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Submitted via e-mail

Australian Law Reform Commission ("ALRC")
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Re: Class Action Proceedings and Third-Party Litigation Funding
Discussion Paper No 85 (2018)

Dear Hon. Justice Derrington:

We welcome the opportunity to comment on the Australian Law Reform Commission's above-referenced Discussion Paper, issued in June 2018 (hereinafter the "Discussion Paper").

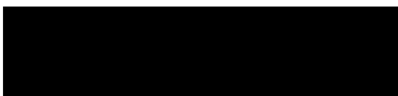
PF2 Securities Consulting ("PF2") was formed in Australia in 2016, as the sister-company to the US-based operation, PF2 Securities Evaluations, Inc. Being newly operational in Australia, we have limited experience in the local market and will therefore confine our comments to observations we have drawn more generally, having worked in a consulting capacity on over 50 litigation matters globally in the last ten years, in the United States, United Kingdom, Canada and, more recently, Australia – with over half of these being class actions.

In our submission, we aim to share our insights as consulting experts who have worked on class actions (both funded and unfunded) and as analysts of marketplace dynamics with experience in the mechanics of competition. We endeavour to explain in what ways competitive forces can be both harmful and helpful, and how *measurement* can be used to drive the more desirable forms of competition.

We hope that our reflections prove valuable to the ALRC in implementing the proposed licensing regime and directing the proposed competitive changes in a manner that strengthens, rather than weakens, funding standards.

Please do not hesitate to contact me at gene.phillips@pf2se.com if additional information may be helpful in reviewing this submission, or if PF2 may otherwise be able to be of assistance to the ALRC in fulfilling its mission.

Yours sincerely,



Gene B. Phillips
Director, PF2 Securities

General Comments – Game Theory and Context

The ALRC is tackling, in the Discussion Paper, what would be considered a multi-*party* and multi-*factor* analysis.

The *parties*, for the most part, are the plaintiffs (class members), the lawyers representing them, and the funders funding the litigation.[1] The *factors* are the objectives and restrictions set in the Discussion Paper, including for example the concurrent interests to (1) increase access to justice, (2) limit the costs of proceedings, and (3) maintain judicial standards and integrity.

This balance is delicate. First, the parties often have similar interests (when pursuing litigation) but sometimes have competing interests (when determining their take in a fixed settlement pie). Next, the factors themselves are inter-related and at cross-purposes, therefore making them difficult to manage: regulation that seeks to maintain or improve judicial standards might, for example, interfere with the intent to limit costs.[2]

Mathematicians often call complex puzzles such as these *games*. The competing interests of the beneficiaries of a settlement would be called a "zero-sum" game, in that one party's higher take must necessarily come at the expense of the other parties. But at the initiation of a lawsuit, the game is certainly not a zero-sum game, with all parties typically working together (rather than competing) to grow the size of the settlement pie.

While we may think of this as a game, it certainly is not one: the class action funding business is a serious marketplace – and it is a competitive marketplace. Rational participants are independently motivated to seek profits, and new entrants can enter and have entered the marketplace to take advantage of perceived opportunities. Thus, the Australian marketplace for litigation funding would be said to exhibit at least some forms of efficiency.

It is in the context of this competitive and changing marketplace that we focus the commentary in our submission.

We aim to convey certain observations about the nature of competition that the ALRC might find valuable as it navigates the implementation of the proposed licensing scheme. Our comments are respectfully offered in the context of the multi-player, multi-factor game we describe, with the hope that if our insights help clarify any parts of the puzzle or its dynamics, the ALRC will be in a better position to solve it.

[1] The respondents are also, certainly, a "party" at issue, but in a manner different to the nature of the "game" subsequently described in this section. The interests of the respondents are regularly but not necessarily always adverse to those of the plaintiffs and their representatives.

[2] The newly proposed oversight of funders, which seeks to maintain or improve standards, increases their operating costs and, therefore, the costs of litigating funded cases. Similarly, lifting the ban on contingency fee arrangements prompts competition, which may well lower the costs for plaintiffs – but it simultaneously drives up the costs for funders, subsequently less likely to "win" each marginal engagement, and risks lowering standards and integrity, as we discuss herein.

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Sections 3 and 5: Topics of Competition and the Regulation of Litigation Funders

Section 5 of the Discussion Paper puts forward the proposal, under certain conditions, to permit solicitors to enter into contingency fee agreements. Section 3 of the Discussion Paper proposes that third-party litigation funders be licensed and audited, and seeks suggestions from submitters as to prudent oversight measures.

