JONES DAY

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COMMENTARY

Australian Class Action Settlements Declined Due to Substantial Detriment to Class Members

Key Points

- The Federal Court of Australia refused to approve class action settlements in *Kelly v Willmott Forests Ltd (in liquidation) (No 4)* [2016] FCA 323 due to the settlement imposing a "significant detriment" on some class members by extinguishing their individual claims or defences, without any benefit in exchange and without adequate notice.
- The decision further highlighted the uncertainty in Australian class actions around the finality of a class action settlement by adding to the debate on whether a settlement bound class members in relation to all of their claims, or only claims that formed part of the common issues.
- The judgment drew attention to conflicts of interest that potentially arise in class actions, including conflicts between registered and non-participating class members' interests and between lawyers' interests in receiving legal fees and class members' interests in minimising those legal costs.
- The judgment reinforces the need for effective notice to class members and the Court's responsibility to protect class members, including in relation to the legal fees charged. The Court also suggests a further protection through an additional opportunity to opt out of the class action once the terms of a settlement are known.

Background–Claims

The applicants and class members were investors in forestry plantation managed investment schemes that failed. Originally three inter-related class actions were commenced on 22 December 2011 in relation to schemes from 2007, 2008 and 2009. In one proceeding, the claims were made against the two companies which were the responsible entities in the schemes under the *Corporations Act 2001* (Cth)—Willmott Forests Ltd ("Willmott Forests") and Bioforest Ltd ("Bioforest")—and their directors. In the other two, the claims were made against the lenders—MIS Funding No 1 Pty Ltd ("MIS") and the Commonwealth Bank of Australia Ltd ("CBA")—which financed some of the investors into the schemes. On 13 March 2013, a fourth class action in relation to a 2010 scheme was commenced against Willmott Forests as responsible entity, the directors and a further lender, Willmott Finance Pty Ltd (with MIS and CBA, the "Lenders").[1]

Each scheme was a long-term investment requiring investment over a period of between 15 and 25 years. The investor made an upfront, tax-deductible payment to acquire an interest in a scheme. No further fees were payable until a fee based on a percentage of the proceeds of sale of forest products following harvest was due, more than 15 years later (deferred fee model). By taking out a loan to acquire the interest, an investor could increase the tax benefits associated with the investment. None of the schemes survived to the point where the forest plantations were harvested. On 6 September 2010, receivers and managers were appointed over the assets and undertakings of Willmott Forests and its wholly owned subsidiaries, including Bioforest. On 22 March 2011, Willmott Forests and its subsidiaries were placed into liquidation.

The claims in the proceedings against the responsible entities and their directors centred on omissions and misleading statements in the product disclosure statements ("PDS") that were provided to investors. In particular, the PDS did not disclose that the deferred fee model involved a significant risk because Willmott Forests had to fund the cost of planting, maintaining and harvesting the trees before it received any further fees, which meant it was dependent on the sale of interests in future schemes to fund its existing obligations.

The failure of the schemes and the responsible entities meant that investors lost their investment in the schemes, received no return on the investment and, in some instances, still owed substantial monies to the Lenders.

Background–Settlement

The key features of the proposed settlements were:

