.

[78] Michael Legg, 'Entrepreneurs and Figureheads: Addressing Multiple Class Actions and Conflicts of Interest' (2009) 32(3) *University of New South Wales Law Journal* 909, 926. See, eg, *Banksia [No 16]* (n 32) [5]–[10] (John Dixon J).

[79] Legg, 'Class Action Settlements in Australia' (n 38) 603.

[80] See *Endeavour* (n 45) [33] (Murphy J).

[81] Joshua Gans et al, *Principles of Microeconomics* (Cengage Learning, 8th ed, 2021) 203.

law and by offering guidance for the resolution of future disputes.[82] Such benefits are positive externalities, and the players in a class action usually enjoy no financial reward for taking these benefits into account when they make filing, defending or settlement decisions.[83]

Secondly, class actions often require extensive judicial management and supervision.[84] As a result, class actions often consume significant court time and resources. What this entails in terms of externalities depends on the counterfactual: what would the group members have done if the class action mechanism were unavailable? In cases where the group members would not have litigated individually, the availability of the class action procedure reduces the judicial time and resources that will be available for other actions. In these cases, the class action generates negative externalities on other actions that also demand judicial attention, and the players in the class action have no incentive to account for these negative externalities.[85] However, in cases where the group members would still have litigated even if they could not commence a class action, the availability of the class action mechanism generates economies of scale to the advantage of the justice system, given only one case (rather than many) needs to be managed and resolved. This advantage to the justice system generates a positive externality, which the players in the class action do not have an incentive to consider.

Thirdly, the manner in which class actions are conducted can affect the public's perception of the fairness and integrity of the judicial system. Past research has shown that when procedural fairness is observed, members of the public are more willing to comply with the law and have confidence in the civil litigation system.[86] By giving both sides of a dispute a fair and equal opportunity to present their case, procedural fairness also promotes accuracy in the judicial

[82] See, eg, Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42(3) *Duke Law Journal* 557, 562–3, 577–9. Reduced legal uncertainty also promotes the liberal ideal of the rule of law by giving fair notice to individuals of the legal consequences of their actions and holding public officials accountable for their exercise of public power. See generally Jeremy Waldron, 'The Rule of Law', *Stanford Encyclopedia of Philosophy* (Web Page, 22 June 2016) § 6 <https://plato.stanford.edu/entries/rule-of-law>, archived at <https://perma.cc/9JT3-WGPA>.

[83] See Steven Shavell, 'The Fundamental Divergence between the Private and the Social Motive to Use the Legal System' (1997) 26(2) *Journal of Legal Studies* 575, 575, 584.

[84] See Michael Legg, *Case Management and Complex Civil Litigation* (Federation Press, 2nd ed, 2022) ch 8, addressing case management of class actions.

[85] See Shavell (n 83) 575, 584.

[86] See generally Waldron (n 82) §§ 2, 5.2; Michael Legg, 'Reconciling the Goals of Minimising Cost and Delay with the Principle of a Fair Trial in the Australian Civil Justice System' (2014) 33(2) *Civil Justice Quarterly* 157, 157, 168–9 ('Reconciling Goals').

finding of facts and application of the law.[87] Greater accuracy in judicial decision-making tends to encourage potential injurers to learn about the actual consequences of their actions and take precautions accordingly.[88] The observance of procedural fairness in a class action therefore generates positive externalities. Conversely, non-observance of procedural fairness in a class action, such as binding group members to outcomes where they receive no notice or their interests are not represented, generates negative externalities in terms of undermining public confidence in the civil litigation system and reducing willingness to comply with the law. While both class actions and individual actions can positively or negatively affect public perception, the large amount in dispute in class actions tends to attract more media attention. Self-interested players in a class action usually have no financial incentive to take public perception of the civil justice system into account.[89] That said, repeat players such as plaintiff lawyers and litigation funders have an incentive to develop a positive reputation for their own benefit. A positive reputation is helpful for encouraging future group members to be part of a class action.

## IV The Economic Functions of Australian Class Action Law

Guided by Part III above, Figure 1 depicts the principal–agent relationships among the key players in a class action. The arrows represent the usual 'direction' of power in these relationships.

[87] See Emir Kamenica, 'Bayesian Persuasion and Information Design' (2019) 11 *Annual Review of Economics* 249, 263–7; Legg, 'Reconciling Goals' (n 86) 168.

[88] See generally Louis Kaplow and Steven Shavell, 'Accuracy in the Assessment of Damages' (1996) 39(1) *Journal of Law and Economics* 191, 191–3.

[89] See Shavell (n 83) 575, 584.

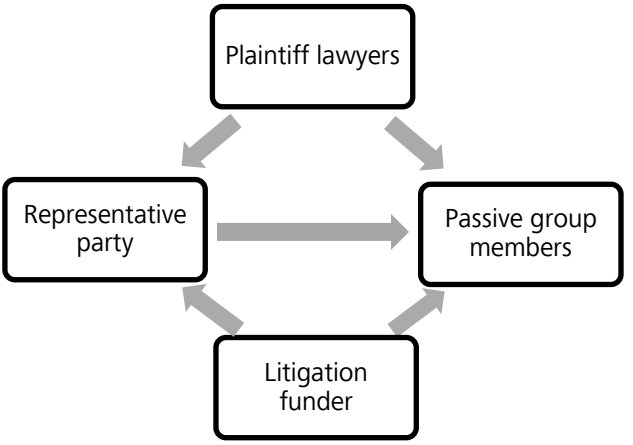


*Figure 1: principal–agent relationships in class actions*

Whilst all of these relationships may generate agency costs, Part III has drawn attention to moral hazard in the relationship between the representative party/passive group members and the plaintiff lawyers, in the passive group members–representative party relationship, and in the representative party/passive group members–litigation funder relationship. This Part will argue that the Australian law of class actions supplies a collection of tools that courts and lawyers may apply to tackle moral hazard and to manage externalities.

### A *Measures to Reduce Agency Costs: Bonding, Monitoring and Relational Sanctions*

This Part lays the conceptual foundation for understanding three kinds of measures to tackle moral hazard, which will ground the subsequent analysis of Australian class action law. While moral hazard can generate agency costs, measures taken to address the problem are also costly to design and implement.[90] Recall that conflicts of interest and ineffective monitoring give rise to the moral hazard problem.[91] This problem may be ameliorated by enhanced monitoring and/or bonding — meaning improved alignment of incentives.[92]

[90] See, eg, Jensen and Meckling (n 8) 308–9.

[91] See above Parts III(A)–(C).

[92] See, eg, Jensen and Meckling (n 8) 308; Charles J Goetz and Robert E Scott, 'Principles of Relational Contracts' (1981) 67(6) *Virginia Law Review* 1089, 1093.

Legal or extra-legal devices that enhance monitoring in turn reduce agency costs by making it harder for the agent to hide any shirking, excessive work or wrongdoing, but these devices are generally costly to implement. The benefits of enhanced monitoring may or may not justify its preventive costs. Bonding devices, on the other hand, aim to improve alignment of the agent's interests with the principal's so that the agent becomes less incentivised to misuse the agent's discretion. Bonding devices can also be costly to implement, thus both the benefits and costs of enhanced bonding need to be taken into account.

In addition to better monitoring and bonding, measures to harness reputational concerns can mitigate the moral hazard problem.[93] Reputational concerns arise when the principal and agent are in an ongoing relationship that exhibits repeated dealings. If the principal suspects that the agent is engaging in shirking, excessive work or wrongdoing, then the principal may be inclined to pay the agent less, or refuse to hire the agent again in the future. Moral hazard on the part of the agent is mitigated if they find the ongoing relationship with the principal sufficiently valuable. However, relational sanctions are not costless. For instance, imposition of relational sanction by way of not hiring the agent in the future hurts the principal if the principal finds it difficult or costly to secure the services of another agent. The principal may also impose a reputational sanction on the agent by mistake; the agent's performance is imperfectly monitored, hence any detection of misconduct is unlikely to be completely accurate. The parties may not be patient enough to wait for reliable evidence of the agent's performance to accumulate over time.[94]

In general, reduction of overall agency costs and preventive costs benefits all key players in a class action. For instance, if moral hazard on the part of the plaintiff lawyers is mitigated, then they are less incentivised to engage in misconduct, which in turn benefits the representative party and the passive group members. As misconduct by the plaintiff lawyers becomes less likely, the group members will be inclined to see costs as fair and be more accepting of the amount.

Agency costs are not the only variables that should be taken into account in choosing and formulating legal measures to tackle agency problems. In

[93] See, eg, Jonathan Levin, 'Relational Incentive Contracts' (2003) 93(3) *American Economic Review* 835, 835; George Baker, Robert Gibbons and Kevin J Murphy, 'Relational Contracts and the Theory of the Firm' (2002) 117(1) *Quarterly Journal of Economics* 39.