3. Regulating Litigation Funders

Proposal 3–1 The *Corporations Act (2001)* (Cth) should be amended to require third-party litigation funders to obtain and maintain a 'litigation funding licence' to operate in Australia.

Proposal 3–2 A litigation funding licence should require third-party litigation funders to:

- do all things necessary to ensure that their services are provided efficiently, honestly and fairly;
- ensure all communications with class members and potential class members are clear, honest and accurate;
- have adequate arrangements for managing conflicts of interest;
- have sufficient resources (including financial, technological and human resources);
- have adequate risk management systems;
- have a compliant dispute resolution system; and
- be audited annually.

Question 3–1 What should be the minimum requirements for obtaining a litigation funding licence, in terms of the character and qualifications of responsible officers?

Question 3–2 What ongoing financial standards should apply to third-party litigation funders? For example, standards could be set in relation to capital adequacy and adequate buffers for cash flow.

Question 3–3 Should third-party litigation funders be required to join the Australian Financial Complaints Authority scheme?

For the reasons that follow, we recommend that any oversight in the proposed scenario must be tightly linked to a quality control mechanism: the measurement of the performance of the licensed entity.

The Discussion Paper notes sources' contrasting perspectives on whether the introduction of a contingency fee billing model would increase competition in the funding market:

- (5.11): "It is also argued that this expansion of the funding market would promote competition and eventually lower commission rates set by litigation funders, creating a more level playing field."
- (5.17): "Those opposed to the introduction of contingency fees suggest that the key inter-related rationales in support of contingency fees—increasing access to justice and competition—are erroneous."

We do not take a formal position here on which of the arguments is "right." Our strong expectation is that permitting contingency fee arrangements would serve to increase competition, although we have not performed any serious analysis to support this expectation.[3]

We focus, rather, on whether the promotion of competition is a positive factor, or under what conditions it may be a positive. Competition is presented in the Discussion paper as a (positive) rationale for introducing the contingency fee billing model, linked to the "lowering of commission rates set by litigation funders."

It is certainly true that, especially in capitalist markets, *competition* is typically seen to be a positive, especially for consumers.

Theoretically, increased competition translates into increased supply <u>of the same product</u>. As long as demand remains constant, an unfettered increase in supply means that the price goes down. In the instant case, the "consumers" would be class action plaintiffs who would, in concept, benefit from increased competition in that the larger supply of funding options would presumably drive down funding costs (e.g., commission rates). But this is simply the basic *theory*. Often it works well, such as in the market for televisions, where competition often directly results in increased options for the same or a substantially similar product. Sometimes it works particularly poorly, including when the basis for competition changes the quality of the good or the service being provided. Competition can negatively impact the nature of the product being provided: slippage can occur.

The so-called Global Financial Crisis (or "GFC") presents any number of examples of how parties competed for new business by *lowering their standards*. To win business from competitors, mortgage lenders performed fewer and less reliable credit checks on borrowers. Lenders (including banks) lowered underwriting standards and decreased their requirements for collateral against the loans they were providing and securitising. Most pertinent here, some licensed credit rating agencies, in the face of competition, actively ignored the outputs of their more accurate or advanced models so as to engineer the specific rating outcomes that would allow them to maintain or grow market share.

The lowering of standards, in the name of commercial interests, is by no means a phenomenon limited to the GFC.[4]

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[3] We note that while all shareholder class actions in Australia are funded, many if not most new shareholder cases in the United States are not funded by litigation funders, but rather by law firms operating on a contingency fee basis. This is certainly not an apples-to-apples comparison, but it indicates that law firms would likely be able to compete, significantly, for the funding of shareholder class actions in Australia. We acknowledge that law firms seeking to litigate shareholder class actions in Australia on a contingency fee basis may, however, need to insure some of their adverse-cost risk in Australia, which risk does not feature as prominently in the United States. In the Canadian class action landscape, which may provide a closer comparison to the Australian market, contingency fee models are common. (See Discussion Paper at section 5.31.)

[4] The credit rating agencies, for example, are criticised to this day for continuing to inflate their ratings for business reasons. See for example Sean Flynn, Andra Ghent (2018) Competition and Credit Ratings After the Fall. Management Science 64(4):1672-1692. https://doi.org/10.1287/mnsc.2016.2604. "We analyze the entry of new credit rating agencies into structured finance products. Our setting is unique as we study a period in which the incumbents' reputation was extremely poor and the benefit of more fee income from inflating ratings was low. We find entrants issue higher ratings than incumbents, particularly for interest-only tranches. Using measures of market share that are exogenous to incumbent ratings, we provide suggestive evidence that incumbent rating levels become more generous as entrant market share in a product type increases."

