Omni Bridgeway Limited
ABN 45 067 298 088
omnibridgeway.com

Submission to Treasury and the Attorney-General's Department

Consultation: Guaranteeing a minimum return of class action proceeds to class members

5 July 2021

1. Introduction

Omni Bridgeway (previously called IMF Bentham) listed on the Australian Securities Exchange in 2001, specifically to promote transparency in what was at that time a new industry. Omni Bridgeway is a global leader in dispute finance, financing disputes from inception through trial, appeal, enforcement and recovery. The company is Australia's largest and most experienced litigation funder.

2. Summary of Omni Bridgeway's submissions

In response to this consultation, Omni Bridgeway submits:

- In all class actions the court must approve any settlement as being fair and reasonable. The courts are the best and most appropriate body to assess the risks of litigation undertaken by litigation funders and an appropriate return for that risk. Those risks vary across each class action and so it is inappropriate to assume that there can be a one size fits all cap to funder returns. The courts have a range of existing powers to determine a fair and reasonable distribution of proceeds from funded class actions and diligently exercise these powers. Price regulation implies that the courts are not capable of or willing to undertake this role, a proposition Omni Bridgeway rejects.

- Expert economic analysis by PwC (appended to this submission) shows that a 70 per cent minimum return to group members is likely to substantially constrain the viability of future funded class actions in Australia. It therefore risks damaging the very people the regime is ostensibly seeking to protect – potential group members who will have their options to access justice curtailed.

- There is no rationale to adopt a statutory minimum return of 70 per cent to group members. A 70 per cent minimum would be an arbitrary measure and is not supported by any analysis by reference to the negative implications for the funding of class actions if it was adopted or the risks assumed by litigation funders.

- A statutory minimum return of 70 per cent to group members would result in a 30 per cent cap on the returns to litigation funders for the legal costs[1] and funder's commission. A 30 per cent cap on the returns to funders inclusive of legal costs will result in an inequality of resources between claimants and defendants. It is foreseeable that defendants may seek to defeat a claim by "deep pocketing" tactics, that is, prolonging and/or complicating proceedings (thereby increasing cost) making it unviable for group members to pursue their claim.

- Sound regulatory theory suggests that pricing intervention should only follow market failure.[2] There is no evidence of market failure in the litigation funding industry[3] in which:

  - there are few complaints by group members;
  - there is no evidence of what has been described as "opportunistic class actions"*4*;
  - competition is pushing down funding rates*5*;
  - there are significant checks and balances in place already, including increasing intervention by the courts in the class action settlement approval process;
  - the 2020 regulatory reforms require litigation funders to hold an Australian Financial Services Licence (AFSL) and to comply with the Managed Investment Scheme (MIS) regime for class actions.

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[1] These costs comprise lawyers' fees and disbursements (which are the other costs to bring the proceedings such as court fees and expert fees).

[2] PwC, *Models for the regulation of returns to litigation funders*, 16 March 2021 (PwC March Report), page 9 (Appendix 2) and PwC, *A Possible Approach to the Regulation of Litigation Funding – Supplementary Report*, 5 July 2021 (PwC Supplementary Report), page 8 (Appendix 3).

[3] PwC Supplementary Report, page 8.

[4] Report of The Senate Economics References Committee on the Treasury Laws Amendment (2021 Measures No.1) Bill 2021, June 2021. The report states at paragraph 2.210 that "*the government claims that the measures in Schedule 2 are needed because of the threat of 'opportunistic class actions' against companies—but Treasury and the Attorney-General's Department were unable to identify a single example of an opportunistic class action, or even explain what the government meant by that term*".

[5] See the section on industry data on pages 17-19.

- In successful class actions, the court awards an amount for damages and an amount for the successful claimant's legal costs. When a class action settles, the settlement amount is expressed to be inclusive of legal costs. Accordingly, a component of the settlement sum will reflect a component for those costs that have been paid by the funder. A statutory guarantee of a minimum 70 per cent amount of the "gross proceeds" payable to group members that includes those legal costs, whether by way of court order or as part of a settlement sum, would be unjust as the group members have not paid those legal costs.

- For many years Omni Bridgeway has striven to return at least 50 per cent of the gross proceeds to group members. This has not been designed to arbitrarily change the amount going to successful group members across the board (in the majority of cases group members receive more than 50 per cent in any event) but rather to operate as a stop gap to protect group members in the event that, despite settlement, the gross proceeds are materially smaller than was expected at the point of funding. In that context, and recognising the importance of ongoing public confidence in the class action system, Omni Bridgeway recommended a 50 per cent minimum return to group members to the Parliamentary Joint Committee on Corporations and Financial Service (**PJCCFS**) in its inquiry in 2020 on litigation funding and the regulation of the class action industry, intended to operate as guidance to the court or a rebuttable presumption.

- Although Omni Bridgeway's view is that the courts are the best and most appropriate body to assess the appropriate returns to group members and litigation funders, PwC has, at our request, considered the regulatory approach that should be undertaken if there is to be further consideration of a regulatory cap. PwC's view is that the task should be undertaken by an existing and experienced regulatory body applying standard regulatory processes[6].

- The recent advent of group costs orders (**GCO**s – a form of contingency fees for lawyers) in Victoria has resulted in an increase in class actions in that state funded by law firms through the proposed use of a GCO. This has created a dual system for class actions with some 'funders' regulated and others who consider that they are not, and appears to have contributed to an increase in the number of class actions[7]. The playing field should be evened and it should be made clear that law firms acting as funders are subject to the same regulation as third party funders.

[6] PwC Supplementary Report, pages 8-9 (Appendix 3).
[7] Allens, *Class Action Risk 2021,* March 2021, page 8.

3. Unreasonable price intervention will reduce the availability of funded class actions to the detriment of group members

In asking the PJCCFS to establish an inquiry into litigation funding and regulation of the class action industry, the former Attorney-General, Hon Christian Porter MP, stated that "*Nothing in this parliamentary process of scrutiny proposes an end to class actions or litigation funding*."[8]

This is a critical starting point for the consultation process now being undertaken by Treasury and the Attorney-General's Department. It has been generally acknowledged in the submissions to the PJCCFS – see for example submissions by the Australian Competition and Consumer Commission (**ACCC**)[9], Law Council of Australia[10] and Business Council of Australia[11], as well as the report of the PJCCFS (Majority Report) itself[12] - that class actions play an essential role in providing access to justice in Australia. This was also acknowledged in the overarching principles that guided the Australian Law Reform Commission (**ALRC**) in formulating its recommendations following its extensive inquiry into class actions and litigation funding.[13]

Class actions keep corporations and government accountable, complement the actions of regulators, and provide access to justice for Australians who may lack the means, understanding or confidence to engage in the legal system. Until recently, in the vast majority of class actions, it is third-party funding, typically in the form of litigation funding, that provides the only realistic basis for these cases to proceed. The recent advent of GCOs in Victoria has resulted in an increase in class actions in that state funded by law firms through the proposed use of a GCO.14

Regulatory intervention to guarantee a minimum return of class action proceeds to group members (and, by consequence, a cap on the return available to a funder) may in a very real sense threaten the viability of class actions to be brought in the future. A minimum return to group members that provides no or minimal return to the funder after the payment of legal costs might mean future actions could not be funded. Commercial entities will not take on the significant risks inherent in a complex class action, for no return or a return unreflective of these risks.

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[8] *Parliamentary Debate,* House of Representatives, 13 May 2020, p.3339 (Hon Christian Porter MP, Attorney General).
[9] Submission to the PJCCFS, *Litigation funding and the regulation of the class action industry,* Submission 15, ACCC, page 2.
[10] Submission to the PJCCFS, *Litigation funding and the regulation of the class action industry,* Submission 67, Law Council of Australia, page 6.
[11] Submission to the PJCCFS, *Litigation funding and the regulation of the class action industry,* Submission 86, Business Council of Australia, page 1.
[12]PJCCFS, *Litigation funding and the regulation of the class action industry,* Final Report, December 2020, page xiv.
[13] ALRC Final Report, *Integrity, Fairness and Efficiency – An Inquiry into Class Action Proceedings and Third-Party Litigation Funders,* December 2018 (ALRC Final Report), page 25.
[14] Allens, *Class Action Risk 2021,* March 2021; King & Wood Mallesons, *Winter is coming: Class action battles surge to new record,* 24.05.21; Professor Vince Morabito, *Courts see record number of class actions as shareholder proceedings drop in significance,* Lawyerly, 20.05.21. (Professor Morabito is in the Department of Business Law and Taxation at Monash University's Monash Business School.)

Based on industry data, average distributions from funded class actions over recent years has been in the order of approximately 60 per cent to group members, 15 per cent to lawyers (that is, for legal fees and disbursements) and 25 per cent to funders.[15] The data comes from successfully resolved cases and does not take into account losses to funders in the cases that are unsuccessful.[16] This is an average and therefore, consistent with the fact that each case is different, in some cases the return to group members will be greater than the average and in some cases less.

A 'one size fits all' regulation of the proceeds of funded class actions has the potential to substantially constrain the viability of future class actions in Australia to the detriment of Australians who have suffered loss and damage from wrongdoing.

In this regard, Omni Bridgeway commissioned PwC to analyse the impact of imposing a statutory minimum return to group members using historic publicly available class action outcomes[17], as part of a broader report on potential models of regulation (**PwC March Report** - attached as **Appendix 2** to this submission).[18] In June 2020, we commissioned PwC to analyse the impact of imposing a statutory minimum return based on another historic publicly available set of data (**PwC Supplementary Report** - attached as **Appendix 3** to this submission).[19]

A statutory minimum return of 70 per cent to group members means an effective cap of 30 per cent on returns to litigation funders to cover all of the legal costs (reimbursement to the funder of the lawyers' fees and disbursements which the funder has paid throughout the lifetime of a case) and the funder's own commission for funding the case. This commission must provide sufficient compensation to the funder for assuming the significant risk that the case is lost and that the funder must pay not only the claimant and group members' costs but also pay adverse costs (the costs of the defendant(s)).

The PwC March analysis shows the following headline impacts based on varying minimum returns to group members (using the historical data):

- 70 per cent minimum: 36 per cent of cases would not proceed as the 30 per cent cap would not have covered the legal costs alone and the funder would have received no commission ; a <u>further</u> 55 per cent of cases would be impacted as the funder's commission would have been reduced.

- 60 per cent minimum: 18 per cent of cases would not proceed as the funder would have received no commission; a <u>further</u> 58 per cent of cases would be impacted as the funder's commission would have been reduced.

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[15] For example, Submission to the PJCCFS, *Litigation funding and the regulation of the class action industry,* Dr Peter Cashman and Ms Amelia Simpson, Submission 55.3, pages 35–36.
[16] For information about the risks assumed by funders, see Section 3 below.
[17] Professor Vince Morabito, *Post-Money Max Settlements in Funded Part IVA Proceedings*, 2020.
[18] PwC March Report (Appendix 2).
[19] Submission to the PJCCFS, *Litigation funding and the regulation of the class action industry,* Law Council of Australia, Submission 67, Appendix A.

- 50 per cent minimum: 12 per cent of cases would not proceed as the funder would have received no commission; a further 33 per cent of cases would be impacted as the funder's commission would have been reduced.

The PwC Supplementary Report analysed and applied the same analytic approach to an alternative database of class action outcomes[20] and sought to establish, as close to as possible, an industry-wide perspective. It found that the two databases yielded practically identical results. PwC concluded:

> *"Hence, based on our analysis and comparison of the data sets, and recognising that direct legal costs are a limited cost item, we consider it reasonable to present that, in general, cases with settlement values below $25 million would be unprofitable and accordingly would not be viable and would not be funded. Such cases comprise 42.3% of the cases in each dataset."*[21]

The analysis in both of the PwC reports shows the devastating impact on class actions of an arbitrarily developed minimum return to group members, which does not represent a robust or contemporary approach to economic regulation. At its most basic level, this kind of regulation lacks adaptability to the circumstances of a specific case. Most importantly, it risks damaging the very people it is ostensibly seeking to protect – potential group members (Australians who have suffered loss and damage) who will have their options to access justice curtailed if the 70 per cent minimum proposal is implemented.