[94] See generally Roy Radner, 'Repeated Principal–Agent Games with Discounting' (1985) 53(5) *Econometrica* 1173; Roy Radner, Roger Myerson and Eric Maskin, 'An Example of a Repeated Partnership Game with Discounting and with Uniformly Inefficient Equilibria' (1986) 53(1) *Review of Economic Studies* 59.

particular, measures that undermine procedural fairness can harm the parties to a particular class action, especially the loser(s), by undermining their confidence in the civil litigation system and willingness to comply with any judicial order.[95] Measures that undermine procedural fairness also generate negative externalities on the public's perception of the fairness and integrity of the judicial system. Thus, while a sought-after reduction in agency costs must be compared with preventive costs in seeking an optimal outcome, attention must also be paid to externalities. The incurrence of preventive costs to reduce agency costs may also reduce negative externalities or increase positive externalities.

### B *Managing Agency Costs and Externalities in Australian Class Actions*

This Part applies the economic framework we have developed to analyse the core tools for managing agency costs and externalities in Australian class actions. Aiming to reduce unfair or unreasonable costs, this Part will also propose reforms to some of these tools.

#### 1 *Judicial Oversight and Selection of Legal Tools to Manage Agency Costs and Externalities*

As Part II has discussed, class actions are often subject to extensive judicial management and oversight. From the perspective of principal–agent theory, extensive judicial involvement can enhance monitoring of the plaintiff lawyers, the representative party, and any litigation funder. Such enhanced monitoring can then mitigate (but not eliminate) moral hazard in the principal–agent relationships in class actions. Moreover, having oversight over settlements enables the court to enhance bonding by declining to approve settlements that reveal a significant conflict of interest between the plaintiff lawyers and some or all of the group members.[96] A further benefit of effective judicial oversight is the generation of positive externalities through ensuring fairness and aiding in the legitimacy of the justice system.[97]

However, judicial oversight of class actions is not perfect. Extensive judicial involvement is costly not just to the court but to the litigants as well.[98] By diverting judicial time and resources from other cases, extensive judicial management of class actions also generates negative externalities.[99] A further problem

[95] See above Part III(D).

[96] Degeling and Legg, 'Class Action Settlements, Opt-Out and Class Closure' (n 32) 338, 344.

[97] See above Part III(D).

[98] See generally Roger Bernstein, 'Judicial Economy and Class Actions' (1978) 7(2) *Journal of Legal Studies* 349.

[99] See above Part III(D).

is that, regardless of how extensive judicial involvement may be, the court generally remains a recipient of information proffered by the lawyers.[100] Group members may also provide information, such as when objecting to a settlement.[101] The court does not generally act on its own motion or carry out investigations into the conduct of a class action.[102] However, the court may improve the quality of information and assistance it receives by appointing contradictors, referees and costs experts, although such appointment increases the costs of the class action.[103] Hence judicial oversight alone cannot cost-effectively eliminate moral hazard in class actions.

While the courts cannot eliminate moral hazard, they may nonetheless reduce the resulting agency costs and manage externalities by *selectively* applying some of the legal tools provided by class action law.[104] As the following Parts will argue, the costs and benefits of these legal tools vary depending on the particular circumstances of the case. We will offer suggestions as to how judicial discretion may be exercised to select the 'right' set of legal tools in a particular case.

The economic analysis to be developed is qualitative; we will describe and analyse agency costs, externalities and preventive costs in Australian class actions but will not provide quantitative estimates. For instance, we will not make

[100] Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 933; Jeremy Kirk, 'The Case for Contradictors in Approving Class Action Settlements' (2018) 92(9) *Australian Law Journal* 716, 719–20.

[101] See, eg, *Cantor v Audi Australia Pty Ltd [No 5]* [2020] FCA 637, [241]–[242] (Foster J); *Kelly* (n 48) 447–8 [27]–[28] (Murphy J); *Stanford v DePuy International Ltd [No 6]* [2016] FCA 1452, [82]–[83] (Wigney J).

[102] See *Webster (Trustee) v Murray Goulburn Co-Operative Co Ltd [No 5]* [2020] FCA 1405, [3] (Murphy J). Justice Murphy, on the Court's own motion, wrote to the parties, the litigation funder and contradictor to ascertain whether any of them wished to apply to the Court, including to revisit the approval of legal costs and litigation funding charges after the plaintiff's lawyers and litigation funders had been the subject of serious allegations of impropriety in another class action. None of the parties expressed a wish to apply to the Court, and the contradictor informed the Court that it did not intend to make any application at this stage. Consequently, the Court took no further steps at that time.

[103] See below Part IV(B)(7).

[104] Some of the legal tools discussed are applied by judicial discretion, for example, the appointment of a contradictor (see below Part IV(B)(7)) and notices where no claim for damages is included (*FCA Act* (n 16) s 33X(2)). Some other tools involve less discretion as they are pre-existing or mandatory standards of conduct — for example, fiduciary duties and adequacy of representation: see below Parts IV(B)(2)–(3). Moreover, there is a judicial discretion over the choice of remedy for breach of fiduciary duty and the award of any allowance to the errant fiduciary. See also below nn 137–40 and accompanying text.

any empirical claim that agency costs are greater or smaller than negative externalities. Future research may potentially take a quantitative approach to test our qualitative propositions. Any such empirical research should not steer focus away from the particular case at bar towards undue generalisations. With or without the benefit of empirical research, our qualitative analysis can offer guidance to judges and practitioners who have to make value judgments in individual cases.

Australian courts must frequently make value judgments without guidance from empirical research. In the case management system of civil litigation that prevails in Australia, the courts have an overriding obligation to facilitate the just, efficient and timely resolution of civil proceedings.[105] 'There is no class action exception' to the overriding obligation.[106] The courts are obliged to balance the values of justice, cost and delay not just in a particular case, but in the civil litigation system as a whole.[107] The exact and relative weight given to these values is a matter of judicial discretion. With or without guidance from empirical research, the courts are required to, and have been, making value judgments.

The balancing act we call for is not materially different from what Australian courts have already been doing in the case management context. Agency costs in class actions are costs to the parties, which the courts have been able to value in making case management decisions. Given the factor of justice encompasses procedural fairness,[108] the courts are also capable of considering externalities that impact the public's perception of procedural fairness in class actions. Moreover, the courts can account for the factors of efficiency and delay; this enables them to consider the negative externalities that arise when some class actions divert court time and resources from, and cause delay in, other actions. Similarly, the courts can consider the positive externalities arising from some class actions generating economies of scale to the courts themselves. Finally, preventive costs are costs to the parties and the civil justice system, and the courts have been able to weigh the cost factor. In other words, if we accept that the courts can make value judgments regarding justice, cost and delay in the case management context (with or without guidance from empirical research), then it

105 *Aon Risk Services Australia Ltd v Australian National University* (2009) 239 CLR 175, 217 [111] (Gummow, Hayne, Crennan, Kiefel and Bell JJ). While this case concerned the *Court Procedures Rules 2006* (ACT) r 21, other Australian jurisdictions have adopted equivalent overriding purpose provisions: see, eg, *Civil Procedure Act 2005* (NSW) s 56. See generally Legg, 'Reconciling Goals' (n 86) 166–7.

106 Allsop (n 4).

107 Legg, 'Reconciling Goals' (n 86) 159, 165–6.

108 Ibid 168–9.

logically follows that the courts can also make value judgments using our economic framework.

### 2 *Fiduciary Duties*

Fiduciary duties can function to enhance bonding in the principal–agent relationships in class actions. The fiduciary duty of loyalty requires fiduciaries to avoid any unauthorised conflict of interest or personal profit.[109] Good faith on the part of the fiduciary does not excuse a breach of fiduciary duty.[110] Through the lens of the principal–agent theory, fiduciary duties function as a bonding device that ameliorates the conflict of interest between the fiduciary (agent) and the beneficiary (principal).[111] Fiduciary duties deter fiduciaries from placing themselves in a position of conflict in part by disgorging any personal gain arising from that position.[112] The availability of disgorgement remedies adds to the deterrent effect of compensatory remedies.[113] In addition, fiduciary duties are couched in morality rhetoric;[114] a finding of breach can impose on the fiduciary informal costs of guilt and moral opprobrium.[115] As long as the fiduciary is more likely to engage in misconduct when they have a conflict of interest, prohibition of conflicts is a prophylactic measure to deter misconduct.[116]

[109] *Keech v Sandford* (1726) Sel Cas T King 61; 25 ER 223, 223 (Lord King LC). See generally Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing, 2010) 40–4 ('*Fiduciary Loyalty*').

[110] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134, 143, 145 (Lord Russell), 153 (Lord Macmillan), 154 (Lord Wright), 158 (Lord Porter).

[111] Goetz and Scott (n 92) 1092–3, 1127–8; Robert H Sitkoff, 'An Economic Theory of Fiduciary Law' in Andrew S Gold and Paul B Miller (eds), *Philosophical Foundations of Fiduciary Law* (Oxford University Press, 2014) 197, 201–2, 206–7.

[112] See Sitkoff (n 111) 197, 201–2, 206–7, explaining fiduciary duties as penalty defaults.

[113] See ibid 202, 206–7.

[114] See, eg, *Meinhard v Salmon*, 164 NE 545, 546 (Cardozo CJ) (NY, 1928), quoted with approval in *Warman International Ltd v Dwyer* (1995) 182 CLR 544, 557 (Mason CJ, Brennan, Deane, Dawson and Gaudron JJ) ('*Warman*').