- No compensation or damages is to be paid to the class members in respect of their losses, and (i) in the case of the 2007/08/09 scheme proceedings, there is no reduction in the outstanding balances of their loans, but the Lenders grant an extension of time to make repayments for class members currently in default; [2] or (ii) in the case of the 2010 scheme proceeding, three options are provided for the reduction of outstanding loan balances (representing various trade-offs between delaying payment and reducing the loan balance).[3]
- Amounts are to be paid by the respondents, to be expended on the *pro rata* reimbursement of class members who are or were clients of the lawyers acting in the class action and to refund monies paid as security for costs or to cover insurance taken out: (i) in the 2007/08/09 scheme proceedings, $3.1 million is to be paid to partially reimburse a total of $6.086 million in legal costs to the law firm and approximately $2 million paid to a fund for security for costs returned to class members who had made contributions; and (ii) in the 2010 scheme proceeding, $1.408 million is to be paid, $1 million of which is to be expended to partially reimburse a total of $1.749 million in legal costs and $408,000 of which is to be expended to pay Amtrust Europe Limited for an After the Event insurance policy taken out by the applicant to cover adverse costs.
- The applicants in each proceeding will provide binding admissions on behalf of the class members as to the validity and enforceability of the loan agreements between the Lenders and class members ("the binding loan enforceability admissions").
- The applicants in each proceeding will agree on behalf of the class members, that if a class member obtains damages or compensation in any Third Party Proceeding (as defined) and an order for contribution is made against a Lender or a related party in respect of those damages or compensation, the class member will indemnify the Lender or related party against that order for contribution ("the indemnity term"). "Third Party Proceeding" is broadly defined and includes any claim brought by the applicant or a class member against a person who is not a party to the Settlement Deed arising out of or relating to their investment in one or more of the relevant schemes. This would include financial advisors who recommended the acquisition of interests in the Schemes.
- The applicants in each proceeding, on their own behalf and on behalf of the class members, will provide broad releases to the respondents.

The settlement took place after class members were provided with the opportunity to opt out as mandated by s 33J of the *Federal Court of Australia Act 1976* (Cth) and after a "class closure" process. Pursuant to the class closure process, orders were made which provided that class members who did not satisfy the requirements for registration continued to be class members but were excluded from seeking any relief in the proceeding or any benefit from a settlement ("non-participating class members"). One of the requirements for registration in the 2007/08/09 scheme proceedings was either to make a contribution to a fund to provide security for costs or to provide information to show that the class member was financially unable to do so.[4] As a result of these orders, about 77 percent of class members in the 2007/08/09 scheme proceedings (approximately 2,427 persons) and 52 percent of the class members in the 2010 scheme proceeding (approximately 182 persons) were not permitted to obtain the benefit of the settlements but were subject to the binding loan enforceability admissions.

Loss of Individual Defences–*Res Judicata* / Anshun Estoppel

The first reason for refusing the settlement put forward by Murphy J was the binding loan enforceability admissions. The admissions would be significantly detrimental for some class members because it would preclude them from defending loan enforcement proceedings by the Lenders on any basis, even in reliance on claims or defences that were not pleaded in the class actions and which are based on a class member's individual or unique circumstances. Moreover, Murphy J also found that class members were not clearly informed that if they did not opt out they would be so precluded. Further, the proposed settlement did not allow class members an opportunity to opt out at the point of settlement.

It was submitted that the binding loan enforceability admissions were fair because if the class action proceeded to judgment and was unsuccessful, the outcome would be the same by reason of Anshun estoppels or principles of abuse of process.

The effect of a judgment requires resort to the principle of *res judicata*, issue estoppel, Anshun estoppel and abuse of process. The principle of *res judicata* provides that, where an action has been brought and proceeds to judgment, no subsequent proceedings can be maintained on the same cause of action.[5] In a similar vein, issue estoppel precludes a party from raising an issue of fact or law against another where the contrary has already been established in proceedings between the same parties or their privies.[6] A related principle is that of Anshun estoppel, which precludes parties or their privies from raising in subsequent proceedings issues of fact or law which should have been raised and dealt with in the prior litigation.[7] Considerations similar to those which underpin Anshun estoppel may also support a preclusive abuse of process argument.[8] Abuse of process is "capable of application in any circumstances in which the use of a court's procedures would be unjustifiably oppressive to a party or would bring the administration of justice into disrepute".[9] In the class action context, it is also necessary to apply s 33ZB of the *Federal Court of Australia Act 1976* which provides:

> A judgment given in a representative proceeding:
>
> (a) must describe or otherwise identify the group members who will be affected by it; and
>
> (b) binds all such persons other than any person who has opted out of the proceeding under section 33J.