4. No rationale for a minimum return set at 70 per cent

Introduction of a 70 per cent minimum would be an arbitrary measure and is not supported by reference to any analysis of the negative implications for the funding of class actions or the risks being assumed by litigation funders. As the PwC analysis shows, introduction of a 70 per cent minimum is likely to result in fewer class actions being funded to the detriment of potential group members.

According to the Minority Labor Members on the PJCCFS[22], the 70 per cent minimum appears to have emerged as follows:

> *"Some of the statements in the report are just factually wrong. For example, Liberal members of the Committee have repeatedly cited a supposed proposal 'by some class action law firms and litigation funders to guarantee a minimum return of at least 70 per cent of the gross proceeds to class action members, and recommends the government investigate the best way to implement this floor'.*
>
> *To our knowledge, no law firm or funder has proposed a 70 per cent 'floor'. Rather, in the spirit of compromise, at least one law firm has proposed amendments to the*

[20] Attachment A of the Law Council of Australia's submission to the PJCCFS (supra note 10).
[21] PwC Supplementary Report, page 12 (Appendix 3).
[22] The December 2020 report of the PJCCFS included a separate report of the Minority Labor Members who did not endorse the Majority report (paragraph 1.12, Minority Report by Labor Members).

> *Corporations Amendment (Litigation Funding) Regulations 2020 so that a litigation funder that guarantees a 70 per cent minimum return to plaintiffs would not have to comply with the managed investment scheme rules. If implemented, that proposal would arguably create an incentive for litigation funders to guarantee a 70 per cent minimum return to plaintiffs – but it would not mandate it (contrary to the suggestion by Liberal members)."*[23]

Nevertheless, the Majority Report noted in its executive summary "***the proposal by some class action law firms and litigation funders to guarantee a minimum return of at least 70 per cent of the gross proceeds to class action members, and recommends the Australian Government investigate the best way to implement this floor***."[24] Omni Bridgeway has never proposed or supported such a proposal. To the best of Omni Bridgeway's knowledge, neither has any other litigation funder and it appears that the proposal may have arisen from a newspaper article which is referenced in the Majority Report as the source of the suggested minimum guarantee.[25]

The Majority Report itself acknowledged the lack of any sufficient analysis to support a legislated return to litigation funders. It stated:

> *"However the Committee has not received sufficient evidence to quantify what an appropriate risk based premium should be in order to achieve outcomes for both class members and litigation funding returns that are reasonable, proportionate and fair."*[26]

Nevertheless, one of the government's first actions following the Majority Report was to consult on the best way to guarantee a minimum return to group members and whether a minimum gross return of 70 per cent to group members is the most appropriate floor. There has not been any consultation on whether there should be a statutory minimum return at all, nor any independent financial analysis commissioned by the government on the consequences of a return set at any particular level.

The proposed maximum return to funders of 30 per cent of the gross proceeds (inclusive of legal costs) is unreasonable, for reasons which include:

- Based on the PwC March Report (referred to in Section 3 above), in 36 per cent of class actions examined, the legal costs have exceeded 30 per cent of the gross class action proceeds (also referred to as the recoveries). It is therefore clear, based on these statistics, that there is a real and substantial risk in a class action that if the funder's return is limited to 30 per cent which includes the reimbursement of legal costs, the funder will either receive no return or make a loss and, as such, a reasonable funder will not provide finance for those claims.

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[23] Minority Report by Labor Members, paragraphs 1.52 and 1.53.
[24] Majority Report, page xviii.
[25] Ibid, paragraph 13.61 and footnote 65: "Ronald Mizen, *Litigation Funding Rules on The Brink As Dissent Grows,* Australian Financial Review (AFR), 11 November 2020".
[26] Majority Report, paragraph 13.60.

- The size of the legal costs in a case is affected by many factors outside the control of the funders. The funders are not the lawyers. The funders cannot control how a defendant runs the proceedings or how long it takes.[27] A 30 per cent maximum return to funders inclusive of legal costs makes the funders the guarantors that the legal costs will not exceed 30 per cent of the recoveries and that the defendants will run their case in a reasonable manner. The funder's role is to fund the proceedings and it should not be placed in a position of having to guarantee the costs will not exceed a certain level.

- In all class actions the court must approve any settlement as being fair and reasonable. There is no evidence that in class action cases where the courts have accepted that a return to group members amounting to less than 70 per cent of the gross proceeds is a fair and reasonable outcome, that the courts were in error or were not best placed to make that determination.

- It is impossible to say what is a reasonable and proportionate return for the funder accepting the risks in any case, without examining the circumstances of that case and the risks assumed. Each case is different. Therefore, adopting a guaranteed return to group members that applies across all cases is not a reasonable approach. The courts are best placed to assess the risks on a case by case basis.

- A statutory minimum would create an inequality of resource issue. It has not been proposed that defence side fees will also be subject to a cap. If the proposed minimum includes legal costs that will mean that the litigation funder will need to absorb those costs that are beyond the cap for no return, or the litigation may become under-resourced once the legal costs approach or exceed the cap, or the funder may withdraw if the costs become too significant. It is foreseeable that defendants may seek to defeat a claim by "deep pocketing" tactics, that is, prolonging and/or complicating proceedings making it unviable for group members to pursue their claim.

- In successful class actions, the court awards an amount for damages and an amount for the successful claimant's legal costs. When a class action settles, the settlement amount is expressed to be inclusive of legal costs. Accordingly, a component of the settlement sum will reflect a component for those costs that have been paid by the funder. A statutory guarantee of a 70 per cent minimum amount of the "gross proceeds" payable to group members that includes those legal costs, whether by way of court order or as part of a settlement sum, would be unjust as the group members have not paid the legal costs.

- The financial results of Omni Bridgeway over the last 10 years[28] shows losses in some years. The results do not demonstrate "windfall" profits and demonstrate that there is not an unfairness in the allocation of recoveries as between group members, funders and lawyers.[29]

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[27] See further risks of the proceedings that the funder assumes outlined on pages 15-16 below.
[28] See note 48.
[29] Omni Bridgeway's results are based on its recoveries and losses in all the cases it funds, including class actions.

5. 5. A one size fits all approach is flawed

The approach to impose a statutory minimum across all funded class actions that goes beyond a basic 'floor' of 50 per cent is fundamentally flawed because it assumes that all class actions are the same.

A statutory minimum does not differentiate between members within the one class. In shareholder class actions, group members generally comprise retail investors, as that term is defined in the Corporations Act (but colloquially described as "mums and dads"), and sophisticated investors, such as corporations and superannuation funds. As an approximation, sophisticated investors generally comprise around 80 per cent by value of group members, who do not require the protection of the state over their contracts.

Group members, including retail investors, are afforded a number of protections under the funding arrangements, including a 21-day cooling off period and the offer of independent legal advice for the group, paid for by the funder. (See further at Section 8 below.)

Risk profile of different types of class action

A minimum does not differentiate between the variable risk profiles of different types of class actions. Factors affecting those risk profiles include difficulties of proof or law, number of defendants (and consequent adverse costs risk), size of claim, cost of pursuing claims, complexity of assessing group member losses and recoverability .

Justice Beach in the Federal Court of Australia considered a minimum return to group members of 50 per cent in the class action against Sirtex Medical Limited (*Sirtex*)[30] and said:

> *".....a 50% level compares favourably with other contexts. But one has to be careful with such a metric, let alone some general assertion that "in every class action, group members should get at least 50% of the gross settlement sum". Take the following situation. Assume that a litigation funder and external lawyers take on a very complex and high risk case (with a commensurably higher commission rate than normal) on behalf of say a large group of persons who have contracted cancer. Say that proving causation by the alleged carcinogen is extremely difficult. Assume that the action has been launched on the basis only of problematic epidemiology showing a heightened risk and some biology that shows only a possible biological pathway. Then assume that after extensive discovery and expensive expert reports it becomes clear that there is no viable biological pathway demonstrated, such that it is apparent that the group members have no cause of action for damages. Let it also be assumed that nevertheless the respondent is prepared to pay a modest amount to settle the matter, and let it also be assumed that legal expenses and the funding commission would soak up 90% of that modest settlement sum. Is it seriously suggested that the group members should receive at least 50% of the settlement sum for what, after forensic investigation that group did not have*

[30] *Kuterba v Sirtex Medical Limited (No 3)* [2019] FCA 1374 (*Sirtex*). The claimants and group members were funded by Omni Bridgeway.

to pay for and where the risk for this on their behalf was taken on and funded by others, are shown to be likely valueless claims? One can multiply such examples.

No power contained in or philosophy underpinning Part IVA provides a proper basis for giving group members something for what turned out to be nothing or to give them something beyond what the true value of their claims are worth, reflecting the product of the face value times the probability of success times the probability of recovery. Moreover, to so artificially allocate is economically distortive and unnecessarily disincentivises the reasonable investment of time and expense in investigating, funding and prosecuting class actions."[31]

Inquiries that have considered caps on funders' fees

The Productivity Commission (**PC**) has considered percentage caps on litigation funder fees but rejected them as being unnecessary.[32] The PC recommended instead the licensing of litigation funders (which has now been implemented) and that regulation of the ethical conduct of funders should remain a function of the courts.[33] The PC said:

"The first question is whether there should be a limit on the percentage of damages paid to litigation funders (similar to the limits recommended for lawyers above). While there is likely to be some overlap, litigation funders provide a different service to lawyers — they provide funding and manage claims on behalf of clients rather than providing legal advice. As noted above, current commissions charged by funders appear commensurate to the services offered. Further, if a limit is imposed on lawyers using damages-based billing, then to some degree funders' fees will become constrained, as they would have to differentiate their service offering to justify charging higher amounts, a point noted by Maurice Blackburn (trans., p. 641).

Therefore, the Commission considers that there is no need to place a limit on the fees of litigation funders."[34]

The ALRC has also consulted on whether there should be statutory limitations on funding fees in class actions, including whether the rates should be "subject to statutory caps that limit the proportion of income derived from settlement or judgment sums on a sliding scale, so that the larger the settlement or judgment sum the lower the fee or rate?"[35]. The ALRC did not make any recommendations regarding statutory caps but recommended instead that the

[31] Ibid, paragraphs 18 and 19.
[32] Productivity Commission (PC), *Access to Justice Arrangements*, September 2014, page 635. The PC conducted an inquiry into Australia's system of civil dispute resolution, with a focus on constraining costs and promoting access to justice and equality before the law.
[33] Ibid, page 633.
[34] Ibid.
[35] ALRC Discussion Paper, *Inquiry into Class Action Proceedings and Third-Party Litigation Funders*, May 2018, question 5-2.

Federal Court be given an express statutory power to reject, vary, or amend the terms of such third-party litigation funding agreements.[36]

The PJCCFS itself seems to have recognised the shortcomings of a maximum return to litigation funders (the corollary of a statutory minimum percentage of gross proceeds to group members). The Majority Report included:

> *"A cap on the percentage of the settlement available to litigation funders would address some windfall returns. However, small-dollar value class actions would be uneconomic for litigation funders, while funders may still make windfall profits on large class actions."*[37]

Difficulty with caps and resolving disputes

Omni Bridgeway has noted that a number of leading lawyers that regularly act for defendants in class actions have commented on the difficulty of implementing a statutory minimum for group members given the diversity of these actions (as we have outlined above), and also raised the prospect of the cap proposal making it more difficult to resolve disputes.[38]

Omni Bridgeway agrees that the proposed cap may make matters more difficult to settle.

6. Impact on consumers

A centrally important focus of this consultation is the impact on consumers – in this case, group members. Regulation of class action proceeds may be justified if there was market failure which might include widespread dissatisfaction from group members. However, there are few indications that group members have complaints with the returns received from the funded class actions in which they have been involved and no evidence of what has been described as "opportunistic class actions".