[115] See generally Hanoch Dagan and Sharon Hannes, 'Managing Our Money: The Law of Financial Fiduciaries as a Private Law Institution' in Andrew S Gold and Paul B Miller (eds), *Philosophical Foundations of Fiduciary Law* (Oxford University Press, 2014) 91, 109–10; Hanoch Dagan and Elizabeth S Scott, 'Reinterpreting the Status–Contract Divide: The Case of Fiduciaries' in Paul B Miller and Andrew S Gold (eds), *Contract, Status, and Fiduciary Law* (Oxford University Press, 2016) 51, 64.

[116] See Conaglen, *Fiduciary Loyalty* (n 109) 57, 62–3, 185–7; Henry E Smith, 'Why Fiduciary Law Is Equitable' in Andrew S Gold and Paul B Miller (eds), *Philosophical Foundations of Fiduciary Law* (Oxford University Press, 2014) 261, 261–2, 264, 267, 271, 273.

Moreover, as Chief Justice James Allsop has stated extrajudicially:

> [T]he administration of justice is a partnership between the courts and the profession. Neither institution (and that is how *both* should be viewed) can bring about the necessary change or proper state of functioning of the system without the other.[117]

By deterring misconduct, fiduciary duties function to improve the actual quality of legal representation in class actions. Better legal representation then assists to improve the public's perception of class action lawyers, who are integral to the administration of justice. Better public perception of the administration of justice is therefore a positive externality that may arise from the imposition of fiduciary duties.[118]

The above economic considerations can inform the resolution of several doctrinal controversies, in addition to supporting the uncontroversial position that plaintiff lawyers owe fiduciary duties to the representative party and any other group members with whom they have a retainer.[119] One such controversy in the case law concerns whether some duties owed by plaintiff lawyers to the subset of group members with whom no retainer exists should be characterised as fiduciary in nature, or as merely duties to act in those group members' best interests.[120] Unlike the fiduciary characterisation, the best-interests characterisation does not necessarily prohibit conflicts of interest. Considerations of agency costs and externalities support characterising such duties as fiduciary. Another controversy concerns whether the representative party owes fiduciary

[117] Allsop (n 4) (emphasis in original).

[118] See above Part III(D).

[119] *Dyczynski* (n 25) 635 [208] (Murphy and Colvin JJ), 672–3 [378] (Lee J); Legg, 'Class Action Settlements in Australia' (n 38) 596.

[120] See generally *Dyczynski* (n 25). Justices Murphy and Colvin summarise the differing views in the case law as to whether the plaintiff lawyer's duty to group members who are not their clients is fiduciary or only a duty to act in the class members' interests: at 635 [209]. Justice Lee refers to the need for the lawyer to perform the role consistently with the duty not to act contrary to the interests of those in respect of whom the lead applicant acts in a representative capacity, that is, not to take steps contrary to the interests of the group members: at 673 [379]. *Dyczynski* (n 25) 635 [209] (Murphy and Colvin JJ) was cited in *Wigmans v AMP Ltd* (2021) 270 CLR 623, 670 [117] (Gageler, Gordon and Edelman JJ) ('*Wigmans*'). See also Peter Cashman and Amelia Simpson, Submission No 55 to Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Litigation Funding and the Regulation of the Class Action Industry* (26 October 2020) 49–55; Legg, 'Class Action Settlements in Australia' (n 38) 596 n 23; Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 915; Degeling and Legg, 'Class Action Settlements, Opt-Out and Class Closure' (n 32) 337.

duties to the passive group members.[121] Our economic analysis supports the imposition of fiduciary duties in the group members–representative party relationship.

Moreover, there is a controversy among courts and commentators regarding whether litigation funders should owe fiduciary duties to group members.[122] Regarding the subset of group members who are in a contractual relationship with the funder, the funding contract also tends to include clauses that purport to exclude any fiduciary duties.[123] While such clauses will likely preclude the funding contract itself from giving rise to a fiduciary relationship,[124] they may fail to exclude any fiduciary duties arising from pre-contractual dealings.[125] As Part III(C) has explained, moral hazard affects the relationship between the funder and the group members, funded or unfunded. Given fiduciary duties can enhance bonding (as argued above), we support the imposition of such duties on funders in respect of both funded and unfunded group members.[126]

A common criticism of fiduciary duties, which can be raised against our views on the above doctrinal controversies, is that prohibition of fiduciary

[121] For judicial statements describing some duties owed by the representative party to the group members as fiduciary, see, eg, *Wigmans* (n 120) 670 [117] (Gageler, Gordon and Edelman JJ), citing *Tomlinson v Ramsey Food Processing Pty Ltd* (2015) 256 CLR 507, 524 [40] (French CJ, Bell, Gageler and Keane JJ) and *Dyczynski* (n 25) 636 [210] (Murphy and Colvin JJ). Cf *Timbercorp Finance Pty Ltd v Collins* [2016] VSCA 128, [160] (Warren CJ, Santamaria and McLeish JJA), stating that the representative party does not owe fiduciary duties to the group members. See generally Cashman and Simpson (n 120) 49–55.

[122] See, eg, Degeling and Legg, 'Fiduciaries and Funders' (n 75), supporting the imposition of fiduciary duties on funders. Cf Vicki Waye, Submission No 5 to Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Litigation Funding and the Regulation of the Class Action Industry* (26 October 2020) 5, arguing against the imposition of fiduciary duties on funders; Vicki Waye, 'Conflicts of Interests between Claimholders, Lawyers and Litigation Entrepreneurs' (2007) 19(1) *Bond Law Review* 225, 255–6, arguing that funders are unlikely to be fiduciaries except for limited purposes or in limited circumstances. See also Duffy (n 11) 193–4, 200, arguing that a duty of utmost good faith could be imposed on funders. See generally Cashman and Simpson (n 120) 55–62.

[123] Victorian Law Reform Commission (n 3) 61 [3.52].

[124] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 99 (Mason J) ('*Hospital Products*'). See, eg, *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd [No 4]* (2007) 160 FCR 35, 80 [306]–[307], 85 [345] (Jacobson J); *Taheri v Vitek* (2014) 87 NSWLR 403, 427 [115] (Leeming JA) ('*Taheri*').

[125] *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1, 11–12 (Mason, Brennan and Deane JJ). See also Degeling and Legg, 'Fiduciaries and Funders' (n 75) 257–9.

[126] *PJC Report* (n 3) 272 [15.73], which 'endorses an approach whereby litigation funders are not required to cede control, but instead are held to the similar standard of lawyers to avoid conflicts of interest', without labelling such standard as fiduciary.

conflicts precludes efficient 'breaches'. Such 'breaches' include conduct that is mutually beneficial to the fiduciary and the beneficiary.[127] Such 'breaches' also include conduct that generates more benefits than costs.[128] The usual response to the efficient 'breach' criticism is that fiduciary duties are commonly understood as *default* rules that yield to the parties' own modification, including by contract.[129] A fiduciary who wishes to avoid liability for engaging in efficient 'breaches' may seek the fully informed consent of the beneficiary in advance.[130] To obtain such beneficiary consent, the fiduciary must comply with strict disclosure requirements.[131] These requirements facilitate an agreement that allows the beneficiary to share some of the fiduciary's gain from the efficient 'breach'. If the fiduciary fails to obtain beneficiary consent in advance, then it is not a defence to prove that the beneficiary would have consented if consent had been sought.[132] Thus, the preventive costs associated with the prohibition of efficient 'breaches' may be small if the fiduciary can cost-effectively obtain beneficiary consent for non-compliance with a default fiduciary duty.[133]

However, while fiduciary duties are default in theory, in many class actions they practically operate with *mandatory* force. Consider, for instance, the representative party/group members–plaintiff lawyers relationship. On the one hand, the plaintiff lawyers may obtain consent for fiduciary conflicts from the representative party and any other group members who have a retainer with the plaintiff lawyers. On the other hand, especially in an open class action, it would be impossible or prohibitively costly for the plaintiff lawyers to obtain consent from some or all passive group members.[134] These members are

127 See, eg, *Boardman v Phipps* [1967] 2 AC 46 ('*Boardman*'). See generally John H Langbein, 'Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?' (2005) 114(5) *Yale Law Journal* 929, 933.

128 See, eg, Goetz and Scott (n 92) 1089–90, 1128–9; Sitkoff (n 111) 206–7.

129 *Hospital Products* (n 124) 99 (Mason J); *Taheri* (n 124) 427 [115] (Leeming JA). Some aspects of fiduciary duties may potentially be mandatory rules: see, eg, *Bristol & West Building Society v Mothew* [1998] Ch 1, 16–19 (Millett LJ), precluding a fiduciary from acting in bad faith even with their beneficiary's fully informed consent; *Armitage v Nurse* [1998] Ch 241, 253 (Millett LJ), accepting that trustees owe their beneficiaries 'an irreducible core of obligations', being the duty 'to perform the trusts honestly and in good faith for the benefit of the beneficiaries'.

130 Matthew Conaglen, 'The Extent of Fiduciary Accounting and the Importance of Authorisation Mechanisms' (2011) 70(3) *Cambridge Law Journal* 548, 563–4 ('Authorisation Mechanisms').

