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Houle Look Out for the Absent Plaintiffs? Divisional Court Upholds Judge-Initiated Amendments to Third Party Class Action Funding Agreement

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Once considered unlawful "champerty", third party litigation funding has been on the rise in Canada following more recent case law holding that third party funders should be permitted to fund private litigation.[1] A recent product liability class actions decision demonstrates the unique issues posed by third party funding in the class actions context. A class action funding agreement is not just a civil contract; it is an arrangement subject to intense scrutiny in the public interest. In *Houle v. St Jude Medical*, a highly anticipated judgment controlling the 'business model' of class actions in Ontario, the Divisional Court has upheld the decision of a leading class actions judge to intercede in the arrangement between class representatives and the private third party lender engaged to fund the litigation.[2]

A Unique Arrangement: The Proposed Third Party Funding Agreement

The agreement at issue in this case, a proposed class action involving allegedly defective defibrillators, was a unique one to Canadian courts. Subject to minor restrictions, the lender agreed to pay:

a) 50% of class counsel's legal fees throughout the action, up to a certain cap;

b) 100% of class counsel's disbursements; and

c) Any adverse costs awards or order for security for costs.

In turn, class counsel would provide the lion's share of any contingency fee arising from success or settlement to the lender. The split between class counsel and the lender ranged from 10/20% if the matter resolved within 18 months, all the way up to 13/25% if it resolved after three years. For context, to date, Canadian courts have only approved arrangements where the funder takes on a lesser burden and seeks up to 10% of recovery.[3]

At the outset of the proposed class proceeding, the plaintiffs sought an order approving the litigation funding agreement with the lender, which was opposed by the defendants.

Approved, With Comments: The Motion Judge's Decision

Despite the fact that the representative plaintiffs were given access to quality independent legal advice before signing the third party funding agreement, the motion judge had serious concerns about the third party funding arrangement. The motion judge noted among other things that the contingency fee after three years of litigation (38%) exceeded the standard 33%.[4] The motion judge was also concerned that there were several clauses that seemed to imply that the representative plaintiffs were responsible to the lender for the conduct of the action, and that the lender had the benefit of 'ripcord clauses' that would allow it to resile from the funding agreement if it disagreed with the trajectory of the class action.

The motion judge ordered that the agreement be modified to permit 10% recovery for the lender, along the lines of the standard return allocated to Ontario's public class actions funder, the Class Proceedings Fund – and then, in light of the significant additional risk and costs taken on by the lender in excess of what that the fund would cover, the motion judge ordered that the remainder of the allocation be determined at the conclusion of the proceeding, in the same way class counsel fees must be approved at the time of settlement or judgment. This decision was subsequently appealed by class counsel.

Judicial Rewrites Upheld: The Divisional Court Decision

The Divisional Court – the first level of appeal for interlocutory decisions between the motion court and the Ontario Court of Appeal[5] – upheld that decision.

In seeking to overturn the motion judge's unilateral amendment of the funding agreement, the plaintiffs effectively argued that the matter should be viewed through the lens of contract, while the defendants (and, to date, the courts) seemed to approach it through the lens of class actions procedure and "champerty": the ancient common law and statutory offence forbidding intermeddling in a stranger's lawsuit. The plaintiffs noted that the parties were independently advised, that class actions are recognized by the courts as a social good,[6] and that the plaintiffs' counsel would not provide a backstop against adverse costs awards. That, the plaintiffs argued, should have been the end of the inquiry into privileged affairs. Representative plaintiffs enter into contracts that bind the class all the time, after all, including expert retainers, counsel retainers and e-discovery services agreements.

In upholding the motion judge's direction that the third party funding agreement must be amended to receive court approval, the Divisional Court pointed to the risk of abuse of absent, non-participating class members and the courts' responsibility to those parties under the *Class Proceedings Act*. The court found the motion judge's proposed amendments were appropriate to avoid the risks of overcompensating the lender or giving the lender undue control over the plaintiffs' conduct of the litigation. The Court declined to treat the arrangement as a pure contract between arm's-length parties. These funding arrangements have only recently been ruled to be something short of illegal, and as a result the courts continue to justify their maintain control over potentially champertous arrangements that could overcompensate a lender for its actual risk, at the expense of a highly vulnerable population.

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Key Takeaway Principles

While the Divisional Court's decision in *Houle* makes clear that third party funding is here to stay, it also makes clear that the courts will take an active role in scrutinizing these arrangements in the public interest:

As the industry grows and new forms of transactions emerge, they will be considered on their merits with due input from the affected parties. The law will continue to be concerned to protect vulnerable parties whose recovery is the subject of the proposed bargain. It will continue to be concerned with the potential for harm to the administration of justice that could accrue if the court is seen to allow third parties who are not parties to the litigation to profit unduly from or unreasonably control that litigation.[7]

The friction between the law of contract and the law of champerty, unsettled as it now is, looks to be a recipe for uncertainty: particularly since the courts are assessing the legality of these agreements on a case-by-case basis. Watch this space, as the plaintiffs are likely still within time to appeal the decision further. In the meantime, expect to see third party funding arrangements continue in Ontario, though with a bit of a chill. Any funder would be hesitant to enter an agreement that might be rejected by the court, but worse still for business is any agreement that could be *modified* by the court at will.

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[1] See, *inter alia, Fehr v Sun Life Assurance Company of Canada*, 2012 ONSC 2715; compare with *Metzler Investment GmbH v Gildan Activewear Inc.* (2009), 81 CPC (6th) 384 (Ont SC).
[2] *Houle v St. Jude Medical Inc.*, 2018 ONSC 6352, <http://canlii.ca/t/hvq7d> ["***Houle***"].
[3] See, *inter alia, Dugal v Manulife Financial Corp.*, 2011 ONSC 1785; *Musicians' Pension Fund of Canada (Trustee of) v Kinross Gold Corp.*, 2013 ONSC 3974; compare with the rejection of 30% or more in *Schenk v Valeant Pharmaceuticals International Inc.*, 2015 ONSC 3215.
[4] *Houle v St Jude Medical*, 2017 ONSC 5129 <http://canlii.ca/t/h5nnm>.
[5] The Court of Appeal had previously refused to hear the appeal, referring it back down to the Divisional Court as it found the decision below to be an interim, rather than final, disposition despite the practical effect the decision might have on the proceeding: *Houle v St Jude Medical*, 2018 ONCA 66.
[6] *Dutton v Western Canadian Shopping Centres*, 2001 SCC 46.
[7] *Houle*, supra at para. 51.