In fact, the reality in Omni Bridgeway's experience over more than two decades is that the overwhelming majority of group members are satisfied with the allocation of proceeds. Historically, there have been very few complaints about the funding arrangements. For example, in the three PFAS class actions (arising out of chemical contamination at Williamtown, Oakey and Katherine), brought on behalf of over 2,000 group members, fewer than 3 per cent of group members lodged objections to the litigation funder's commission or the lawyers' fees and disbursements or the size of the settlement itself. The judge considered the objections but nevertheless found that the settlements achieved a result which "can fairly be described as excellent".[39]

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[36] ALRC Final Report (supra note 13), recommendation 14, page 10.
[37] Majority Report, paragraph 13.57
[38] *'Ill-fitting' and 'inappropriate': Experts pan some proposed class action reforms*, Lawyerly, 8 January 2021 (paywall).
[39] *Smith v Commonwealth of Australia (No 2)* [2020] FCA 837 (PFAS class actions), paragraph 68.

If that is the case, what problem is being solved through regulatory intervention to establish a minimum return to group members?

PwC stated:

> *"…as we noted in our earlier report, there has been an acceptance since the mid-1990s, that government interventions in markets should generally be restricted to situations of market failure and that each regulatory regime should be targeted on the relevant market failure or failures. This is built from the principle that, as a general rule, efficiency is maximised when markets are allowed to operate unhindered, but in certain circumstances, some markets fail, creating a legitimate reason for government to step in and correct the 'market failure'. The PJCCFS inquiry report does not establish the existence of a pervasive market failure in the case of litigation funding that would justify price regulation."*[40]

An argument that is sometimes made by critics of litigation funding – that claimants get greater returns from unfunded class actions than they do from funded class actions – is no more than a statement of the obvious. Funders recover their costs and fees from any recoveries, which of course reduces returns for claimants. The real question is how many claimants in those funded class actions would have received nothing because they were unable to take action as individuals without the support of litigation funding.

Group members, properly informed, understand the cost and risk that is involved and the bargain that needs to be struck for their rights to be pursued. See for example, submission of Rod Barton to the PJCCFS:

> *"While the proportion of the overall settlement that is ultimately received in compensation is not ideal, this outcome is a lot better than what happens in many other cases that have merit but may not stack up as being financially viable – they don't ever get a chance to see the light of day. Those people who feel they have been wronged and wish to pursue justice are left with no real avenue to mount their case - the financial burden and risk is simply prohibitive"* [41]

It is arbitrary to set a minimum of 70 per cent return to group members. Doing so will deprive group members from participating in funded cases from which they could have received a return (at less than 70 per cent) but which are no longer viable for funders to bring as the legal costs and funder's commission would exceed 30 per cent. Shouldn't group members be able to decide if that is a bargain they wish to strike, that is, whether they would prefer the opportunity for a return, as opposed to no return?

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[40] PwC Supplementary Report, page 8 (Appendix 3).

[41] Submission to the PJCCFS, *Litigation funding and the regulation of the class action industry,* Submission 9, Rod Barton MP, page 2.

In Omni Bridgeway's view, a 70 per cent minimum would therefore be contrary to the public interest, in particular, the interests of a significant number of potential group members in Australia who have suffered loss and damage.

7. The proposed statutory cap is based on a false premise about returns to funders

The proposed statutory cap on funders returns of 30 per cent is based on a false premise (or at best a misunderstanding) that litigation funders are making windfall profits, that the returns are "inappropriate", "unfair" and "unreasonable" and disproportionate to the costs and risks assumed by funders in class actions. Assessing proportionality requires consideration of the risks assumed by litigation funders and also of the appropriate portion of the proceeds to go to group members.

What are the risks?

The proposal of a 70 per cent minimum has been put in circumstances where there has been inadequate or no:

- Examination of the risks in fact assumed by funders in the cases they fund.
- Account taken of the profits and losses in fact made by litigation funders.

In the context of the PJCCFS inquiry, there was a significant focus on returns to litigation funders. There was considerably less focus on the risks assumed by funders in class actions cases which is essential to forming a valid view on the reasonable allocation of class action proceeds.

In essence, Omni Bridgeway's funding for class actions is provided on a limited-recourse, open cheque basis – that is, we pay the claimant's costs as the case proceeds (i.e. legal fees and other costs to bring the case), assume an exposure to uncapped adverse costs if the case is lost and are only reimbursed if the case is successful.

The risks assumed by a funder can be summarised as follows:

- The risk of the case failing at trial. The funder has no real control over 'success'. The funder can lose up to 170 per cent or more of its investment – the legal costs that it has paid (that is, the lawyers' fees and disbursements to bring the case) as well as adverse costs in the event that the case is lost[42].

[42] In the class actions Omni Bridgeway has funded since 2001, the potential adverse cost order exposure has been estimated at substantially more than $172 million – or approximately 70 per cent of the project costs provided by Omni Bridgeway. The average length of a case funded by Omni Bridgeway is 2.6 years (and the average length of a class action is longer and approximately 3.7 years). This is effectively the period of investment required by the company before its first return – and only then if the funded client is successful in the matter. In the PFAS class actions for chemical contamination at Williamtown, Oakey and Katherine, the matters ran for 4.5 years and Omni Bridgeway faced potential costs of more than $50 million in the event they were unsuccessful.

- The funder is not the lawyer and has no control of the defence litigation strategy, including whether the defendant joins more parties pushing up litigation expenses and adding to the adverse cost risk.

- The funder has no control over changes to the law that may affect the success of the case.

- At the time of the decision to commit to fund litigation, the investment by the funder is an open-ended amount – reflecting the uncertainties and complexity of litigation.

- The litigation process itself throws up a multitude of risks including the possibility of witnesses not being willing to give evidence or not performing as expected, bad recollection by witnesses, ulterior motivations of parties, appeals, satellite litigation and/or multiple class actions for the same claim against the same defendant, and appeals.

- The likely amount of damages is uncertain. Normally only a wide range can be estimated at the outset.

- If the class action settles, there is still uncertainly over whether the court will intervene to lower the funding commission.

- The funder has no control over the investment period – even in a successful case, it may take many years for the funder to receive a return on its investment.

- Whether the defendant will have the capacity to pay (a successful judgment or settlement) 3 to 4 years after the class action commences.

Most importantly, the financial risks assumed by litigation funders – running to tens of millions of dollars in many cases – cannot validly be examined with the benefit of hindsight once the outcome of a case is known. Litigation funders are required to evaluate and then assume these risks upfront, before the first court hearing, when there are material uncertainties in terms of the time it will take to resolve the matter, the legal and other costs of the case and, of course, the outcome.

In approving the settlement in the PFAS contamination matters, Justice Lee made the following statement:

> *"....in assessing 'justice' in this context, it is important that the assessment not be distorted by hindsight bias...*
>
> *"On any view of it, this was complex litigation attended by some risk. Moreover, it is appropriate to focus on the risk when the funding agreements are entered into, not assess the risk after the making of implicit findings (following the reports of referees being adopted) and all the work preparing for hearing had essentially been done. Although I am conscious of the complaints of some group members as to the size of the funding fee deduction, when one compares this to other settlements and the risks*

involved, the amount of 25 per cent commission across the three proceedings could not be stigmatised as being unreasonable in all the circumstances."[43]

The risks also need to be judged in light of the fact that sometimes those risks crystalise. Omni Bridgeway seeks to fund class actions in which the likely costs and risks are proportionate to the likely damages award, so that group members are likely to achieve a substantial recovery. However, it is simply not possible to guarantee any particular return or outcome. Even the best of cases, as assessed following detailed due diligence by the funder, can ultimately yield a disappointing outcome or even be lost. For example, approximately $30 million was lost by Omni Bridgeway (then IMF Bentham) in the actions that it funded on behalf of bank customers over various bank fees. In recent years, there have been losses on other significant funded class actions.[44]

What are the returns?

An error made by some critics of litigation funder returns is incorrectly treating funding commissions and the total payments received by litigation funders, as one and the same thing. This issue was identified by Professor Morabito in his 2019 work[45]:

> *"As far as I have been able to ascertain, the higher figures that have frequently been mentioned in the media and the legal literature appear to be attributable, to some extent, to: (a) reliance on only the better-known class action settlements; and/or (b) incorrectly treating funding commissions and the <u>total payments</u> received by litigation funders, pursuant to class action settlement agreements, as being the same thing.*
>
> *In order to ensure that readers of this report do not make the same mistake outlined in point (b) above, it is important to draw attention to the fact that pursuant to settlement agreements executed in class action litigation, funders usually receive reimbursements for all or some of the costs they incurred in the course of the litigation plus a funding commission or fee, usually calculated as a percentage of the total compensation secured on behalf of the claimants*[46]

This is a critical distinction in a concluded class action where, for example, group claimants receive 60 per cent of the proceeds, legal costs paid throughout the lifetime of the class action (that is, the lawyers' fees and other costs to bring the case) account for 15 per cent, and the funder's return (commission) is 25 per cent. Clearly, the 15 per cent paid to the lawyers is in no sense a gain or profit by the funder. The 70 per cent proposal seeks to include the legal costs as part of the 30 per cent return to the funder.

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[43] PFAS class actions (supra note 39), paragraph 87.
[44] *TPT Patrol Pty Ltd as trustee for Amies Superannuation Fund v Myer Holdings Ltd* [2019] FCA 1747; *Crowley v Worley Limited* [2020] FCA 1522; *Dwyer v Volkswagen Group Australia Pty Ltd t/as Volkswagen Australia* [2021] NSWSC 715 (a Takata air bags class action). None of these cases were funded by Omni Bridgeway.
[45] Professor Vince Morabito, *Common Fund Orders, Funding Fees and Reimbursement Payments*, January 2019 (Morabito January 2019 report), chapter 2.
[46] Ibid, pages 11-12.

More broadly, cherry picking - or looking at the return to a funder from an individual case - fails to deduct the cost of operating the underlying business that supports the funding. Litigation funders employ a significant infrastructure that manages the process of raising capital, sourcing potential litigation investments, conducting due diligence to assess the merits of litigation investments, drafting and negotiating the relevant funding documents and then, ultimately, managing the drawn-out process that is litigation. The blended, uncertain returns from their risky investments must cover the cost of running the business and ultimately providing an acceptable return to investors that provide capital.[47]

Sophisticated analysis requires that returns are assessed across a portfolio of cases and recognises that returns calculated for the risk of funding litigation are not comparable with the returns, for example, on a government bond, as the risks are not comparable. The risks associated with litigation funding as an investment are unique.

Assessing proportionality

In addition to considering the risks assumed by litigation funders, an assessment of proportionality also requires a consideration of the appropriate portion of the proceeds to go to group members - to ensure they receive a fair and reasonable portion of the class action proceeds in funded cases.

In order to do justice, this assessment needs to be determined at the time the litigation process begins (at the time the funding commences), not at the point when the litigation has been run and won and the proceeds collected and available for distribution.

The central test is always to measure the balance between what the group member puts into the arrangement and what that same group member is to receive out of the arrangement if the litigation is successful (generally expressed as a percentage).

Determining what the group member contributed to the arrangement with the funder requires an examination of the nature of the claim to damages held by the group member. Some commentators make the point that, without funding, group members will receive nothing, so that “some return [to the group member] is better than no return”. That is a true but is a shorthand way of explaining the nature of a claim for damages.
A claim for damages is property of a unique nature. It is known to the law as a ‘bare cause of action’. It is of uncertain existence, unliquidated and only enforceable against the alleged wrongdoer

upon a final judgment from a court of competent jurisdiction. Even when shown to exist, it is incapable of precise measurement and only becomes a liquidated amount upon the separate judgment of the court after the liability of the wrongdoer has been determined. In a class action, a group member’s claim is generally of such an amount that it is not viable to be

[47] For a discussion of this issue and litigation funding pricing including in the context of this consultation, see Tets Ishikawa, *Funders’ pricing and the real value of litigation risks*, Thomson Reuters Practical Law Dispute Resolution Blog, 25 June 2021.

brought on a stand-alone basis except without great cost and risk, well beyond the potential value of the claim itself.