131 Ibid 576.

132 *Murad v Al-Saraj* [2005] EWCA Civ 959, [8], [70]–[71] (Arden LJ).

133 See generally Conaglen, 'Authorisation Mechanisms' (n 130) 560–4.

134 Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 926–7; Degeling and Legg, 'Class Action Settlements, Opt-Out and Class Closure' (n 32) 339–41.

'identifiable but unidentified' and 'faint in appearance';[135] while some of their interests can be ascertained due to the class actions requirements of having a common issue and sharing the 'same, similar or related circumstances', the requirements also permit differences amongst group members, preventing an accurate assessment of their interests as part of seeking informed consent. Thus, to the extent that fiduciary duties are owed to passive group members, the preventive costs associated with the prohibition of efficient 'breaches' may be high.

Moreover, exposure to potential fiduciary liability may encourage plaintiff lawyers to exclude from the plaintiff class those members from whom consent for fiduciary conflicts cannot be sought. In particular, the plaintiff lawyers may adopt a closed-class group definition that only includes claimants who have entered into retainers and/or litigation funding agreements.[136] Such an exclusion strategy in the class definition may undermine the goals of the class action mechanism. It may reduce the number of plaintiffs who receive compensation, diminish access to justice and, because of the resulting decrease in the expected amount of compensation, reduce the deterrent effect on the defendant. It may also foster multiple competing class actions, which undermines the goal of efficiency in the resolution of disputes.

While our support for strong fiduciary regulation in class actions may give rise to the above preventive costs, the courts can exercise their remedial discretion to reduce such costs when they are likely to be high. Australian law affords the courts a discretion over the choice of remedy for breach of fiduciary duty, the exercise of which is informed by established equitable principles. An account of profits, equitable compensation, and a constructive trust are among the available remedies.[137] Such remedial discretion extends to granting due allowance to the errant fiduciary in respect of their skill, efforts, property and resources, as well as the risks they have taken.[138] By making explicit the benefits and costs of fiduciary regulation in class actions, our economic analysis above can inform courts' exercise of remedial discretion in particular cases. For instance, in cases where a plaintiff lawyer (or funder) has committed an efficient 'breach' of fiduciary duty that has produced significant benefits to the group

[135] Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 926.

[136] Degeling and Legg, 'Class Action Settlements, Opt-Out and Class Closure' (n 32) 343–4.

[137] See, eg, *Grimaldi v Chameleon Mining NL [No 2]* (2012) 200 FCR 296, 402–5 [503]–[511] (Finn, Stone and Perram JJ); *Ancient Order of Foresters in Victoria Friendly Society Ltd v Lifeplan Australia Friendly Society Ltd* (2018) 265 CLR 1, 32 [74], 38–9 [92] (Gageler J).

[138] *Warman* (n 114) 561–2 (Mason CJ, Brennan, Deane, Dawson and Gaudron JJ).

members,[139] our economic analysis suggests that the court should exercise its remedial discretion to grant a generous allowance in recognition of the lawyer's (or funder's) skill, efforts, resources and/or taking of risks. This suggestion aims to reduce the preventive costs associated with strong fiduciary regulation.[140] Moreover, in an open class action, the preventive costs that arise from the plaintiff lawyers' (or funder's) inability to obtain consent for fiduciary conflicts from some or all passive group members should be taken into account in the judicial exercise of remedial discretion.

In summary, our economic analysis supports the imposition of fiduciary duties on plaintiff lawyers, representative parties and litigation funders, in order to enhance bonding in their relationships with group members. Such enhanced bonding reduces the agency costs arising from moral hazard. Reduction of agency costs leads to better legal representation, which may assist with improving public perception of class action lawyers and of the justice system. Yet the potential reduction of agency costs and subsequent generation of positive externalities are not without their flaws. In particular, imposition of fiduciary duties may generate the preventive costs of prohibiting efficient 'breaches' that are mutually beneficial or generate more benefits than costs. Moreover, exposure to potential fiduciary liability may encourage plaintiff lawyers and any litigation funder to exclude those members from whom consent to fiduciary conflicts is impossible or too costly to seek. Such exclusion reduces the number of plaintiffs who may receive compensation as well as the deterrent effect on defendants. The courts may nonetheless exercise their remedial discretion in part to reduce the preventative costs associated with strong fiduciary regulation in particular cases.

### 3 *Adequacy of Representation*

Australian class action law permits individual group members to apply to the court for orders to replace a representative party who 'is not able adequately to represent the interests of the group members'.[141] The provision operates as a 'safeguard' for the group members.[142] The court may order replacement of the representative party with another group member. It may also be possible to appoint an additional representative party or create a subgroup.[143] Some of the state regimes also provide for a class action to be discontinued where 'a

[139] See above nn 127–33 and accompanying text.

[140] This suggestion is consistent with *Boardman* (n 127) 104 (Lord Cohen), 112 (Lord Hudson).

[141] *FCA Act* (n 16) s 33T(1).

[142] *Wong v Silkfield Pty Ltd* (1999) 199 CLR 255, 266 [25] (Gleeson CJ, McHugh, Gummow, Kirby and Callinan JJ).

[143] *FCA Act* (n 16) s 33T allows a court to 'make such other orders as it thinks fit'.

representative party is not able to adequately represent the interests of the group members'.[144]

Whether the representative party may adequately represent the passive group members in part depends on the convergence or divergence of their interests.[145] For example, in *Carnie v Esanda Finance Corporation Ltd* ('*Carnie*'), two borrowers originally sought a declaration to determine the meaning of a statutory provision regulating the provision of credit, and a declaration that the loan contracts that violated this provision were null and void.[146] The two borrowers sought to sue on their own behalf and on behalf of other borrowers who had entered into similar loan contracts. However, the two borrowers subsequently had to delete the claim for the declaration that the loan contracts were null and void. While the representative and passive borrowers had the same interest in the determination of the statutory provision's meaning, they might not all have wanted their loan contracts to be void.[147] By amending the claim to delete the declaration that the loan contracts were null and void, the representative borrowers were able to satisfy the court that they had the same interest as the passive borrowers.[148] Justice Brennan relevantly opined that

> if, for any reason, the court is not satisfied that the interests of the absent but represented class are being properly advanced, the court should exclude the represented persons from the action.[149]

Through the lens of principal–agent theory, adequacy of representation enhances bonding in the relationship between the representative party and the passive group members. It does so by providing a mechanism to replace the representative party in cases of sufficient divergence of interests. It also provides a mechanism to partition the plaintiff class into different groups or subgroups, so that each group/subgroup has a representative whose interests are sufficiently aligned with the group/subgroup members'. Adequacy of representation thus reduces the agency costs arising from moral hazard by enhancing bonding between the representative party and the passive group members. Moreover,

144 *Civil Procedure Act 2005* (NSW) s 166(1)(d); *Civil Proceedings Act 2011* (Qld) s 103K(1)(d).

145 See generally Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 930–1.

146 (1995) 182 CLR 398, 405–6 (Brennan J) ('*Carnie*'). This was a representative action brought pursuant to the *Supreme Court Rules 1970* (NSW) pt 8 r 13(1).

147 *Carnie* (n 146) 421 (Toohey and Gaudron JJ).

148 Ibid 408 (Brennan J), 421, 426 (Toohey and Gaudron JJ), 427, 431 (McHugh J).

149 Ibid 408 (Brennan J) (citations omitted).

mitigation of moral hazard leads to better representation of passive group members in class actions, which may enhance perceived fairness and integrity of the class action system. This is a positive externality.

However, adequacy of representation is not free from defect. First, in an open class action, passive group members may not be aware of their inclusion in the plaintiff class and may thus be unable to argue that they were inadequately represented.[150] Secondly, in cases where inadequacy of representation is remedied by replacing the representative party, moral hazard may continue to affect the relationship between the new representative and the other group members, although closer alignment of interests should aid in minimising agency costs. Thirdly, in cases where inadequacy of representation is remedied by partitioning the plaintiff class, the commencement of a second group/subgroup necessitates the appointment of a second representative party.[151] If the second representative party engages separate legal representation, then not only will legal costs be increased, but a new source of moral hazard in the relationship between the second representative party and the second plaintiff lawyer will also be created. Moreover, a partition of the plaintiff class may reduce the economies of scale in the provision of legal services because each group/subgroup is smaller. Such partitioning further reduces the collective bargaining power of the plaintiff class and the economies of scale in the judicial management and resolution of disputes.

### 4 *Costs and Funding Agreements and Group Costs Orders*

Conditional-fee and funding agreements can also be understood as bonding devices. A conditional-fee agreement allows the plaintiff lawyers to charge a premium on the legal services provided if the claim succeeds.[152] Such an agreement requires the plaintiff lawyers to charge no fee if the claim fails. By tying the plaintiff lawyers' monetary reward to the success of the group members'

[150] See generally Legg, 'Judge's Role in Settlement of Representative Proceedings' (n 34); Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 931–2.

[151] Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 931.