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The term "competitive laxity" refers to the practice among credit rating agencies of lowering their standards (i.e., their methodologies) to draw business away from their competitors. The credit rating industry has been particularly vulnerable to the threat of competitive laxity in areas where issuers and underwriters can engage in rating shopping. Rating shopping (like forum shopping) is the process of seeking out the rating agency (or forum) that will provide the most favourable outcome. The difficulty lies in that the users of ratings (or funding services) can shop, or threaten to shop, thereby encouraging each rating agency (or litigation funder) to out-bid its competitors, or risk losing prospective clientele.

Increased competition often results in reduced costs or expenses, as intended, especially in a situation in which you have a pre-existing monopoly or oligopoly. But in the process of reducing expenses, competition can drive competing parties to lower their standards – which we refer to as slippage or competitive laxity.

At its worst, competition, could prompt funders to hasten their due diligence or agree to less commercially-viable terms. These are just two examples of negative consequences that can imperil a funders' viability, the very thing that regulatory oversight seeks to buffer against.

If competition may lead to "competitive laxity," how do we protect against a lowering of standards?

The appeal of competition is that it can lead to lower prices for the same product or it can spur companies to improve their product. But if competitors compete on price or the speed of responsiveness, the quality of the product provided is not maintained: a race-to-the-bottom precipitates, resulting in slippage.

One simple answer, then, is that regulation (or licensing) needs to encourage parties to compete *on quality*.

If the overseer monitors the performance of the licensee, and links the licence to the meeting of performance targets, licensed entities will be further discouraged from making any hasty decisions or taking undue risks.[5]

We draw a distinction here between the oversight of policies, procedures, systems and resources, and of performance itself. The credit rating agencies may have been staffed with learned analysts, and housed state-of-the-art policies and world-class systems. But many crisis-era credit ratings were simply wrong: at times they were stale, based on outdated data and models, or exhibiting little or no predictive content. Importantly, in certain situations, the analysts were found to have selectively deviated from their published procedures.[6]

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[5] Further, if the performance metrics, as designed, are found to be violated, a specific mechanism ought to provide for the suspension of the licence, potentially for a short "sit-out" period. See for example Professor Calomiris' opinion piece in the *Wall Street Journal*: "Financial Reforms We Can All Agree On." https://www.wsj.com/articles/SB124044213684645481

[6] Many of these revelations came through congressional hearings, or by way of the post-crisis Financial Crisis inquiry Commission. Pertinently, the U.S. Securities and Exchange Commission ("SEC") which regulates the credit rating agencies, does not opine on the quality of their models, methodology or the predictive content of the resulting ratings. Credit rating agencies produce credit ratings, and the rating agencies are licensed to help ensure their ratings are reliable and objective. The SEC audits rating agencies' procedures, including for dealing with conflicts of interest. But the key ingredients and products – the quality of methodologies employed and the predictive content of the ratings – go unaudited.

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For the reasons delineated above, we recommend that the oversight of the licensed firms must necessarily be tightly focussed on the monitoring and measurement of actual performance.[7]

[7] Assuming we could limit the potential *race-to-the-bottom* in terms of standards, the question may be asked "*Why do we care about the quality or performance of the litigation funder, as long as they can pay their bills?*" There are several reasons why the legal community should care about quality. The Discussion Paper captures, by reference to the Victorian Law Reform Commission and elsewhere, that funders and lawyers may have conflicting interests or reasonable disagreements when working together on a funded case: "The lawyers may consider aspects of the case to have legal merit, yet the litigation funder may not wish to finance these aspects of proceedings." (Section 4.9) Similarly, the Discussion Paper cites to situations in which a funder's commercial interests may conceivably interfere with the perceived best interest of the class members: "It may be in the commercial interests of a litigation funder to accept a settlement offer, even when the representative plaintiff may wish to negotiate further to produce a better settlement outcome, or to proceed to trial, where there is a risk of losing." (Section 4.8) But in the opposite scenario, too, the perceived conflict may provide an efficiency with the funder providing a steady hand: in a fully-funded matter that is progressing poorly, both the solicitors (billing by the hour) and the plaintiffs (having scarce if any downside-risk) may have little interest in settling, while the funder may be the party most interested in folding. Importantly, the funder alone has a natural risk-return profile, having both upside and downside exposure. From the perspective of consulting experts, too, the balanced nature of a higher-quality funder's decision-making can be similarly valuable. In complex litigation commercial decisions have to be made, including whether to seek out additional experts and better, or more comprehensive, supporting data sets. A stronger funder makes more efficient budgetary decisions and has a keener appreciation for the legal landscape and how it can change during the course of the proceedings. This manifests in a healthier understanding of the challenges faced by legal teams and experts in ensuring the models are robust, and the arguments are tight. For experts like ourselves (or the teams of experts we oversee) having an astute funder therefore adds a level of protection: on the back of judicious decision-making, legal teams are better equipped to finance (1) the building and management of the appropriate team of experts and (2) the purchase of data necessary to explain, make, or defend a position – and these attributes limit the potential for experts having to "stretch" in their conclusions or beyond their areas of expertise. Altogether, among other things, a more discerning funder is less likely to interfere unduly with the litigation, and is more likely to be balanced in both its budgeting and its risk-taking, including in ways that serve to protect testifying experts. Finally – and we acknowledge that the following is not based on any serious analysis – we posit that knowledge of the presence of a more experienced funder (and a deeper pocket) on the other side *might* bring certain cases to a more expeditious resolution.