A claim for damages is property which effectively disappears after the 6 year limitation period for its enforcement expires. In the meantime, it cannot be sold or transferred. It can't be used as collateral for a loan. It is not generally included as an asset in the balance sheet of corporations. Put bluntly it is of little or no value in the hands of the damaged party unless and until that party can afford to enforce it through litigation. Consequently, the shorthand argument is made that some return is better than none.
Currently, the courts undertake this balance - judges use their training and experience to adjust the balance between what the members contribute and what they are to receive for that contribution according to aspects such as the apparent strength or weakness of the case in question (the stronger the case the more valuable will be the members contribution), the clarity of the law involved in the case and the apparent ability of the defendant to pay the full potential judgment. As a final step, the courts look to see if the proceeds distribution that is proposed is inherently too favourable to the funder. This approach of the court has worked and is the reason why there have been so few complaints from class action members over the nearly two decades of class actions in Australia.

Omni Bridgeway returns

While Omni Bridgeway has delivered reliable returns to its investors across its portfolio and over the longer-term, the group has reported losses on individual cases and for full financial years, including in FY18, FY19, FY20 and HY21. Omni Bridgeway has reported losses in seven of the 20 years since listing on the ASX, and also a loss for first half of the current year.[48]

The returns of litigation funding should be measured against the returns to investors – namely those that provide the equity capital – in the same way as they would otherwise provide capital to other ASX companies. In the past decade, Omni Bridgeway's total return to shareholders has been 17.8 per cent per annum (including reinvestment of dividends). While this exceeds the nine-year ASX average total shareholder return of 7.4 per cent per annum, it is in line with many other successful growing companies on the ASX.

Industry data

In the *Sirtex* settlement approval decision[49], Justice Beach had regard to class action statistics published by Professor Morabito[50] who is widely regarded as an industry expert and the best source of analysis on funding fees in Australia.[51] Beach J elaborated on funding commission rates and concluded that the rate sought in the action – a 25 per cent funding commission on

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[48] In the last ten years, Omni Bridgeway's consolidated profit/(loss) have been as follows: FY11 $22.9m; FY12 $43.0m; FY13 $14.1m; FY14 $10.0m; FY15 $8.6m; FY16 $20.9m; FY17 $15.4m; FY18 -$ 11.1m (loss); FY19 -$36.1m (loss); FY20 -$11.5 m (loss); HY21 -$69.9m (loss).
[49] *Sirtex* (supra note 30).
[50] Morabito January 2019 report (supra note 45), chapter 2
[51] Some of Professor Morabito's reports have been partially funded by Omni Bridgeway. His research has also been funded by the Federal Government's Discovery Grant from the Australian Research Council, the Victoria Law Foundation and law firm Herbert Smith Freehills. (Omni Bridgeway has also provided funding to other Australian academics and institutions, such as the University of NSW.)

the gross settlement sum – was well within the range that he considered to be reasonable and proportionate for the risks undertaken by the funder:[52]

> *"I do not subscribe to any 'race to the bottom' philosophy in setting commission rates. As a corollary, I do not accept that rates should be set that do not properly provide a reward for the risk undertaken."*

Beach J said he did not require any further inquiry into the rates and had confidence in Professor Morabito's statistics as, at least, a suitable *prima facie* benchmark.[53]

In his 2019 report, Professor Morabito presented statistics in relation to funding fees based on data gathered from judicially approved class action settlements.[54] He presented the data in several ways, including calculating for each of the identified settlement agreements in his possession the percentage paid to funders, with respect to their funding commissions, and then determined the median funding commission rate. He concluded that the median percentage of settlement funds "consumed" by funding fees in funded federal class actions, and also in all funded class actions, settled during the review period was 25 per cent.

Professor Morabito said these figures were substantially lower than he had been expecting.[55]

Professor Morabito has also examined cases from a very similar review period in a study carried out by the ALRC – between 2013 and 2018.[56] He concluded that the median percentage of settlement funds "consumed" by funding fees in funded federal court class actions settled during the period from January 2013 to December 2018 was 26 per cent and the median percentage of settlement funds "consumed" by funding fees in all funded class actions (including state Supreme Courts as well as the Federal Court) settled during this period was 25.5 per cent.

Professor Morabito found that:

> *"The first median figure above of 26%, for funded federal class actions, is somewhat lower than the figure of 30% that the ALRC arrived at on the basis of its more limited database."*[57]

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[52] The risks included that Sirtex's assets would be removed from the jurisdiction (see *Kuterba v Sirtex Medical Limited (No 2)* [2018] FCA 1489).
[53] *Sirtex* (supra note 30), paragraph 14.
[54] Morabito January 2019 report (supra note 45), page 10. This data represented (a) 85% of all judicially approved settlement agreements in Australian funded class actions and (b) 87% of all judicially approved settlement agreements in federal funded class actions as at the end of 2018.
[55] Ibid, page 11 (and see quote from Professor Morabito on page 15 above).
[56] See ALRC Final Report (supra note 13). The conclusions reached by the ALRC were drawn from a small sample size of only 30 cases that had finalised in the Federal Court (in the period 2013 – October 2018) which the ALRC's report acknowledged had limitations. Due to confidentiality orders and incomplete data, these were the only cases on which the ALRC held enough information about legal and funding fees to calculate the returns to group members in that period.
[57] Morabito January 2019 report (supra note 45), page 12.

And that:

> *"…in approximately two-thirds of all funded cases settled during the review period more than 50% of the settlement proceeds were left for distribution to class members. Class members receiving (collectively speaking) more from class action settlements than solicitors, funders, barristers and various experts combined, in two out of every three Australian class actions settled over the last 27 years, may be said to be a positive thing."*[58]

In assessing whether current returns may be disproportionate to the risks assumed, it is important to take into account the various safeguards set out below, including the role of the court in assessing class action risk, as being the body best placed and most qualified to do so.

8. Current constraints and safeguards concerning allocation of proceeds adequately protect group members

Court oversight

Australian courts retain oversight of litigation funding fees, a power they exercise when determining whether to approve a class action settlement. This is just one of numerous checks and balances that already exist in the legal system to regulate and, in some cases, moderate litigation funders' commissions, including:

- Litigation funding agreements (LFAs)[59] which set out the commission to be earned by the funder and include consumer protections such as a cooling-off period and support for group members to obtain independent legal advice.
- The Federal Court Class Action Practice Note requires LFAs to be disclosed to the court and the defendant. LFAs stipulate the appointment of an independent QC in the event of a dispute regarding settlement between any of the claimants, lawyers and funders.
- Group members are represented by two groups of lawyers: solicitors (retained by members, rather than the funder) and independent barristers, both whose over-riding obligation and fiduciary is to their client. LFAs make clear that the lawyers' obligation is to the client, not the funder.

[58] Ibid, page 12.
[59] Historically, the courts have reviewed the litigation funding agreement. Going forward, post introduction of the MIS regulations, it is likely that the courts will instead review the Litigation Funding Scheme documents including the Scheme Constitution and Product Disclosure Statement. In recognition of the historical role of the courts in providing oversight of litigation funding schemes, Omni Bridgeway has included provisions in the constituent documents to facilitate court oversight and, if necessary, intervention to modify constituent documents.

- Mediations and settlements are typically overseen by current or former judges or practising senior officers of the court, such as an SC or QC. It is routine in settlement approval applications for the appointment of an independent expert to review reasonableness of legal costs.

- Group members have the right to opt out of class actions and object to settlements, as well as general law protections covering unconscionable conduct, misleading and deceptive conduct and unfair contracts.

- The courts have significant power to impact the role and returns of funders including the ability to:

  – Address the duplication of class actions
  – Stay proceedings
  – Declass a class action
  – Grant a defendant summary judgment or strike out if the case is without merit
  – Order costs directly against the funder
  – Order security for costs
  – Appoint an amicus or contradictor for the group members' benefit.

The courts use their powers to examine and intervene in the allocation of class action proceeds – this shows the system working.

The implication of a statutory minimum return to group members is that the courts are unable or unwilling to assess the appropriate return to group members, lawyers and funders. Omni Bridgeway rejects this view and, on the contrary, considers that the court is best placed to perform this role, based on the specific circumstances of each case.

Any determination as to whether a distribution to group members in a particular class action is fair and reasonable includes consideration of a number of components including risk, complexity, length and likely proceeds from the case. Close examination of these components demonstrates the training, expertise and experience required to make such a determination.

The determination is required to be made prospectively - as at the time the litigation funding documents are prepared and executed - and not with the benefit of hindsight. The risks (that we have outlined in Section 7 above) and the other components that must be considered can only be fully identified and measured by a party with legal training, who is independent and has significant experience in litigation and particular expertise in the class action process (for example, as senior counsel followed by time as a specialist class action judge). The determination needs to be done timeously, and as cheaply as possible so as to prevent delay and unnecessary extra cost.

The judge hearing the case (or an alternate judge) fulfils all of these requirements. If he or she is the trial judge they will be fully versed in the issues in the case. The judge knows the facts and the law of the case they are called upon to approve (including having access to a confidential opinion from the class members' senior counsel providing reasons for recommending a settlement) and what has happened in other class actions and so are able to assess legal risk on an absolute and comparative basis.

The judiciary can and has the power, where circumstances require, to seek expert guidance in performing its function - for example, it can appoint a contradictor or an independent legal costs assessor. The diversity of class actions based on variables outlined above in Section 5 clearly illustrates the importance of a case-specific assessment of returns.

For many years Omni Bridgeway has striven to return at least 50 per cent of the gross proceeds to group members. This has not been designed to arbitrarily change the amount going to successful group members across the board (in the majority of cases group members receive more than 50 per cent in any event) but rather to operate as a stop gap, to protect group members in the event that, despite settlement, the gross proceeds are materially smaller than was expected at the point of funding. Litigation is unpredictable and uncertain and this can occur for a multitude of reasons including when costs greatly overrun the budget, the members claims turn out to be weaker or worth less than anticipated or the defendant suffers some financial impact which lessens its ability or willingness to pay.

In these and other circumstances, this can mean that group members receive little or nothing under the terms of the funding agreements once legal costs are recouped and the funders commission is paid. A 50 per cent minimum means that the members receive that amount and the funders contractual commission is reduced accordingly. The 50 per cent minimum has, to date, been a voluntary effort by Omni Bridgeway to avoid extreme results. It is a benchmark that we believe some other leading funders use in their internal case assessment processes.

In this light, and in recognition of the importance of ongoing public confidence in the class action system, our recommendation to the PJCCFS was a minimum 50 per cent return of gross proceeds to group members (which would mean a 50 per cent cap on legal costs and funder commission). We believe that this recommendation strikes an appropriate balance between the interests of group members and the interests of funders. However, it has a different purpose and therefore significantly different implications to a legislated 70 per cent minimum to group members, which suffers from the problems discussed in this paper.

We consider that the minimum return of 50 per cent should be expressed as guidance to the court or in the form of a rebuttable presumption to allow for flexibility on a case by case basis and it should be implemented on a prospective basis. This mechanism would make clear the policy expectation while preserving the flexibility referred to by Justice Beach in *Sirtex*.[60]

Regulatory oversight

In considering the issues raised in this consultation, and any other changes proposed by the PJCCFS, it is imperative that policymakers recognise that arguably the most significant regulatory reforms since the commencement of Australia's class action system in 1992 became effective as recently as August 2020.

[60] *Sirtex* (supra note 30).

The impact of these reforms – the requirement for litigation funders to hold an AFSL and to register third party funded class actions under the MIS regime – is currently unknown but the early indications are that they will have a dampening effect on the incidence of funded class actions. It now appears there are currently only a handful of litigation funders holding an AFSL compared with the approximately 25 funders that had previously been active.[61] According to a recent article in Law.com International:

> *"The Australian Securities and Investments Commission, which issues the licenses, told Law.com International that litigation funding licenses have so far been issued to six entities—only a fraction of the 25 litigation funders active in Australia identified in a government-commissioned inquiry into class actions and litigation funding in December 2018."*[62]

[61] ALRC Final Report (supra note 13).
[62] *Only a Handful of Litigation Funders Obtain Licenses Under New Australia Law*, Law.com International, 8 June 2021.