[152] See, eg, *Legal Profession Uniform Law 2014* (NSW) ss 181–2; *Legal Profession Uniform Application Act 2014* (Vic) ss 181–2. In contrast, a contingency fee agreement allows plaintiff lawyers to receive a proportion of the group members' recovery from any judgment or settlement if their claim succeeds. This form of costs agreement is common in the US but illegal in all Australian jurisdictions. See, eg, *Legal Profession Uniform Law 2014* (NSW) s 183(1); *Legal Profession Uniform Law Application Act 2014* (Vic) s 183(1), stating that

> [a] law practice must not enter into a costs agreement under which the amount payable to the law practice, or any part of that amount, is calculated by reference to the amount of any award or settlement or the value of any property that may be recovered in any proceedings to which the agreement relates.

claim, the agreement reduces the misalignment of interests; the plaintiff lawyers and the group members share the risks and rewards of litigation.[153] Litigation funding agreements also operate on the same principle, given the funder only recovers their fee if the class action is successful.

However, conditional-fee and litigation funding agreements may be a source of conflict when, for instance, the parties to these agreements value monetary and non-monetary outcomes differently and/or have different risk preferences. For example, consider the plaintiff lawyers' incentives under a conditional-fee agreement. The plaintiff lawyers may prefer a settlement because they are motivated by monetary reward, while some group members may prefer a trial in which to voice their complaint in a public forum (over a small share of the settlement amount). Similarly, the plaintiff lawyers may be more risk averse than some group members; the plaintiff lawyers may prefer a settlement over a risky trial, while these group members may have the opposite preferences because their individual shares of the settlement are small. Hence, enhanced bonding by conditional-fee agreements alone can mitigate, but not eliminate, moral hazard on the part of the plaintiff lawyers. By the same token, enhanced bonding by a litigation funding agreement has a limited effect in reducing moral hazard on the part of the litigation funder.

Moreover, the Victorian class actions legislation has been amended to allow a plaintiff to apply to the court for a 'group costs order'. The court may order that the legal costs payable to the plaintiff lawyers be a percentage of the amount recovered in the proceedings, and that the whole plaintiff class share liability for those legal costs.[154] Like conditional-fee and litigation funding agreements, group costs orders facilitate the sharing of risks and rewards between the plaintiff class and the plaintiff lawyers.[155] Such sharing enhances bonding in the representative party/group members–plaintiff lawyers relationship, which in turn ameliorates (but does not eliminate) moral hazard in that relationship. The group costs order legislation may provide additional protections for passive group members as the costs charged must be approved by the court. This is

[153] See Winand Emons, 'Legal Fees and Lawyers' Compensation' in Francesco Parisi (ed), *The Oxford Handbook of Law and Economics* (Oxford University Press, 2017) vol 3, 248–9, 251–4.

[154] With effect from 1 July 2020, the *Justice Legislation Miscellaneous Amendments Act 2020* (Vic) s 5 added s 33ZDA to the *Supreme Court Act 1986* (Vic). The amendment also reflects the Australian cost-shifting approach by requiring that the lawyer agree to be liable for the costs of the defendant if the case fails, and provide any security for those costs. The Court can only make the order if it is satisfied that it is 'appropriate or necessary to ensure that justice is done in the proceeding'.

[155] Victorian Law Reform Commission (n 3) 58 [3.38], 60 [3.47].

unlike conditional-fee agreements and litigation funding agreements, where the fee is a matter of contract. The courts have taken steps to provide oversight in the conditional fee and litigation funding context, as discussed below in Part IV(B)(7), but it is discretionary and in relation to litigation funding the power to do so is uncertain.

However, similar to litigation funding and conditional-fee agreements, group costs orders may generate conflict when the plaintiff lawyers and some group members have different valuations of monetary and non-monetary outcomes and/or different risk preferences. Consider a realistic scenario where a proposed settlement gives the plaintiff lawyers a percentage that is much greater than the individual shares of some group members. The plaintiff lawyers may prefer to support the settlement due to their profit motive, while the group members may prefer the non-monetary benefit of voicing their complaint in a public trial. Another non-monetary benefit that these group members may want is a binding court determination to hold the defendant accountable for their actions. Similarly, the plaintiff lawyers may prefer to avoid a trial due to risk aversion, while some group members may have a greater appetite for risk because their individual share of the settlement is small anyway. In this scenario, conflicts between the plaintiff lawyers and group members are a source of moral hazard, and enhanced bonding by group costs orders can mitigate but not eliminate such moral hazard. Group costs orders should, and are, reinforced by judicial oversight, fiduciary regulation and other bonding mechanisms.[156]

### 5 *Right to Opt Out*

As explained above, Australian class actions adopted an opt-out model. Proceedings are commenced without consent, but a date is fixed for opt-out, notice is given to group members, and the group members have an opportunity to withdraw from the proceeding.[157] As a mandatory rule in Australian class actions,[158] the opportunity to withdraw or a right of exit may be a powerful relational sanction because it ends the agency relationship. The group member exits the class action and is no longer represented by the representative party or plaintiff lawyers. It also puts an end to any litigation funding agreement, although whether it would be seen as a termination or a breach may turn on the terms of the agreement. Thus, the right to opt out may mitigate the moral

[156] Ibid 60 [3.49], 63 [3.66], [3.68], 66 [3.84].

[157] *Webb v GetSwift Ltd [No 2]* [2018] FCA 994, [2] (Lee J) ('*Webb*').

[158] *FCA Act* (n 16) s 33J(1), stating that '[t]he Court *must* fix a date before which a group member may opt out of a representative proceeding' (emphasis added).

hazard problem and, by so doing, may enhance public perception of the civil justice system.

Compared to lay group members,[159] large institutional group members can more effectively utilise the right to opt out as a relational sanction. First, while the relationship between litigation lawyers and lay litigants tends to be short-lived, litigation lawyers can develop an ongoing relationship with large institutions. Ongoing relationships with large institutions are generally more profitable to lawyers than short-term relationships with lay litigants. As a result, large institutional group members can combine an exercise of the right to opt out of a class action with a decision to discontinue any ongoing relationship with the plaintiff lawyers (or a refusal to commence an ongoing relationship). This combination is a more powerful relational sanction than opting out alone. Secondly, large institutional group members tend to have a greater financial stake, a higher degree of legal sophistication and more resources than lay group members.[160] Large institutions can therefore better understand the consequences of exercising or not exercising the right to opt out, and be more capable of commencing their own actions upon opting out. For example, as discussed above, Cadbury opted out of a class action against the packaging cartel of Amcor and Visy and brought its own action.[161] Cadbury did so in part because it was able to engage separate legal representation to benefit from having complete control of its own action.[162] By comparison, lay group members may be less able to benefit from exiting the class action.

Indeed, lay group members may be unable to effectively utilise their right to opt out, undermining the ability of this mechanism to operate as a relational sanction. Lay group members are unlikely to have in place institutional mechanisms (such as reception staff to monitor and inspect letters and emails) to ensure that they receive notice that they have been included in a class action and that they can exclude themselves. An implication is that lay group members are often unaware of the class action. Indeed, even if lay group members receive the notice, they may not have the legal sophistication to understand that they

[159] We define 'lay group members' as group members who do not have detailed knowledge, or do not have the resources to be able to obtain assistance in gaining such knowledge, of class actions.

[160] See, eg, Legg, 'Institutional Investors' (n 35) 479.

[161] See above nn 58–60 and accompanying text.

[162] Gatto (n 59) 00:00:45–00:00:51. Cadbury engaged Mallesons Stephen Jaques (now King & Wood Mallesons) to conduct its own action, while Maurice Blackburn conducted the class action.

are group members and that the notice applies to them. Further, if they recognise that they are group members, they may not comprehend what that means for them in terms of the impact on their legal rights and the costs they incur and avoid.

For a group member to make an informed decision about the opportunity to opt out, they may need to incur the cost of independent legal advice in relation to the operation of the class action procedure, prospects of success and the cost of alternative actions.[163] The evaluation of prospects by a lawyer without recourse to the due diligence undertaken by the lawyers who conduct the class action and any litigation funder may be expensive, or incomplete. The alternative actions are usually seen as bringing suit individually, which requires incurring the costs of legal representation and being liable for the defendant's costs if the claim is unsuccessful, or not suing at all. However, a more sophisticated analysis may also consider options for alternative dispute resolution or action being brought by a regulator seeking to obtain compensation for people such as the group members, or at least establishing a contravention of the law.[164] The class action, even with agency costs, may be a cheaper or more efficient way to resolve a dispute than the available alternatives.[165] This is especially so for lay group members. Moreover, if the amount at stake for the group member is small, then taking any of the above alternatives to a class action may simply not be worthwhile — the group member would be 'rationally apathetic'.[166]

The right to opt out typically occurs only once and, if not availed of, is lost. The disciplining effect of the threat of opting out may therefore be limited. Indeed, the behaviour which negatively impacts the group members may only occur after the right to opt out has passed. For example, problems involving the manner in which a trial is prepared or conducted, or the terms of a settlement. These problems may be illustrated, once again, by *Kelly*. In *Kelly*, a notice of the right to opt out was given and remained open until 2 June 2014.[167] A settlement deed was signed by the parties on 7 April 2015 and orders were made

163 See *Petrusevski v Bulldogs Rugby League Club Ltd* [2003] FCA 61, [23] (Sackville J), recognising the need for 'the assistance of a legal adviser' to ascertain whether a claimant falls within the group definition.