Murphy J was called on to consider the above principles in the context of judgments where their application to class actions had been discussed. The Great Southern class actions and the Timbercorp class actions were also claims by investors in failed agricultural managed investment schemes that included loans to some of the investors. The decisions were by Croft J in *Clarke v Great Southern Finance Pty Ltd (in liquidation) (No 2)* [2012] VSC 338 and *Clarke v Great Southern Finance Pty Ltd (in liquidation)* [2014] VSC 516 ("*Clarke No 4*"), by Judd J in *Clarke v Great Southern Finance Pty Ltd (in liquidation)* [2014] VSC 569 and by Robson J in *Timbercorp Finance Pty Ltd (In Liq) v Collins and Tomes* [2015] VSC 461 ("*Collins and Tomes*").

In *Clarke No 4,* Croft J held that the binding loan enforceability admissions in that settlement were not unfair to class members because, upon judgment or settlement, class members would be barred from asserting any claims or defences that their loan agreements were unenforceable because of issue estoppel, Anshun estoppel and abuse of process.[10] In *Collins and Tomes,* Robson J took a different approach. Robson

J found that s33ZB did not create common law privies but rather "s 33ZB privies" which has an application similar to issue estoppel but not Anshun estoppel.[11]

Murphy J observed that it was common ground before him that a judgment or settlement of the class actions would bind class members to an estoppel in respect of the common claims which were pleaded, and that a judgment or settlement may bind class members to an estoppel in respect of common claims that could have been pleaded in the class actions but were not. However, his Honour did not need to decide this issue as the focus was on class members' individual claims or defences. Further, no evidence was before the Court to allow for determination of whether Anshun estoppel or abuse of process arose.

Turning to the class members' individual claims or defences, Murphy J considered whether class members could or were required to raise their individual or unique claims or defences within the class actions framework. Murphy J found that class members were not granted standing to make applications under ss 33Q, 33R or 33S of the *Federal Court of Australia Act 1976*. Rather, these provisions allow the applicant to seek, or the Court on its own motion to make, orders for dealing with non-common issues. A class member was given standing to seek to replace a representative party that was an inadequate representative pursuant to s 33T but it did not apply to the current circumstances. More generally, requiring class members to come forward with non-common issues would undermine the goals of the class action legislation, namely to promote the efficient resolution of multiple claims and avoid inconsistent findings. Murphy J also found that it was not unreasonable for class members to have not raised their individual claims. Central to this finding was that neither the opt out notices nor the lawyers representing the class members advised them that they would or might be precluded from advancing individual claims or defences in subsequent proceedings.

Incomplete Case Preparation and the Duty of Lawyers

The Court found that there were substantial difficulties in funding the proceedings which resulted in significant gaps in the preparation of the cases. In particular, no independent forensic accountant was retained to support important elements of the case. Murphy J found that this was relevant to whether the lawyers for the applicant were in a position properly to inform the Court as to the merits of the claims which then informs the fairness and reasonableness of the settlement.

The incomplete case preparation also was significant in that class members were not informed that the case had not been adequately prepared which "might adversely affect prospects of success at trial or the applicants' lawyers' consideration of the adequacy of a settlement offer".[12] Murphy J's reasoning suggested that the lawyers may not have fulfilled their duties to both their clients and to class members who had not retained the lawyers. Murphy J observed that most of the registered class members entered into a Retainer Agreement so that a solicitor-client relationship arose with the effect that the lawyers had a fiduciary duty to act in their clients' interests, as well as common law duties and contractual obligations, including "obligations to properly prosecute their interests, properly prepare the proceedings, and to inform class members of any circumstances which prevented it from doing so".[13] The lawyers, in accepting instructions to act as the solicitor in "open class" proceedings, also took on the obligation to act in the interests of all class members, not just their clients.