Appendix 1: Consultation Questions

Omni Bridgeway has discussed the important issues raised by this consultation in detail in our submission above and refer to those sections in response to the Consultation Questions below.

1. *What is the best way to guarantee a statutory minimum return of the gross proceeds of a class action (including settlements)?*

As we have stated above, there has not been any consultation on whether there should be a statutory minimum return at all, nor any independent financial analysis commissioned by the government on the consequences of a return set at any particular level.

In Omni Bridgeway's submission, the courts are the best and most appropriate body to assess the risks of litigation undertaken by litigation funders and an appropriate return for that risk. Those risks vary across each class action and so it is wrong to assume that there can be a one size fits all cap to funders returns.

Imposing arbitrary price regulation on class action proceeds, with no evidence of market failure and no proper reasoning, is not in the best interest of Australia's class action system. We believe it would be contrary to the public interest, in particular, the interests of a significant number of potential group members in Australia.

'One size fits all' price regulation has the potential to substantially constrain the viability of future class actions in Australia. An arbitrarily developed 70 per cent minimum return to group members does not represent a robust nor contemporary approach to economic regulation (Section 3).

Assessing the validity of the premise of this question requires consideration of the impact on consumers (Section 6), risks assumed by the funder (Section 7), evidence of funder returns from class actions (Section 7), appropriateness of these returns (Section 7), and the current constraints and safeguards concerning allocation of class action proceeds, including court and regulatory oversight (Section 8). When these factors are considered, it is clear that a 30 per cent cap on funders returns inclusive of reimbursement of legal fees, is unreasonable.

Although Omni Bridgeway's view is that the courts are the best and most appropriate body to assess the appropriate returns to group members and litigation funders, PwC has, at our request, considered the regulatory approach that should be undertaken if there is to be further consideration of a regulatory cap. PwC's view is that the task should be undertaken by an existing and experienced regulatory body applying standard regulatory processes.[63]

[63] PwC Supplementary Report, pages 8-9 (Appendix 3).

2. *How would the suggested mechanism interact with the class action system (including court processes) and the litigation funding regime?*

Omni Bridgeway repeats its submission in response to question 1. The courts are the best and most appropriate body to assess the risks of litigation undertaken by litigation funders and an appropriate return for that risk, based on the specific circumstances of each case.

3. *Is a minimum gross return of 70 per cent to class members the most appropriate floor for any statutory minimum return? If not, what would be the appropriate minimum and its impact on stakeholders, the class action system and the litigation funding industry?*

Based on data from publicly available class action outcomes, a 70 per cent minimum return of gross proceeds to group members would mean 36 per cent of cases would not proceed and a further 55 per cent of cases would be impacted (PwC March Report, Section 3). A 70 per cent minimum would therefore decimate the Australian class action system.

Omni Bridgeway supports a minimum 50 per cent return of gross proceeds to group members as a stop gap. Expressing this as guidance to the court or in the form of a rebuttable presumption would avoid inappropriate application of this floor and be flexible to the individual circumstances of the case (Section 8).

4. *Is a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases?*

Whilst length and likely proceeds are informative for any proposed regulatory approach, risk and complexity are highly subjective factors that are hard to define.

All of these factors are currently taken into consideration by judges in class action proceedings when assessing the allocation of proceeds. In Omni Bridgeway's submission, the courts are best placed to assess these risks.

5. *How would a graduated approach to guaranteed returns for class members be implemented? This can include how a decision is made that a particular case is straightforward, how cases could best be classified to determine the minimum return applicable to a particular case and at what stage of an action such a determination should be made.*

A graduated approach is also an arbitrary mechanism and suffers from the same defects as only having one level of guaranteed return.

Although Omni Bridgeway's view is that the courts are the best and most appropriate body to assess the appropriate returns to group members and litigation funders, PwC has considered a regulatory approach to graduated returns.[64]

[64] PwC Supplementary Report, section 3 (Appendix 3).

6. What other implementation considerations would be relevant to the issues raised in this consultation paper? Please provide examples

Recent studies by Australian law firms, Allens and King & Wood Mallesons[65] both found that, although there was a small increase in class actions filed in the past year, the proportion of class actions funded by litigation funders is in substantial decline. As noted in Section 3, in the last year there has been a sharp increase in class actions in Victoria funded by law firms through the use of a GCO. The regulatory changes that have been implemented in the last year have created a dual system for class actions with some 'funders' regulated and others not, and has resulted in an increase in the number of class actions.

To date, no justification has been provided as to why funders are subject to one set of rules regarding licensing, funder reporting and disclosures, whilst it is not clear whether those rules apply to law firms funding class actions. In Omni Bridgeway's submission, the playing field should be evened and it should be made clear that law firms acting as funders should be subject to the same regulation as third party funders.

[65] Supra note 14.

Appendix 2: PwC March Report

Models for the regulation of returns to litigation funders

16 March 2021

pwc

Disclaimer

This report is not intended to be read or used by anyone other than Omni Bridgeway.

We prepared this report solely for Omni Bridgeway's use and benefit in accordance with and for the purpose set out in our engagement letter with Omni Bridgeway dated 3 December 2020. In doing so, we acted exclusively for Omni Bridgeway and considered no-one else's interests.

We accept no responsibility, duty or liability:

- to anyone other than Omni Bridgeway in connection with this report
- to Omni Bridgeway for the consequences of using or relying on it for a purpose other than that referred to above.

We make no representation concerning the appropriateness of this report for anyone other than Omni Bridgeway. If anyone other than Omni Bridgeway chooses to use or rely on it they do so at their own risk.

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Executive summary

The Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) recently released its report into litigation funding and the regulation of the class action industry.[1] One of its areas of focus was the perception that third party litigation funders were earning an 'excessive' return from successful cases, at the cost of unacceptably lower returns to the plaintiffs.

While not being definitive in its conclusions, the PJCCFS pointed to a future reform agenda focusing on the regulation of returns to third party funders. Specifically, Recommendation 20 provides:

> *13.62 The committee recommends the Australian Government consult on:*
> - *the best way to guarantee a statutory minimum return of the gross proceeds of a class action (including settlements);*
> - *whether a minimum gross return of 70 per cent to class members, as endorsed by some class action law firms and litigation funders, is the most appropriate floor; and*
> - *whether a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case is appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases.*[2]

The matters directly raised by PJCCFS Recommendation 20 relate to the apportionment of litigation outcomes between class action industry participants and class members.

Based on an analysis of publicly available litigation outcomes,[3] the PJCCFS's mooted approach (i.e. effectively a cap of 30% of gross returns for litigation funders), is projected to result in 36% fewer class actions (i.e. cases where the litigation costs alone would not have come within the proposed 30% cap, meaning the funder would have made a loss or been in a break even position and made no profit at all). This demonstrates the tradeoff inherent in any cap on litigation funder returns; it would provide higher returns to some class members, but some members would not receive returns they would have otherwise expected as fewer actions would be undertaken.

Our comments in relation to these matters are from the perspective of established economic regulatory regimes in Australia. The proposals mooted in Recommendation 20 are not based on a consideration of economic returns or economic efficiency in a conventional regulatory sense, but are instead directly based on considerations of proportionality and allocation.

Indeed, this approach is not consistent with regulatory theory and does not provide a balanced economic basis for the form of price regulation proposed in the report.

The divergence from standard regulatory analysis is unfortunate given that a number of submissions to the PJCCFS posited frameworks for the formal calculation of appropriate returns for litigation funders. Specifically, these are:

- submission 100 by Professor RR Officer, which sets out a discounted cashflow (DCF) model
- submission 101 by Mr Sean McGing, which sets out an actuarial/insurance approach.

In this report we assess the applicability of these models, and consider more broadly how a pricing mechanism could be established consistent with current regulatory practices employed by Australian economic regulators.

More detail would need to be developed for each model in order for it to comprise an effective regulatory mechanism or regime.

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[1] PJCCFS (2020)
[2] PJCCFS (2020, p.206)
[3] See Morabito (2020)

In reviewing the efficacy of each model, it has been necessary to assume how each model might be specified, in order to consider how they may apply in practice. Our assumptions may differ from those made by the developers of the models which underpin general model design features.

The lack of specificity of both the models is understandable, given the necessary requirement for brevity in the submissions to the PJCCFS and the lack of comprehensive industry data regarding outcomes and returns to litigants, lawyers, funders and others.

The DCF model

The DCF model suggested by Professor Officer, in terms of its general treatment of costs and revenues, is consistent with accepted principles of financial economics. It also constitutes a form of price control model – as could be applied *ex ante* to litigation funding pricing or *ex post* to a review of pricing. On these bases, the DCF model could form the basis of a holistic economic regulatory framework.

The model as currently specified has a number of clear limitations:

- It in effect projects a position that efficient costs of litigation funding will comprise a fixed percentage of the settled sum in each case.

- It presents a general rule of proportionality based on an assumed individual class action concluded, based on particular assigned probabilities, in favour of plaintiffs. This is not a comprehensive basis for determining whether litigation funders' returns are fair and reasonable, as it will not reflect the characteristics of all cases across a litigation funder's portfolio.

- The basis for the benchmark reasonable rate of return applied commensurate with investment risks is a judgemental value. It is a material issue for regulation of litigation funding pricing that the generally accepted financial market theory on risk and return has limitations in application to litigation funding investments.

The DCF model mechanism that presumes efficient costs are incurred in proportion to settlement sum outcomes can give rise to pricing that embodies a risk-sharing arrangement between plaintiffs and litigation funders. Such an arrangement, although it may not be cost-reflective in individual cases, could promote class actions as an efficient means of obtaining compensation, relative to other avenues. In this way, the fixed percentage presumption need not be a limitation to the achievement of efficient outcomes.

The other limitations of the DCF model could be generally addressed by consideration of principles and procedures from the insurance industry, as are broadly set out in submission 101, as discussed below.

The insurance model

The insurance model is based on the principle that pricing should be based on costs incurred and incorporate a rate of return that reflects the risks of the investment undertaken. This basic principle also underpins regulatory pricing regimes.

The insurance model specifies procedures for including a full range of costs relevant to litigation funding business, so that potentially a balanced position on costs and returns could be established.

It also builds upon conventional financial market-based theories for determining reasonable rates of return by providing additive processes to evaluate and reflect the specific risks of litigation funding investments. There is however limited available data, and absence of a generally accepted theory, in relation to how to measure such risks.

The insurance model is not an overarching regulatory pricing model in the manner of the DCF model and does not, of itself, embody a risk-sharing arrangement between plaintiffs and litigation funders reflective of a portfolio approach to risk management as may be used by litigation funders.

A possible blended approach

Our analysis shows that a balanced regulatory regime could be developed from the principles and procedures of the models in both submissions 100 and 101, with the DCF model providing the overarching framework.

As such, if there is to be further consideration of a regulatory cap, we believe that the task should be undertaken by an existing and experienced regulatory body applying standard regulatory processes.[4]

We believe that the development of the cap should:

1. be undertaken on an industry-wide basis (i.e. rather than on a case-by-case or funder-by-funder basis)
2. be based on a DCF framework as an overarching approach
3. include appropriate amounts/loadings for the full range of costs including:
    a. business development costs
    b. capital costs
    c. operating costs
    d. overhead costs
4. involve consideration of actual or notional costs in relation to capital at risk and insurance. Such costs may be addressed by risk premia or by funders adopting a portfolio approach to managing risks across individual class actions
5. the rate of return developed for a litigation funder regulatory model should be founded on generally accepted corporate finance principles, but include specific additive factors or adjustments to account for the specific risks associated with litigation funding investments (such factors should be based on verifiable data and tested theory).