164 See generally Michael Legg, 'A Comparison of Regulatory Enforcement, Class Actions and Alternative Dispute Resolution in Compensating Financial Consumers' (2016) 38(3) *Sydney Law Review* 311; Nicholas Alejandro Bergara, 'Nipping It in the Bud: Fixing the Principal–Agent Problem in Class Actions by Looking to Qui Tam Litigation' (2022) 97(1) *New York University Law Review* 275.

165 John C Coffee Jr, 'Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation' (2000) 100(2) *Columbia Law Review* 370, 381.

166 Ibid 425.

167 *Kelly* (n 48) 450 [43] (Murphy J).

requiring the plaintiff lawyers to publish a notice describing the settlement by 22 May 2015.[168] As explained above, the proposed settlement provided no benefit to the passive group members who took no action, yet obliged all members to give up their claims. Indeed, the settlement went further and required those group members with loans from the defendants to accept that they were enforceable and could not be challenged — a 'significant detriment'.[169] It is apparent from the dates of the opt-out and settlement that the group members were asked whether they wanted to opt out *before* they knew they would receive no benefit, but a significant detriment. The judgment given by Murphy J also referred to 'gaps in … preparation' which would have affected any trial.[170] In short, the right to opt out had passed before the plaintiff lawyers' actions were known and, consequently, its utility as a relational sanction had expired. Justice Murphy effectively recognised this when his Honour raised whether a second opt-out opportunity should be made available in cases like *Kelly*.[171]

Any opportunity for a second opt-out should nonetheless be limited. While *Kelly* is somewhat unique in that the settlement resulted in an additional detriment to group members, all class actions expose group members to the risk that the claim may be unsuccessful and they are bound by that outcome.[172] To uniformly permit a second opt-out would mean group members are only bound by settlement outcomes that they deem sufficiently successful for them to give up their rights. Justice Murphy's suggestion was that the availability of a second opt-out would depend on 'the interests of justice' and 'the circumstances of the case'.[173] The possibility of a second opt-out may have a chastening effect on plaintiff lawyers and any litigation funder, but its discretionary nature would also undermine its effectiveness unless case law developed so as to cabin and guide that discretion. For instance, drawing on *Kelly*, the second opt-out may be considered more necessary when the settlement contains terms beyond

[168] Ibid 443 [1], 450 [43], 451–2 [51] (Murphy J).

[169] Ibid 444 [6] (Murphy J).

[170] Ibid 444 [8], 504 [289]–[290].

[171] Ibid 467–8 [136]–[140].

[172] *FCA Act* (n 16) s 33ZB; *Timbercorp Finance Pty Ltd (in liq) v Collins* (2016) 259 CLR 212, 235 [52] (French CJ, Kiefel, Keane and Nettle JJ) ('*Timbercorp*').

[173] *Kelly* (n 48) 468 [140].

those that directly relate to the matters pleaded (ie the common questions) or addressed in the first opt-out notice.[174]

### 6 *Notices*

The opt-out notice has been a central requirement of the class action regime, as it is the method for communicating important information to group members, some or many of whom may not be individually known and therefore cannot be contacted directly. Notices are typically used in two main ways: first, to advise that a class action has been commenced and that the group member may opt out;[175] secondly, to seek approval of a settlement,[176] by advising the amount of such settlement and the fees sought, with a view to allowing group members to object. However, the legislation also provides that '[t]he Court may, at any stage, order that notice of any matter be given to a group member or group members'.[177] This can include corrective notices where either the plaintiff lawyers or the defendant have made misleading statements.[178]

As has been previously observed:

[174] For completeness it should be noted that there are limits on the matters that may be determined by a class action settlement, including group members' individual claims that are separate from the claims being pursued in the class action — that is, claims that do not give rise to common issues that could be included, consistent with the class action requirements. There is no need to address these individual claims through a second opt-out as they cannot be included in the settlement. See *Petersen Superannuation Fund Pty Ltd v Bank of Queensland Ltd [No 3]* (2019) 132 ACSR 258, 264 [27] (Murphy J) ('*Petersen*'), stating that

> [t]he applicant only represents class members in respect of common claims as set out in s 33C of the [*FCA Act*], the existence of which are anterior to the claims actually pleaded in the proceeding. The applicant does not have authority to settle the other claims class members may have …

citing *Timbercorp* (n 172) 235 [52]–[53] (French CJ, Kiefel, Keane and Nettle JJ); *Dillon v RBS Group (Australia) Pty Ltd [No 2]* [2018] FCA 395, [34]–[54] (Lee J) ('*Dillon*'). See also Michael Legg and Samuel J Hickey, 'Finality and Fairness in Australian Class Action Settlements' (2019) 41(2) *Sydney Law Review* 185, 203–6.

[175] *FCA Act* (n 16) s 33X(1)(a). However, a notice may be dispensed with where there is no claim for damages: at s 33X(2).

[176] Ibid s 33X(4), stating that '[u]nless the Court is satisfied that it is just to do so, an application for approval of a settlement under section 33V must not be determined unless notice has been given to group members'.

[177] Ibid s 33X(5).

[178] See, eg, *Williams v FAI Home Security Pty Ltd [No 3]* [2000] FCA 1438; *Jarra Creek Central Packing Shed Pty Ltd v Amcor Ltd* [2008] FCA 575; *Davaria Pty Ltd v 7-Eleven Stores Pty Ltd* [2018] FCA 984.

> [T]he effectiveness of a notice turns not just on whether it is given, but is also determined by how the notice is given, the language used, the time period for responses, and how burdensome it is to respond.[179]

When notices were largely advertisements in newspapers, the likelihood of group members becoming aware of important information was problematic.[180] The cost of giving notices (especially through 'old media') could also deter some individuals from commencing or maintaining class actions.[181] However, the advent of the internet, web pages and social media means that the ability to communicate has increased, while the cost has decreased.[182] It must also be remembered that some group members — or all members in the case of a closed class — will be registered with the lawyers, and notices can be provided personally by letter or email. In terms of content, the courts have consistently required that the notice be accurate and set forth the required information in a manner which is readily understandable to those to whom it is addressed.[183] Moreover, the court has a role in preventing or rectifying misleading communications to group members, 'particularly when they emanate from legal advisers, as to rights and obligations and procedures to be followed by recipients of such communications'.[184]

Efforts to give effective notices may generate a positive externality and reduce agency costs. First, effective notice of legal proceedings is an aspect of procedural fairness,[185] and plaintiff lawyers' (and any funder's) efforts to give effective notice to the group members may be perceived by these members and the

[179] Degeling and Legg, 'Fiduciary Obligations of Lawyers in Australian Class Actions' (n 55) 927.

[180] *FCA Act* (n 16) s 33Y(4), permitting the Court to order that 'notice be given by means of press advertisement, radio or television broadcast, or by any other means'. However, the Court cannot order that notice be given personally to each group member unless 'it is satisfied that it is reasonably practicable, and not unduly expensive, to do so': at s 33Y(5).

[181] For example, in *Carnie* (n 146), after the representative borrowers prevailed in the High Court, their representative proceedings were discontinued because they were unwilling to incur the cost of sending out notices in the form of circulars to 88 similarly situated persons. The representative borrowers were legally aided, and the cost of sending out the circulars could have exceeded the amount of legal aid. See also *Carnie v Esanda Finance Corporation Ltd* (1996) 38 NSWLR 465, 469, 474–5 (Young J).

[182] *Matthews v SPI Electricity Pty Ltd [No 13]* (2013) 39 VR 255, 280 [100] (J Forrest J).

[183] See, eg, *Pharm-a-Care Laboratories Pty Ltd v Commonwealth [No 4]* [2010] FCA 749, [23] (Flick J); *Hodges v Waters [No 3]* [2014] FCA 233, [27] (Perram J); *Webb* (n 157) [3] (Lee J).

[184] *Johnstone v HIH Ltd* [2004] FCA 190, [105] (Tamberlin J), quoted in *Perera v GetSwift Ltd* (2018) 263 FCR 92, 157 [301] (Middleton, Murphy and Beach JJ).

[185] Waldron (n 82) §§ 5.1–5.2.

public as efforts to promote the fairness and integrity of the civil justice system. Effective notices may therefore generate a positive externality.[186] Moreover, even if the notices actually given are not perfect, the mandatory nature of notice-giving, and the court's exertion of effort to give the best notice possible in a cost-effective manner, can promote public trust in the court system and class actions.

Secondly, effective notices may enhance monitoring and bonding in the principal–agent relationships in class actions. The notice facilitates monitoring by requiring court-approved information to be provided to the group members and by setting out the steps they can take. These steps can include opting out of the class action and advising the court of their views (through submissions and/or appearing at the hearing) as to the reasonableness of a settlement and associated fees. At the same time, lawyers and funders know that the notices will be sent and they may wish to avoid the group being reduced by group members opting out, or a settlement being refused approval because of concerns about the quantum of the settlement, or how it is to be distributed, or the level of fees. The lawyers and funders are therefore incentivised to act in a manner that will find approval with the group members. The knowledge of the need for the notice thus acts to align the interest of the agent (lawyers and funders) with the principal (representative party and group members). However, it is costly for individuals to acquire and process new information.[187] In this 'information-rich world' where 'a wealth of information creates a poverty of attention',[188] notices also have to compete with advertisements and other kinds of information for the recipients' attention. Group members do not file objections or attend court to object unless they incur the cost of learning about their entitlements, have sufficient funds at stake, and have the ability to put forward effective arguments.[189] Enhanced monitoring and bonding by notices therefore can mitigate, but not eliminate, moral hazard on the part of plaintiff lawyers and funders.