As a result, Murphy J formed the view that the settlement should not be approved unless class members were given an informed opportunity to opt out of the settlement (discussed below).

Lawyers' Conflicts of Interest

The Court raised as a concern the existence of potential conflicts of interest, including conflicts of duty and duty, as a result of the terms of the settlement.

The first conflict was between the interests of class members who registered in the class member registration process ("registered class members") and the interests of "non-participating class members". While all class members give up their claims and are subject to the binding loan enforceability admissions, only the registered class members receive any benefit in return, being the modest benefits set out above in each settlement. Registered class members may have an interest in accepting the settlement so as to obtain the benefits on offer. However, non-participating class members have no reason for

accepting such an offer. Indeed their interest was described by Murphy J as being "the proceedings continuing, at least until a settlement is reached which does not preclude them from bringing claims or defences against the respondents based in their individual or unique circumstances, or which allows them to opt out of a settlement which they consider to be unfair".[14] A duty-duty conflict of interest may then arise for the lawyers who are required to act in the interests of both sets of class members.

Murphy J found that the settlements should not be approved until the conflicts are recognised and properly dealt with.

A further conflict arises for the lawyers in relation to their interest in receiving legal fees.

Legal Costs

As mentioned above, the applicants' solicitors charged in total some $7.8 million in legal fees on a fixed fee basis. Under the terms of the proposed settlement deed, some $4.1 million of the settlement amount was to be distributed to reimburse class members who had paid legal costs on a *pro rata* basis. While Murphy J was not opposed to the reimbursement of legal costs from the settlement fund, his Honour questioned the reasonableness of the amount of legal fees charged and ordered that evidence be put before the Court on the issue.

In so doing, Murphy J rejected the applicants' lawyers' threshold contention that there was no warrant to consider the reasonableness of the costs because the settlements did not provide for the lawyers to receive any amount for legal costs. His Honour held:[15]

> In the present cases I am well satisfied that the Court should exercise its power to oversee the costs charged to class members. There is an inherent conflict between the interests of [the lawyers] in being paid legal costs and the interests of client class members in minimising legal costs, or at least in paying only reasonable costs or only the costs agreed under the Retainer Agreement. In the present cases there is a pronounced information asymmetry between [the firm] and its clients in relation to costs, and the firm is in a position of particular dominance.

Murphy J went on to explain that each class member client knows only the fixed fee contributions that he, she or it paid. Naturally enough, class members are unlikely to have been interested in ensuring that the legal fees were reasonable overall. Further, class members have limited or no insight into whether the lawyers undertook (properly or at all) the legal work which underpinned the firm's entitlement to charge costs. His Honour also explained that legal costs should be considered as part of the settlement approval process because the assessment of the reasonableness of legal fees may affect the real "return" to class members under the settlements if the lawyers were required to disgorge any costs that are shown to have been excessive.

The Court was also taken to the approach of Croft J in *Clarke No 4*. In that case, the Victorian Supreme Court approved a settlement in which almost $20 million of the settlement amount was to be distributed to class members in *pro rata* reimbursement of the legal costs they paid. It was submitted that the authority in *Clarke No 4* should be followed. Murphy J held, however, that *Clarke No 4* could be distinguished because in *Kelly*, unlike in *Clarke No 4*, there was presently an objection to the reasonableness of costs and Murphy J could not be satisfied, on the basis of evidence before him, that the costs were reasonable. Alternatively, if *Clarke No 4* was not distinguishable, Murphy J declined to follow it.

Opportunity to Opt Out of Settlement

Murphy J raised for consideration the need to allow for a second opt out opportunity for class members where the first opportunity to opt out occurred prior to the terms of the proposed settlement being made available to class members. Murphy J's suggestion was aimed at dealing with his view of the unfairness of class members being subject to the binding loan enforceability admissions in the context where class members were not informed that they would lose the ability to raise their individual claims or defences in the original opt out notice.