In applying the overarching framework of the DCF model, because the model mechanism presuming a fixed relationship between costs incurred to settlement sum outcomes may not reflect costs incurred in individual cases, any percentage value applied to settled sums to determine pricing could represent a guiding value rather than an absolute control value, allow for variations to deal with specific circumstances, or comprise a sliding scale of percentage values that could apply according to the size of the settlement or award.

[4] An example of consideration of price caps on an industry-wide basis in a relatively niche industry is provided in IPART (2019), where the NSW Independent Pricing and Regulatory Tribunal (IPART) considered whether price controls should be established regarding the provision of electronic conveyancing services

1. Introduction

Litigation funding is now an established, if somewhat immature, feature of the Australian class action system.

At its core, litigation supported by third party funding arrangements addresses two principal problems.

- litigation funding is a form of financing. Like a contingency-fee arrangement, the litigation funding arrangement provides financing that may allow budget-constrained plaintiffs to finance litigation that they would otherwise be unable to pursue. It may also allow plaintiff that are not budget constrained to finance litigation without accessing other available funds, using that cash for other purposes

- litigation funding is a risk-transfer mechanism. The non-recourse nature of most litigation funding allows the litigant to protect the downside of a loss by trading to the funder more of the potential gains from a resolution.[5]

These features provide a degree of complexity and concern about how they play out in terms of returns for the various parties.

Class actions and their associated funding has been reviewed in a number of contexts over recent years, with:

- the Productivity Commission's 2014 review of Access to Justice[6]

- the Victorian Law Reform Commission's (VLRC's) 2018 review of Litigation Funding and Group Proceedings[7]

- the Australian Law Reform Commission (ALRC's) 2018 report into litigation funding.[8]

Most recently the Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) undertook a further inquiry into litigation funding and the regulation of the class action industry, with its report released in December 2020.[9]

As the reviews have built upon each other the regulatory focus has moved from a focus on possible licensing approaches (e.g. AFSL, etc) through to concerns about the returns to successful litigation participants (i.e. the relativity between returns to successful plaintiffs and their funders).

As a result, Recommendation 20 of the PJCCFS provided:

> *13.62 The committee recommends the Australian Government consult on:*
> - *the best way to guarantee a statutory minimum return of the gross proceeds of a class action (including settlements);*
> - *whether a minimum gross return of 70 per cent to class members, as endorsed by some class action law firms and litigation funders, is the most appropriate floor; and*
> - *whether a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case is appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases.*[10]

PwC was engaged prior to the release of the final report to:

> *provide an independent assessment (suitable for public distribution) that:*
> - *specifically considers the Officer and McGing submissions to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Litigation Funding and the Regulation of the Class Action Industry*

[5] Heaton (2019, p141)
[6] PC (2014)
[7] VRLR (2018)
[8] ALRC (2018)
[9] PJCCFS (2020)
[10] PJCCFS (2020, p.206)

- *considers what a 'best practice' approach to assessing fair and reasonable returns to litigation funders in the context of class actions could include.*

2. The ‘problem’ of litigation funding and how to respond

It is each legislature’s prerogative to pass laws as they see fit, but at least at a bureaucratic level there has been an acceptance since the mid-1990s, following the Hilmer Review,[11] that government interventions in markets should generally be restricted to situations of market failure and that each regulatory regime should be targeted on the relevant market failure or failures.[12] This is built from the principle that, as a general rule, efficiency is maximised when markets are allowed to operate unhindered, but in certain circumstances, some markets fail, creating a legitimate reason for government to step in and correct the ‘market failure’.

A market failure exists 'where the characteristics of a market are such that its unfettered operation will not lead to the most efficient outcome possible'.[13] There are four commonly accepted situations in which market failure exists:

- public goods – these exist where provision for one person means the good or service is available to all people at no additional cost (i.e. they are non-excludable and non-rivalrous).

- severe information asymmetries – these occur where producers have information that consumers do not. However, it needs to be stressed that 'There is nothing unusual about the asymmetry of information available to a supplier and a consumer. Many products are complex, difficult to compare, have considerable importance for the well-being of consumers or are provided over a long period of time.'[14] A market failure can be said to exist only when the information asymmetries become so severe as to distort actual market outcomes.

- externalities – externalities (sometimes called spillovers) occur when an activity or transaction has positive (benefits) or negative (costs) welfare effects on others who are not direct parties to the transaction. Like information asymmetries, externalities are ubiquitous and only in material cases is regulation considered relevant

- natural monopolies – natural monopoly occurs where it is more efficient for one firm to supply all of a market’s needs than it would be for two or more firms to do so.

The presence of market failures is a necessary but not sufficient condition of government intervention. Government involvement in markets can lead to costs and inefficient outcomes. These need to be recognised in an assessment of policy instruments to ensure the instruments are the most appropriate and effective for the specific market failure that they are targeting, and that they do not create unintended consequences, and are the least restrictive option available.

The PJCCFS report tends to use a range of words and phrases when describing the ‘problem’ associated with litigation funding, including ‘excessive profits’ and ‘excessive litigation funder returns’.

What we see in this language is two factors combined.

The first is a still immature market. There are no structural issues - i.e. barriers to entry - that make litigation funding a natural monopoly. If returns are lower to successful plaintiffs than would be ‘expected’ then we would expect new entrants to come into the Australian market and offer higher returns to those people (i.e. for any above market return to the litigation funder to be competed down to a ‘normal’ return for the funder).

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[11] Independent Committee of Inquiry (1993)
[12] Council of Australian Governments (1991, p.13)
[13] Productivity Commission (2002, p.xxiv)
[14] Financial Systems Inquiry (1996, p.97)

The immaturity of the market is demonstrated by the ability of litigation funders to be highly selective as to the profile of the cases that they adopt:[15]

> *Firms fund cases where the risk is small and where they estimate the probability of winning a successful judgment or settlement to be large. At one firm, the probability of succeeding by judgment or settlement must be greater than ninety-five percent, while at another, the required probability of success is fifty percent. Firms prefer cases that are likely to settle quickly, because the longer and more complex a matter is, the greater the firm's risk. Litigation funding firms also thoroughly investigate the claim holder, especially if the claim holder is to be a key witness in the case.*[16]

This point of competition driving down the returns to litigation funders - i.e. that that the 'problem of excess returns is prima facie not as real as is as claimed - is made by Heaton in a US context where greater volume of funding support means that more marginal (e.g. higher risk, smaller scale, etc) cases are taken on by third party funders:

> *While litigation funding has always been controversial ..., the real problem is that the investment class is a poor one. First, high-stakes civil litigation is far more complex and random than most investors understand. There are an overwhelming number of ways that litigants can lose and far fewer paths to significant victories. Second, few good cases—from an investment perspective—are likely to find their way to funders. Third, litigation funding is probably prone to optimism bias, causing litigation funders to overestimate the probability of victory in their cases. Finally, litigation funding is fungible with little value added by the funder, suggesting that competition will drive down any significant previously-existing profits. While litigation funding serves a valuable social purpose when it finances meritorious cases that otherwise would not be pursued, we can expect investor success in the field to be rare and likely limited to those funders with the most litigation savvy and the best luck. Nevertheless, investors are unlikely to give up on the space despite the large prospect of poor returns.*[17]

This suggests that as the number of litigation funders increases the number of actions supported will increase (i.e. providing increased access to justice) and returns to litigants will increase as litigation funders compete for cases in which to invest..

The second factor, and one that possibly exacerbates the immaturity of the market, is the issue of information asymmetry. In its submission to the PJCCFS the Australian Competition and Consumer Commission (ACCC) noted that:

> *Concerns have … been raised that the win fee structures of class actions are often not clearly or adequately explained to the consumers or small businesses joining class actions, and can sometimes be unreasonably high, leaving the class potentially out of pocket compared to alternative settlement arrangements. Litigation funding agreements are often presented to potential clients at the same time as the class action suit agreement, and clients may not fully understand the ramifications of the funding agreements.*[18]

Such information asymmetries may impede the maturation of the market and support sustained lower returns to the litigants.

A more narrow conception of a relevant information asymmetry is in respect of settlements, and may justify some regulatory oversight.[19] That is, while the interests of funder and plaintiffs are aligned in proceeding to a final judgement, information asymmetries associated with agency[20] mean that the decision to settle may be influenced[21] by a funder so as to maximise their return (i.e. with the ability to manage costs) rather than maximising the interests of the plaintiffs. This is a narrower concern than expressed by the PJCCFS.

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[15] Another example of the immaturity is that we have not yet seen the market develop for third party funding of defendants - (Munoz 2019, p.26)

[16] Abrams & Chen (2013, p.1088)

[17] Heaton (2019, p.139)

[18] ACCC submission 115, p.4

[19] See Hay (1997).

[20] See Duffy (2016)

[21] It is relevant to note that the funder does not make the ultimate decision to settle a case

While not every information asymmetry or externality needs a regulatory response,[22] governments have increasingly turned to mandatory information disclosure to address perceived informational market failures. That is, the primary and direct response to the problem of information asymmetry is to improve information provided to the parties at an information disadvantage.

That is, information instruments are primarily useful in situations where there is an information asymmetry in a market, where one actor (usually the consumer) does not have sufficient information to make an information decision of the relative quality of the products or services in the market.

Hence we have seen information disclosure used in a range of different environments, including, in financial services:

- a standardised 'comparison rate' for loans needs to be shown in loan advertising
- a Product Disclosure Statement (PDS) to alert potential customers to information about a financial product including any significant benefits and risks, the cost of the financial product and the fees and charges that the financial product issuer may receive.

By making organisations disclose certain information the expectation is that consumers will be more informed and so make better decisions.

Even if not directly used, there is a latent hope that third parties can use the information in a manner that brings together the information in a usable format for consumers (e.g. comparison shopping sites).

Information instruments work in a relatively indirect manner — essentially working to change behaviour through more informed decision making. Information instruments are, however, limited by the extent to which consumers, and in some cases suppliers, act on the information provided.

The effectiveness of information instruments rests on the ability and willingness of consumers to use the information in the way that was intended under the instrument design:

- In some cases, where relatively straightforward messages are being conveyed, it is likely that the majority of consumers will use the information correctly (e.g. warning labels on dangerous goods).
- In other cases, the information provided requires greater interpretation, and existing knowledge, and it is less certain that individuals will respond in the manner that was intended.

It is likely that the issue of litigation falls into this second, more complex, class of decisions.

Evidence from the field of 'behavioural economics' finds that individuals are not perfectly rational and that they have a finite capacity to absorb and process information. Individuals do not have endless motivation for continually updating their knowledge on all issues relevant to their lives, reflecting limited time, attention spans and being faced with information overload on a daily basis. In the financial services context, behavioural economics has found that individuals buying financial services are especially prone to making systematic errors in their decision making.[23] It cannot, therefore be assumed that individuals are continually seeking the best information in making purchasing or investment decisions, or equally, that they are able to judge what the 'best' information is.[24]

[22] Market failures are an everyday event; buyers are rarely as informed as sellers, and most transactions have consequences for third parties. For example, the Wallis Inquiry noted that: 'There is nothing unusual about asymmetry of information available to a supplier and a consumer. Many products or services are complex, difficult to compare, have considerable importance for the well-being of their customers or are provided over a period of time.' - Financial System Inquiry (1996, p.97). Furthermore, the Productivity Commission (PC 2000, pp.64 & 76) noted that: 'The need for government regulatory intervention does not immediately follow from the identification of information deficiencies: information deficiencies are pervasive yet most markets continue to function reasonably efficiently. … it is not generally efficient to eliminate all negative externalities or promote infinitely large quantities of positive externalities. In many cases, externalities do not create significant problems.'