### 7 *Independent Legal Representation for Passive Group Members*

The provision of independent legal representation for passive group members can alleviate moral hazard in their relationships with the plaintiff lawyers, the representative party, and any litigation funder. Australian class action law

[186] See above Part III(D).

[187] Herbert A Simon, 'Theories of Decision-Making in Economics and Behavioral Science' (1959) 49(3) *American Economic Review* 253, 272–3.

[188] Herbert A Simon, 'Designing Organizations for an Information-Rich World' in Martin Greenberger (ed), *Computers, Communications, and the Public Interest* (Johns Hopkins Press, 1971) 38, 40.

[189] See Kirk (n 100) 718.

permits the judicial appointment of a contradictor, or litigation guardian, to represent group members.[190] The contradictor can be appointed with a broad or narrow remit.[191] They can be asked to address whether an entire settlement should be approved, or, more commonly, they can be asked to provide submissions as to the reasonableness of the legal and funding costs claimed by plaintiff lawyers and any litigation funder.[192] In the *Bolitho v Banksia Securities Ltd* class action, a settlement was approved but the claimed legal costs and litigation funder's commission were not, and further inquiry was needed.[193] A contradictor was appointed, who successfully identified a range of issues including a dishonest and fraudulent scheme that the lawyers and funder had contrived to claim grossly inflated legal costs and funding commission.[194] In the *Endeavour River Pty Ltd v MG Responsible Entity Ltd* shareholder class action, the Court expressed concern that if the lawyer pressed the application for the proposed funding commission it would give rise to a conflict of interest as the group members' interests are to minimise the funding commission payable, and the funder's interest is to maximise the funding commission payable, so that a contradictor was needed to represent the group members' interests.[195] Moreover, the Australian Securities and Investments Commission ('ASIC') may appear to represent passive group members in class actions alleging contraventions of the *Corporations Act 2001* (Cth).[196] For example, in *Australian Securities and*

[190] See *Banksia [No 6]* (n 32) 315–25 [86]–[123] (John Dixon J). The power to appoint a contradictor may come from the court's inherent or implied power to ensure that it is properly informed of matters which it ought to take into account in reaching its decision, including when its judgment may affect persons other than the parties who are before it. See *United States Tobacco Co v Minister for Consumer Affairs* (1988) 20 FCR 520, 534 (Davies, Wilcox and Gummow JJ). The power may also be found in *FCA Act* (n 16) s 33ZF, under the general power to 'make any order the Court thinks appropriate or necessary to ensure that justice is done in the proceeding'. See also Kirk (n 100) 726–8.

[191] *Banksia [No 6]* (n 32) 313 [78]–[80], 325 [123] (John Dixon J). See also *Endeavour River Pty Ltd v MG Responsible Entity Ltd [No 2]* [2020] FCA 968, [9]–[11], [18]–[21] (Murphy J) ('*Endeavour [No 2]*'), which allowed the contradictor to have targeted discovery and to retain an expert witness.

[192] See, eg, *Kelly v Willmott Forests Ltd (in liq) [No 5]* [2017] FCA 689, [14]–[20] (Murphy J); *Petersen* (n 174) 285 [124] (Murphy J).

[193] See *Banksia [No 16]* (n 32) [5] (John Dixon J).

[194] *Banksia [No 18]* (n 32) [92], [447], [449], [640], [736], [751] (John Dixon J). The contradictor successfully raised further issues including conflicts of interest and breaches by the lawyers and the funder of their obligations to group members and to the Court: at [1447], [1451], [1454], [1494], [1498], [1610] (John Dixon J).

[195] *Endeavour* (n 45) [36] (Murphy J).

[196] See *Corporations Act 2001* (Cth) s 1330(1).

*Investments Commission v Richards*, ASIC intervened to object to a settlement that gave a 35 per cent uplift to group members who had contributed to legal costs.[197] In these instances, the obvious conflict between the passive group members and the plaintiff lawyers/representative party justified the provision of independent legal representation.

A related form of protection for passive group members is court-appointed costs experts who are asked to opine on the fairness of legal costs to assist the court during settlement approval. As part of settlement approval the court must also determine if the legal fees sought should be approved.[198] The reason underpinning court supervision of costs is that the lawyer seeks costs for themselves where there is no contradictor.[199] The Victorian Court of Appeal has observed:

> [A]lthough group members will be required to share the liability for the fees and disbursements, they [are] disadvantaged in their ability to assess the reasonableness of such costs because the information available to them will often be limited.[200]

In the early stages of class action development in Australia, the courts asked for lawyers to provide a report from a costs consultant opining as to the reasonableness of the fee.[201] That approach was subsequently criticised because the consultant was retained by the lawyers and might have lacked independence.[202] Justice Lee referred to it as 'the self-serving process of applicants'[203] and noted that the practice was entirely unhelpful:

197 [2013] FCAFC 89.

198 *Johnson Tiles Pty Ltd v Esso Australia Ltd* (1999) 94 FCR 167, 175–6 [35]–[37] (Merkel J) ('*Johnson Tiles*'); *Modtech Engineering Pty Ltd v GPT Management Holdings Ltd* [2013] FCA 626, [32] (Gordon J) ('*Modtech*'); *Earglow Pty Ltd v Newcrest Mining Ltd* [2016] FCA 1433, [91] (Murphy J) ('*Earglow*').

199 *Modtech* (n 198) [27] (Gordon J) (emphasis in original), stating that '[t]he solicitor is acting for *itself* — *it* seeks an order that *its* costs be approved by the Court and paid to *it*. There is no contradictor.'

200 *Botsman* (n 43) 115 [220] (Tate, Whelan and Niall JJA). The Court also stated that '[g]roup members may not have access to all of the relevant information and may not be well-placed to ensure that any settlement is fair and reasonable': at 136 [335].

201 *Courtney v Medtel Pty Ltd [No 5]* (2004) 212 ALR 311, 322 [59] (Sackville J); *Caason Investments Pty Ltd v Cao [No 2]* [2018] FCA 527, [111] (Murphy J) ('*Caason*').

202 Legg, 'Class Action Settlements in Australia' (n 38) 601–2; *Caason* (n 201) [113]–[116] (Murphy J).

203 *Dillon* (n 174) [66]. Although referring to the applicant, it was the applicant's solicitor who chose the costs consultant.

> Without, I hope, slipping into overstatement, I regard such evidence as next to useless. I have seen many examples, but I am yet to see a cost assessor retained by a solicitor who has formed the robustly independent view that the fees charged by his [or her] retaining solicitor were unreasonable.[204]

His Honour then suggested that courts should establish a regular practice of appointing a referee to inquire and provide a report to the court[205] — a practice which has gained favour.[206] Other practices have included using court registrars[207] or, in Victoria, referring the matter to the Costs Court.[208]

While the courts have clear power to appoint contradictors and costs experts, a further issue is the power to then act on the submissions or reports. The courts have a longstanding power to regulate costs agreements between a solicitor and a client.[209] However, the position is less clear in relation to litigation funding. It is accepted that in an appropriate case, the court may refuse to approve a settlement because a funding commission is excessive or disproportionate.[210] However, whether the court can vary funding agreements in the context of a settlement by altering the contractual promises of group members to pay commission is unsettled.[211] The Australian Law Reform Commission has called

[204] *Lifeplan Australia Friendly Society Ltd v S&P Global Inc* [2018] FCA 379, [40].

[205] Ibid [41].

[206] See, eg, *Petersen* (n 174) 278 [91] (Murphy J); *Money Max Int Pty Ltd (Trustee) v QBE Insurance Group Limited* (2018) 358 ALR 382, 416 [156] (Murphy J); *Caason* (n 201) [122]–[123] (Murphy J).

[207] See, eg, *Modtech Engineering Pty Ltd v GPT Management Holdings Ltd [No 3]* [2014] FCA 680, [53] (Gordon J); *Downie v Spiral Foods Pty Ltd* [2015] VSC 190, [199]–[201] (J Forrest J).

[208] See, eg, *Williams v AusNet Electricity Services Pty Ltd* [2017] VSC 474, [106], [121] (Emerton J); *Williams v AusNet Electricity Services Pty Ltd [No 3]* [2017] VSC 528, [1]–[2] (Wood AsJ).

[209] *Woolf v Snipe* (1933) 48 CLR 677, 678 (Dixon J), quoted in *Johnson Tiles* (n 198) 175–6 [35]–[37], where Merkel J discussed the Court's inherent 'general' jurisdiction and 'statutory' jurisdiction in relation to s 33ZF of the *FCA Act* (n 16).

[210] *City of Swan v McGraw-Hill Companies Inc* (2016) 112 ACSR 65, 71 [30] (Wigney J), cited in *Liverpool City Council v McGraw-Hill Financial Inc* [2018] FCA 1289, [22] (Lee J) ('*Liverpool City*').