The *Federal Court of Australia Act 1976* does not expressly empower the Court to provide class members an opportunity to opt out of a settlement, but Murphy J found that such power existed pursuant to either s 33J(3) or s 33ZF. Section 33J(3) provides:

> The Court, on the application of a [class] member, the representative party or the respondent in the proceeding, may fix another date so as to extend the period during which a [class] member may opt out of the representative proceeding.

Section 33ZF allows the Court to make any order which the Court thinks appropriate to ensure that justice is done in the proceeding.

Murphy J also made reference to the US position. The US Federal Rules of Civil Procedure, r 23(e)(4) provides:

> If the class action was previously certified under Rule 23(b)(3), the court may refuse to approve a settlement unless it affords a new opportunity to request exclusion to individual class members who had an earlier opportunity to request exclusion but did not do so.

Murphy J also cited with approval the American Law Institute's *Principles of the Law of Aggregate Litigation*, in which it opines that "as a matter of fairness, a class member should have an opportunity to opt out after learning about the actual terms of a settlement".[16] In the current case, Murphy J found that the the binding loan enforceability admissions which formed part of the settlement represented a substantial detriment to class members and the failure to provide a second opportunity to opt out was "material" to the refusal to approve the settlement.[17]

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

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Endnotes

1 *Kelly v Willmott Forests Ltd (in liquidation) (No 4)* [2016] FCA 323 ("*Kelly*") at [14]-[22]; *Madgwick v Kelly* [2013] FCAFC 61; 212 FCR 1 at [3].

2 For registered class members who are in default under their loan contracts, the Lenders agree not to commence or take any steps to prosecute any debt recovery proceedings against them until at least 60 days after orders approving settlement, in which time class members will have an opportunity to pay the arrears. If the loan is brought up to date, the Lenders will allow the balance of the loan to be paid over the remaining term.

3 The options for the 2010 scheme proceeding members were:

Repay 50 cents in the dollar on the amounts outstanding within 14 days of the Effective Date (defined as 35 days after settlement approval);

Repay 60 cents in the dollar on the amounts outstanding in equal monthly instalments over 12 months with the first instalment to be paid 30 days after the Effective Date; or

Repay 70 cents in the dollar on the amounts outstanding in equal monthly instalments over 24 months with the first instalment to be paid 30 days after the Effective Date.

4 Security for costs involves a representative party providing a form of security for a respondent's legal costs in the event the class action is unsuccessful and the representative party is liable to pay the respondent's costs of defending the class action. In the 2007/08/09 scheme proceedings, after a number of interlocutory judgments, the class members were asked to voluntarily contribute to a fund for security for costs: *Kelly* at [30]-[33].

5 *Jack v Goldsmith* (1950) 81 CLR 446 at 466 per Fullagar J (in dissent); cited with approval in *Port of Melbourne Authority v Anshun Pty Ltd* (1981) 147 CLR 589.

6 *See e.g. Jack v Goldsmith* (1950) 81 CLR 446 at 455 per Latham CJ.

7 *Port of Melbourne Authority v Anshun Pty Ltd* (1981) 147 CLR 589; *Tomlinson v Ramsey Food Processing Pty Limited* [2015] HCA 28; 89 ALJR 750 at [22].

8 *Tomlinson v Ramsey Food Processing Pty Limited* [2015] HCA 28; 89 ALJR 750 at [22].

9 *Tomlinson v Ramsey Food Processing Pty Limited* [2015] HCA 28; 89 ALJR 750 at [25].

10 *Clarke v Great Southern Finance Pty (Receivers and Managers Appointed)* [2014] VSC 516 at [126].

11 *Timbercorp Finance Pty Ltd (In Liq) v Collins and Tomes* [2015] VSC 461 at [583]-[585].

12 *Kelly* at [310].

13 *Kelly* at [303]

14 *Kelly* at [318]

15 *Kelly* at [333].

16 *Kelly* at [138].

17 *Kelly* at [140].