[23] London School of Economics (2014, p.1)

[24] Weiss (2002, pp.217–254)

The Royal Commission has brought to the fore that financial services have a number of characteristics that mean that the optimal outcome is not guaranteed solely by regulating information disclosure. As the Deputy Chair of ASIC notes, financial products and services:

- are inherently complex and often require consumers to make important decisions involving risk and uncertainty. Yet as the UK financial services regulator notes, people are generally bad (even terrible!) intuitive statisticians and so are prone to making systematic errors in these decisions
- represent extreme examples of 'credence goods', in that the quality may not be known for years or even decades after they are purchased. Credence characteristics are those which the consumer is obliged to take on trust since he or she may not possess the expertise to determine whether the product has been appropriately supplied (eg, the effects of a medicine may not be observable in the period immediately after use, but may be necessary for a long and healthy life is to be lived)[25]
- can involve critical long-term promises to the purchaser (e.g. insurance or investments)
- include examples of products that are infrequently purchased and so provide limited opportunity for feedback and learning
- often involve significant sums of money.[26]

While the *Interim Report* of the Royal Commission notes that 'no new layer of law or regulation should be added unless there is clearly identified advantage to be gained by doing that'[27] the Commission's findings implicitly challenge the reliance on mandated information disclosure as a means of addressing market failures, and specifically information asymmetries.

The challenge is, if information disclosure is not a tool that can be relied upon to the same degree, what is the alternative regulatory approach?

Clearly, every market failure needs to be considered on its merits, but what we may see in a financial services environment, to some degree, is a turn towards prescriptive product regulation to address information asymmetries.

That is, rather than allowing financial service providers to do what they want as long as they disclose certain things in certain ways, there may be a move to place increased reliance on standardised features and default products. In the litigation funding context the AML might not provide sufficient prescription about the specification of the offering of litigation funding.

Such an approach likely reduces the risks for some (maybe even many) less informed/sophisticated consumers as this form of simplification reduces the costs of consumer mis-judgement and deception.

However, there are at least two potential downside risks associated with such a shift in regulatory approach:

- there is a risk of a reduction in product innovation and alternative options for informed/sophisticated consumers[28]
- regulation that restricts access on the grounds of protecting consumers (e.g. tighter income/ expense verification so some groups of consumers cannot borrow) risks pushing people to the 'shadow banking' where there is less regulation.[29]

Clearly, the matters identified by the Royal Commission suggests that these risks are likely to be considered as acceptable in both efficiency and equity terms.

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[25] See Darby & Karni (1973)
[26] Kell (2016, p.2)
[27] Hayne (2018, p.290)
[28] UK Financial Conduct Authority (2016, pp.9-10)
[29] This is a likely example of Sunstein's (1990, p.413) first regulatory paradox - overregulation produces underregulation: 'especially aggressive statutory controls frequently produce too little regulation of the private market'

The real concern will be if this changing mindset is applied unquestioningly. Mandatory information disclosure remains a valuable regulatory tool but we need to be more cognisant of the environment in which it is applied and the manner in which people process the information.

Attempts to improve customer decision making for financial services should stem from the understanding that individuals behave irrationally and that these behaviours are predictable. Behavioural economics evidence has consistently found that individuals are prone to procrastinating, suffering from chronic indecision and following the behaviours of others rather than relying on statistics and facts.

Mandatory information disclosure for financial products will therefore likely remain ineffective unless they incorporate key principles from behavioural economics. For example, product disclosures can be more effective if they are:

- standardised to make competing products (e.g. offers of litigation funding) easily comparable
- meaningful and well presented by using images and graphics to facilitate comprehension and to inform decision-making
- brief to avoid information overload, and accessible by omitting complex technical detail.

While there is considerable debate about whether class actions supported by third party litigation funders should be seen as a financial product, the Royal Commission's findings point to how new products such as litigation funding can better work with how people actually behave rather than how we expect them to. The problems presented to the PJCCFS suggest that such information disclosure and basic product standardisation is the logical step to encourage the maturation of the Australian market for third party funded litigation support. Indeed, the managed investment scheme (MIS) regime now applies to class actions and we will need to see how/if this new regulatory obligation changes the behaviour of both litigation funders and the potential plaintiffs.

3. The impact of the foreshadowed cap on returns

On the basis that perceived 'excess returns' were being generated by litigation funders, and correspondingly lower returns were provided to the litigants, the PJCCFS considered broad options as to how to address this concern.

The focus was on how to guarantee a minimum return to successful plaintiffs (i.e. how to cap returns to litigation funders).[30]

For example, stakeholders provided a range of ideas as to:

- the basis on which to set a regulated cap (i.e. a guaranteed minimum percentage of the resolution for plaintiffs, or a maximum percentage of the resolution for litigation funders which includes reimbursement of investments made, etc)
- the structure of the cap (i.e. whether there should be a single 'cap' or some form of sliding scale based on certain factors).

The PJCCFS - see Recommendation 20 - indicated that further consideration of a cap is necessary, but noted some stakeholders' suggestion that successful plaintiffs will be entitled to a minimum of 70% of the gross returns from the action.

A challenge here, largely due to confidentiality arrangements, is that there are few cases where there is complete public information about the relative return to the plaintiffs, lawyers and funders.

In this instance we are using a compilation of settlements in funded Part IV proceedings as reported by Professor Vince Morabito (2020). This provides:

- returns to litigation funders
- legal costs and disbursements (hereafter called 'litigation costs')

as a percentage of the gross settlement fund. This includes 33 settlements where 'complete' data is available, plus one more where partial data is relevant to the following analysis.

The foreshadowed cap of 30% would have had implications for 91% of publicly available settlements funded under Part IVA proceedings (see Figure 1, next page). That is, 9% of cases would unambiguously proceed as the gross returns (i.e. legal fees and funder returns) would fall below the 30% caps.

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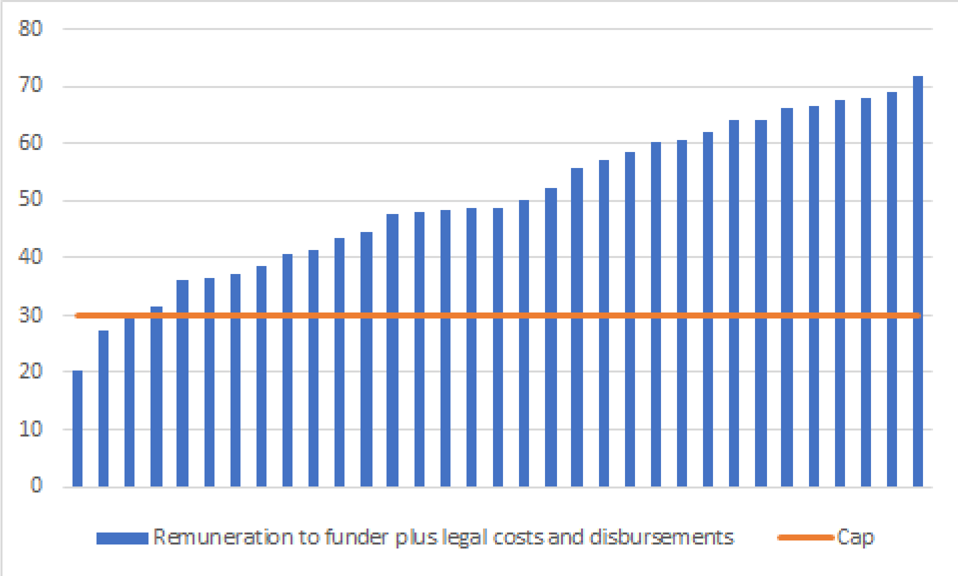
[30] This was despite particular reference by the PJCCFS to the Productivity Commission's view (see PC 2014, pp. 22, 61, 627) that a cap is not appropriate (particularly compared to caps on lawyers) as:

> *litigation funders provide a different service to lawyers — they provide funding and manage claims on behalf of clients rather than providing legal advice. As noted above, current commissions charged by funders appear commensurate to the services offered. … Therefore, the Commission considers that there is no need to place a limit on the fees of litigation funders.*

Figure 1 Gross returns to the funder as a percentage of the gross settlement fund - public data



Source: PwC and Morabito (2020)

The implications for the remaining 91% of actions can take a number of forms.

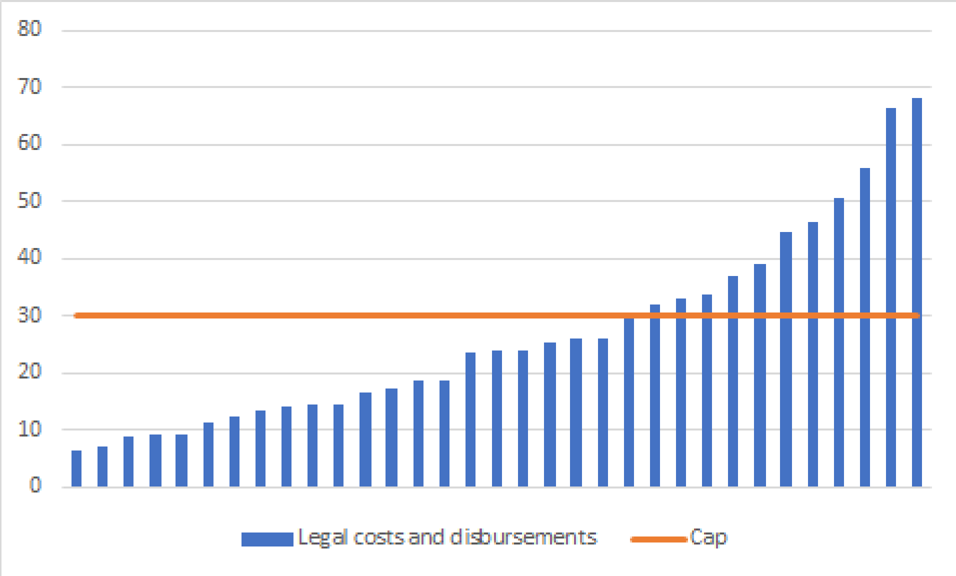
Firstly, litigation funders could seek to reduce litigation costs to bring the total return under the cap. This is challenging in a number of respects:

- Given that courts already scrutinise courts costs as to their appropriateness there is unlikely to be significant opportunity to reduce litigation costs.
- Where costs are reduced (e.g. fewer expert witness reports, etc) this may have a deleterious impact on the likelihood of success. Thus, while getting under the cap might be achieved in some instances, this may reduce the likelihood of any return (and the quantum of that return).

This suggests that there is little scope for a reduction in litigation costs.

As shown in Figure 2 (next page), in 36% of reported class actions supported by litigation funders, a 30% cap on gross returns would not have covered the litigation costs (even before consideration of any return to funders).

Figure 2 Litigation costs as a percentage of the gross settlement fund - public data



Source: PwC & Morabito (2020)

Thus, if the cap had been implemented historically, it is likely that the cap being considered by the PJCCFS would initially have resulted in 36% fewer actions under Part IVA as the case would not have been commercially viable for the funders (i.e. cases where the litigation costs alone would not have come within the proposed 30% cap, meaning the funder would have made a loss or been in a break scenario and made no profit at all).

As demonstrated above, a 30% cap on gross returns to litigation funders will have the effect of reducing the investment by third parties to support class actions.

What we see is a tradeoff; by providing higher returns to some plaintiffs, there will be fewer supported actions, and hence zero returns to other potential plaintiffs.

Of course, other caps could be selected to generate a different tradeoff.

For example, in its initial submission (No. 73, p.2), Omni Bridgeway recommended that legislation be introduced to 'require a minimum return to group members in a funded Australian class action of no less than 50 per cent of the gross proceeds from the action' (i..e. 50% rather than the 30% mooted in the PPJCCFS's subsequent Recommendation 20).

Using the public Morabito (2020) data, in Table 1 we summarise the potential impact on case numbers under three cap scenarios.

Table 1 Number of cases affected by different caps on gross returns - public data

Possible cap on gross returns	Percentage of cases that would not proceed as litigation costs are higher than the gross settlement (i.e. a negative return for the litigation funder)	Additional percentage of cases affected (i.e. where the return to the litigation funder is reduced but remains above zero)
30% (possible cap mooted by the PPJCCFS)	36%	55%
40%	18%	58%
50% (cap recommended by Omni Bridgeway)	12%	33%

Source: PwC

In Table 1 the ‘Additional percentage of cases affected’ columns highlight the percentage of actions where it is unclear whether or not the actions would be funded. From the perspective of the litigation funder, two outcomes are possible in these circumstances - specifically, litigation funders could either:

- take a lower financial return, or
- not proceed with the action.