[211] *Earglow* (n 198) [133]–[158] (Murphy J); *Blairgowrie Trading Ltd v Allco Finance Group Ltd (recs and mgrs apptd) (in liq) [No 3]* (2017) 343 ALR 476, 504 [101] (Beach J); *Mitic v OZ Minerals Ltd [No 2]* [2017] FCA 409, [27]–[29] (Middleton J); *Liverpool City* (n 210) [18]–[51] (Lee J); *Endeavour [No 2]* (n 191) [4] (Murphy J).

for the enactment of an express statutory power to reject, vary, or amend the terms of a litigation funding agreement.[212]

Our principal–agent analysis lends qualified support for a reform proposal for greater involvement of contradictors or independent costs experts, including in relation to litigation funding, in Australian class actions.[213] As Part III(A) has argued, passive group members rarely, if ever, monitor the exercise of discretion by the plaintiff lawyers, the representative party, and any litigation funder. The conflict of interest among these players generates a moral hazard problem that may adversely affect the interests of the passive group members. A contradictor who is appointed to provide independent legal representation to the passive group members can enhance monitoring of the plaintiff lawyers, the representative party, and any litigation funder. The contradictor also takes over some or all of the legal services that the plaintiff lawyers would (or should) otherwise provide to the passive group members.[214] This reduces the power of the plaintiff lawyers, giving them less opportunity to engage in shirking, excessive work or wrongdoing. The resulting improvement in the quality of legal representation may further help improve the public's perception of the quality of class action lawyers and of the civil justice system, which is a potential positive externality.

Moreover, it has been argued that greater involvement of contradictors in Australian class actions can address 'the limitations on the adversarial process through lack of participation' by passive group members.[215] Contemporary research in the economics of information design reinforces the widely held belief in common law jurisdictions that competition between advocates tends

[212] *ALRC 2018 Report* (n 3) 169 recommendation 14. The recommendation chose to refer to terms rather than only fees so as to capture other abuses: at 176 [6.91].

[213] See generally Legg, 'Class Action Settlements in Australia' (n 38) 611–12. See also *ALRC 2018 Report* (n 3) 176–7 [6.92]; Kirk (n 100) 719, arguing that

> in cases where there is some significant potential for conflicts of interest, or where the issues likely to arise on the approval application are not simple, then the judge should in general require that a contradictor be appointed to represent the interests of group members.

See also *PJC Report* (n 3) 186–7 [12.70], recommending a presumption in accordance with the argument in Kirk (n 100).

[214] For example, the contradictor could make submissions in court on behalf of some or all passive group members as to the reasonableness of a litigation funder's fee or the structure of the settlement distribution scheme put forward for court approval. Such advocacy services would or should otherwise be provided by the plaintiff lawyers.

[215] Legg, 'Class Action Settlements in Australia' (n 38) 612. See also *Botsman* (n 43) 73 [5] (Tate, Whelan and Niall JJA), finding that 'the judge [at first instance] was denied the benefit of a proper contest on the reasonableness of the claimed payment' due to the confidentiality orders the judge had made, and that the resulting problems could have been 'addressed by the appointment of a contradictor'.

to improve information provision to rational decision-makers.[216] By 'creat[ing] an adversary contest',[217] the involvement of a contradictor improves the quality of information provided to the court about the case at bar. With better information, the court can better perform its monitoring and supervisory functions. Better legal representation for passive group members and better information provided to the court can further improve accuracy in judicial decision-making and public perception of the civil justice system. These are positive externalities.

A court-appointed costs expert, although not directly engaging in an adversarial contest like the contradictor, also assists the court in performing its oversight role by providing independent information.[218] This then indirectly assists the passive group members and the representative party, who may lack the resources to be able to effectively monitor the plaintiff lawyers.

Greater involvement of contradictors and costs experts is not without issue: it raises the questions of 'who pays the [contradictor/costs expert], who instructs the [contradictor/costs expert] and how confidential information is made available to the [contradictor/costs expert]'.[219] These potential costs may be deducted from the settlement fund,[220] or the court may order that they be borne by the plaintiff lawyers or possibly the funder.[221] However, it should be recalled that at least in relation to costs experts, this expense was previously incurred by the applicant.[222] Referees have been seen as saving costs in terms of

[216] See generally Kamenica (n 87) 263–7.

[217] Legg, 'Class Action Settlements in Australia' (n 38) 611.

[218] See generally Kirk (n 100) 723–4.

[219] Legg, 'Class Action Settlements in Australia' (n 38) 613.

[220] *Caason* (n 201) [124] (Murphy J), stating that

> it should be kept in mind that the costs of such supervisory processes ultimately come out of the settlement fund, and the Court should be astute to ensure that the cost of such supervision is proportionate to the costs claimed and the amount that might potentially be saved.

[221] *FCA Act* (n 16) ss 43(1), (3)(f) provide the Court with a broad discretion to award costs, including requiring payment by a lawyer. The discretion may be sufficiently broad to apply to third parties such as a litigation funder, but funders are not specifically referred to. See also *PJC Report* (n 3) 187 [12.70], recommending reforms to

> ensure the Federal Court of Australia may order the costs arising from the work undertaken by a contradictor be paid by the plaintiff law firm, or the litigation funder, in circumstances where the conduct on the part of the lawyer or the litigation funder justifies such an order being made.

[222] Legg, 'Class Action Settlements in Australia' (n 38) 601.

court time.[223] Unlike the private appointment of experts, judicial appointment can be informed by 'a perspective that transcends the individual litigant' and 'take[s] into account considerations of access to justice generally'.[224] Moreover, not appointing a contradictor in an effort to save costs may be counterproductive when judicial determinations miscarry and judgments are appealed.[225] Finally, the cost of a contradictor will often be minor in comparison to the size of the claim and the lawyers' costs.[226]

It might also be argued that moral hazard may arise in the relationship between the passive group members and the contradictor/costs expert. Just like plaintiff lawyers, the contradictor/costs expert is not monitored by the passive group members, yet the way in which they undertake their appointment impacts the group members' interests. Notwithstanding these problems, given an independent contradictor/costs expert does not serve the plaintiff lawyers, the representative party or any litigation funder, the contradictor/costs expert is a less conflicted agent to the passive group members than any of the other agents. Thus moral hazard tends to be less problematic when the contradictor/costs expert, rather than the plaintiff lawyer, is engaged to serve the passive group members. Moreover, while the contradictor/costs expert is tasked to further the interests of the passive group members, he or she is appointed by, and subject to oversight by, the court. Indeed, a referee must report to the court, and the court then has discretion to adopt, vary or reject a report while acting judicially.[227]

## V Conclusion

Taking a law and economics approach, this article has developed a framework for understanding the problems of information asymmetry and externalities in Australian class actions. This framework explains the core characteristics of Australian class action law and practice, and offers suggestions for ensuring the costs of the class action procedure do not outweigh its benefits. In particular, our framework explains that adequacy of representation, fiduciary duties and

223 *Kadam v MiiResorts Group 1 Pty Ltd [No 4]* (2017) 252 FCR 298, 310 [47], [50] (Lee J) ('*Kadam*'), citing with approval Richard A Posner, 'An Economic Approach to Legal Procedure and Judicial Administration' (1973) 2(2) *Journal of Legal Studies* 399, 400–1, which discusses the concept of 'direct costs', which include costs to the court.

224 *Kadam* (n 223) 310 [49] (Lee J).

225 *Botsman* (n 43) 136 [336] (Tate, Whelan and Niall JJA).

226 Kirk (n 100) 720.

227 *FCA Act* (n 16) s 54A; *Kadam* (n 223) 310–14 [51]–[62] (Lee J). See also at 310 [50] (Lee J), citing with approval the concept of 'error costs' discussed in Posner (n 223) 400–1.

the right to opt out function, in part, to mitigate moral hazard and enhance public perception of the civil justice system — but not without cost. Similar functions are also performed by judicial management and oversight of class actions, which again come with a cost. Moreover, the courts have a discretion over the giving of notices and the appointment of contradictors, referees and costs experts. The courts also have a discretion over the choice of remedy for breach of fiduciary duty and the award of any allowance to the errant fiduciary. Given the costs and benefits of these legal mechanisms vary from case to case, our framework offers guidance on how best to exercise the judicial discretion in a particular case.

Our economic framework complements and enriches traditional legal reasoning. For instance, this framework sheds light on doctrinal controversies about fiduciary regulation, calls for legislative amendments in relation to oversight of litigation funding, and informs the exercise of judicial discretion.[228] We make no large claims or grand theses about whether a particular legal rule or principle is or should be efficient. Instead, we offer a vocabulary and a coherent theory to assist the courts and others to gauge the consequences of select legal rules and principles, with a view to confirming or revising them.[229] Deriving propositions from transparent assumptions and logical arguments, our rigorous framework provides insights and direction in addition to what we can learn from analogy, common sense or intuition.

[228] See, eg, above Parts IV(B)(1)–(2).

[229] Such use of economic analysis is acceptable in judicial reasoning according to Sir Anthony Mason, 'Law and Economics' (1991) 17(2) *Monash University Law Review* 167, 173.