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Additional Comments

> **Question 3–2** What ongoing financial standards should apply to third-party litigation funders? For example, standards could be set in relation to capital adequacy and adequate buffers for cash flow.
>
> 3.34 A key value of a licensing regime is its ability to provide a minimum threshold for entry into the industry. It provides a mechanism for assessing the character and qualification of those who seek to enter the business of litigation funding. Given the role litigation funders play in litigation and their provision of a financial service, the ALRC has considered the existing requirements for entry into the legal profession and the requirements for AFS licensees. In this regard, the ALRC notes that many litigation funding businesses are run by those with an extensive background in civil litigation, often as partners or principals of large legal firms, and that being able to assess the legal merits of a case is essential for the success of any litigation funding business, which requires a high success rate in funded litigation to be sustainable. Similarly, expert management of capital and cash flow is required to ensure a sustainable and competitive business model.
>
> 3.35 While lawyers and AFS licensees provide useful potential models, the ALRC seeks more information from stakeholders as to the appropriate character and skill requirements for litigation funders in order to protect consumers of litigation funding services and other litigants who may rely on promises made by a litigation funder during the course of litigation.

A well-designed capital adequacy model may seek to quantify both the potential magnitude and timing of risks inherent in a funder's portfolio, and it may allow or require the funder to regularly adjust its expectations (of success or failure) and the result thereof (likely incoming revenues or outgoing expenses or costs), *including during trial*.

Constant measurement allows for firms to maintain appropriate provisions in reserve to cover expected or potential outlays and disbursements. Financial firms regularly use models to systematically monitor this exposures and often to automatically update their estimates as to the size and timing of potential losses, or the likelihood that foreseeable or larger-than-expected losses would exceed their capital buffers.[8]

To limit the potential for litigation to become disorderly upon the failure of any single funding institution to make the necessary disbursements during the course or settlement of a particular matter, the ALRC might consider the design of a shared escrow account, as a form of common insurance. All licensed funders could be required to contribute into this common fund a portion (whether it be 0.1% or 1% or as determined) of all revenues or profits, to be used to satisfy the missed payments demanded from the failed institution in the litigation. If the escrow account were to surpass a pre-specified dollar threshold, some amounts could be returned to the licensed funders in proportion to their contributions to the account.

[8] See, for example, Value-at-Risk measurements, also called "VaR" or "V@R." We are not here opining that VaR is the appropriate metric to use in this context.

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> 5.80 The ALRC is interested in whether any other self-funding models are operating. An appropriate model may include the following characteristics:
>
> - one percent of fees recovered from contingency agreements or litigation funding agreements are reinvested into the fund
> - the fund is used to provide financial assistance and indemnify representative plaintiffs in certain class actions
> - the fund is controlled by a board that determines which actions are meritorious and are unable to proceed under any other funding model

One example might be The Class Proceedings Fund, established in 1992, which receives a levy in the amount of 10% of any awards or settlements in favour of the plaintiffs in funded proceedings plus a return of any funded disbursements. Its initial funding came from a $500,000 grant from The Law Foundation of Ontario.[9]

Disclosure: PF2 notes that while it holds itself out as an independent party, including in the context of its litigation consulting work, its own commercial interests may be seen to colour its opinions here. In that context, PF2 wishes to explicitly acknowledge that its clients include law firms, regulatory institutions and supervisory authorities, other experts and litigation consulting companies, and litigation funders. PF2 also consults on behalf of institutional investors outside of the realm of litigation, but our institutional investor-clients are often litigious, including being directly involved in class actions either among the members of the class or among the respondents.

[9] http://www.lawfoundation.on.ca/class-proceedings-fund/