How litigation funders decide between these two courses of action depends on the rate of return required by the businesses given their costs.

If there is an ongoing desire to regulate returns then, rather than the blunt instrument of arbitrarily developed revenue caps, we consider the approaches outlined in the subsequent chapters are a more contemporary approach to managing the perceived ‘problem’ of litigation funder returns.

4. Two suggested models for the regulation of returns to litigation funders

Most of this discussion, and the resultant PJCCFS Recommendation 20, reflected observations by stakeholders and does not appear grounded in a broad understanding of best practice in terms of how to design a regulatory framework appropriate to the industry.

The matters directly raised by Recommendation 20 relate to the apportionment of litigation outcomes between class action industry participants and class members. Our comments in relation to these matters are from the perspective of established economic regulatory regimes in Australia, such as the major regimes established under the Competition and Consumer Act 2010 (CC Act) administered by the Australian Competition and Consumer Commission (ACCC).[31]

The major economic regulatory regimes are generally focused on addressing issues of market power and on achieving efficient outcomes. By protecting, promoting, or acting as a surrogate for competition, economic regulation seeks to achieve the benefits of competition, which can be characterised to include:

- pricing that embodies a reasonable economic return on efficient costs
- product or service innovation consistent with the operation of a competitive market.

This is to result in improved efficiency of the economy and an increase in the welfare of Australians.

Under a conventional regulatory approach the efficiency of outcomes can be measured, on an *ex ante* or *ex post* basis, by the rate of return on costs, specifically on capital invested

The proposals in Recommendation 20 are not based on a consideration of economic returns or economic efficiency in a conventional economic regulatory context but rather are instead based on considerations of proportionality and allocation.

Two submissions specifically considered the issue of how to establish an equitable return in the context of broader regulatory theory. Specifically, these are:

- submission 100 by Professor RR Officer, which sets out a discounted cashflow (DCF) model. This model is based on economic regulatory principles and calculates a proportionate allocator of litigation outcomes to funders
- submission 101 by Mr Sean McGing, which sets out an insurance (i.e. actuarial) approach. The approach extends conventional regulatory cost of service procedures and does not determine an allocation factor.

In the following sections of this chapter we consider these suggested approaches.

4.1 Approach one - DCF model

4.1.1 Model overview

In Submission 100 Professor Officer sets out a DCF model to estimate the net present value (NPV) of the investment by the 'funder' in the plaintiffs' case:

[31] For example, the regime under Part IIIA of the CC Act relating to third party access to the services of significant infrastructure facilities.

- if that NPV is positive from a funder's perspective the investment should proceed
- a fair return to the funder (i.e. from a court's perspective) is when the NPV is zero (or approximately so).

The NPV is what the *ex ante* (i.e. before the decision or commitment to fund) benefits are relative to costs, where the benefits and costs are discounted at the investors opportunity cost rate.

Such an approach is usually expressed as expected benefits relative to the expected costs, such that:

NPV = (Expected Proportion of the Settled Sum or benefits – Expected Costs including a required return), all discounted at the time value of money, the opportunity cost of the investor.

In effect, the investment is the costs involved in funding the plaintiff's action and the benefit is the proportion the funder receives of the Settled Sum.

Professor Officer describes a how a court might proceed to define the appropriate return for the litigation funder in these terms:

$$x = \frac{E(C)}{E(SS)}(1+R)$$

Where:

- *x* is the proportion of the Settled Sum that represents a 'fair' amount
- *E(C)* is the expected costs
- *E(SS)* is the expected Settled Sum
- *R* is the cost of capital (required return) for this type of investment.

The expected costs - *E(C)* - reflect the:

- probability of incurring costs in a particular period
- required return for an investment of this type
- time value of money (also an opportunity cost of investing).

In the submission the model was then applied in a stylised manner, with Professor Officer providing the inputs, which are estimates based on his personal observations, and in some key instances, are simply given as examples.

4.1.2 Commentary on the DCF model

The model calculates the proportion of a settled sum that represents a 'fair' amount for litigation funders to recover their costs (including a required return) incurred in relation to a class action.

The settled sum can be taken to be either an amount determined by a settlement or court decisions in favour of the plaintiffs.

The model formula, in terms of its general treatment of costs and revenues, is based on generally accepted principles of financial economics relating to the time value of money and the NPV measure.

The estimated fair proportion value (X) shown in submission 100 is the result of the application of stated input values to the basic model formula.[32] The key inputs of costs and the settled sum depict an assumed individual class action which is successful, based on a weighted average of probabilities .

No basis for the assumed parameter values provided

The input values applied are in the nature of value judgements or notional example values. The values for costs and the settled sum are in effect values posed by way of example, but are the fundamental determinants of the settlement sum recovery proportion - the key output of the model. The proportion value X in the submission can accordingly be considered a judgemental value.

The proportion value X shown in the submission is therefore not the result of applying verifiable financial and statistical data inputs, as would be necessary for the settings of a regulatory model.

Risk reflected in the rate of return

The value for R applied in calculating the X proportion represents the author's 'opinion, based on investment experience'. In economic regulatory contexts, such a value (i.e. the weighted average cost of capital - WACC) would be determined by rigorous, transparent process involving application of independently verifiable data to accepted formulae relating to business risks and returns.

For consistency with standard NPV approaches and for consistency within the calculation of related internal rate of return (IRR) values, the value for R - the stated opportunity cost of capital - should also serve as the time value of money opportunity cost factor in determining the values for the expected costs (E(C)) and the expected settled sum (E(SS)).

Third party funding of litigation has a number of characteristics that create significant risk over and above what we might consider 'normal' in other financial investments:

- the funding is effectively a non-recourse advance of funds:

  > *The loans that fund lawsuits are truly nonrecourse in nature in that if the case is lost, the lender loses the entire amount, while the borrower does not owe anything. Indeed, the aforementioned fact inherently makes litigation funding a risky venture.*[33]

- there is no secondary market. In many high risk financial activities there exists an opportunity to sell the investment for some lower value (e.g. a private equity investor owns the assets that could be on-sold) should the need arise; there is no such opportunity once a litigation funder has committed to the case. This increases the downside risk as exit opportunities are then limited solely to settlement

- the litigation funder is exposed to adverse costs (i.e. a court order requiring a party to court proceedings to pay the other party's or parties' costs in relation to court proceedings - which may include fees, disbursements, expenses and remuneration. This risk differentiates litigation funding in Australia from the United States. Thus funds at risk in any case may be larger than the direct investment made by the litigation funder

- the cost base is uncertain as it is, in part, driven by other parties' actions (ie. the defendant, and the court).[34]

As Smith & Johns (2018) note, 'there has not been a definite formula to calculate the cost of capital or required return of third party litigation funding that considers all of the risk factors'.[35]

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[32] The value of X is not duly calculated according to all of the stated input values on pages 4 and 5 of the submission. This does not affect the efficacy of the mechanism proposed.

[33] Smith & Jones (2018, p.414)

[34] For the interplay of some of these risks see *Asirifi-Otchere v Swann Insurance (Aust) Pty Ltd (No 3)* [2020] FCA 1885

[35] Smith & Jones (2018, p.415)

Determination of the reasonable rate of return is a material issue for the application of any regulatory model to litigation funding. The benchmark example of rates of return approaches from Australian economic regulatory regimes has limited applicability to litigation funding investments. The generally accepted formulae and approach in relation to business risk and return used in regulatory contexts is based on the portfolio theory of the Capital Asset Pricing Model (CAPM), which is founded on the analysis of investment in listed, highly liquid and divisible financial securities. The CAPM does not have straightforward application to litigation funding investments, which are highly illiquid, non-divisible, with potentially limited tradeable values.

The insurance model discussed in the next section provides a framework which encompasses major, non-market risk issues associated with litigation funding investments.

Presumption of direct relationship between costs incurred and settlement value

The DCF model projects a presumption that efficient costs of litigation funding (incorporating a reasonable rate of return on capital) comprise a fixed percentage of the settled sum in each (successful) case. However, in individual cases, there need not be a direct relationship between settlement sum outcomes and reasonable costs incurred.

Analysis does not account for the portfolio nature of the litigation funder

The example in submission 100 is based on the assumed values of costs and settled sum of an individual class action which concludes, based on particular assigned probabilities, in favour of the plaintiffs. Given litigation funders' portfolio approach to managing risks and returns across class actions, the application of a general rule for litigation funding based upon a specific successful case outcome would involve a 'selection bias' for determining whether litigation funders' returns are fair and reasonable.[36] There will be a spectrum of 'successful'[37] outcomes: not all class actions which are commenced are concluded in favour of the plaintiffs; and costs can be incurred in relation to class actions that are ultimately not taken. The portfolio risk management basis of litigation funding should be taken into account in determining any general rule that may be applied to the industry.

Consistent with established general economic regulatory practice, the full cost of running the business, including costs of case development and selection, and supporting capital and corporate costs, should be incorporated into a determination of whether costs and related returns on capital of the business are fair and reasonable. The insurance model discussed in the next section outlines general procedures for considering and determining costs to be included.

The Productivity Commission suggested that compensation for risk should take a portfolio view and reflect a spread of wins and losses across a firm's overall caseload.[38] It is arguable, as the concern is about the industry position, that this analysis should be on industry-wide data rather than firm-specific data.

4.2 Approach two - Insurance model

4.2.1 Model overview

Submission 101 to the PJCCFS by Mr Sean McGing sets out a framework based on the principle that a litigation funder's return should be determined based on the actual risk-weighted costs of the particular action being considered. The framework seeks to apply both investment and insurance principles in the determination of a fair and reasonable return for a litigation funder.

This model provides an actuarial perspective in analysing business prospects by valuing or discounting risky future cash flows, and in applying pricing expertise to create a fair and reasonable valuation.

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[36] 'Survivorship bias' or 'survival bias' - a form of 'selection bias' - is the logical error of concentrating on the people or things that made it past some selection process and overlooking those that did not

[37] Even if a plaintiff is successful in a case that does not guarantee that there will be the financial return hoped for or, indeed, any financial return

[38] PC (2014, p.628)

The concept of insurance involves an entity or consumer paying a premium to an insurer to take the risk of a particular loss. An insurer calculates the specific risk of loss based on its experience of a large number of risks and what it can reasonably expect to pay out based on the ‘expected’ total amount of claim for the specific loss. An insurer also receives payment for the risk of the total amounts of claim being different to that expected. The payment should meet the insurer’s expenses and provide a reasonable profit. Entities often ‘self-insure’ by carrying their own risks.

The core inputs driving the level of the return that an insurer sees as fair and reasonable are amounts of:

- insurance/protection for the amount of loss at risk
- risk undertaken
- expected claims to be paid
- expenses.

It is the interaction of these elements that determines the output, a fair and reasonable insurance premium that incorporates the profit and risk margin.

The potential insurance premium rises with an increase in risk. Using this principle, insurers associate low levels of risk with lower insurance premiums, and high levels of risk with higher insurance premiums.

The insurer makes their assessment and forms their view at the time of taking (or not taking) a particular insurance contract. Subsequent events will determine the actual level of insurance payout.

An insurer may also have an element of investment and the investment principles would also apply.

The insurance model framework appears to be predicated on the application of a ‘building block’ approach to costing and does not tie litigation funder’s costs to settlement proceeds.

The framework accordingly is not focussed on settlement sum values: litigation pricing is simply reflective of costs (incorporating a reasonable risk-adjusted rate of return). The costs – other than the opportunity cost of the rate of return on invested capital – are not defined, specified, or presented in detail in the framework. The framework does however extend the traditional building block approach to pricing by encompassing actual or notional costs in relation to capital at risk and insurance. Details for calculating such costs (other general percentage loadings to be applied to base costs) are not provided in the submission.

A material focus of the framework is on determining a reasonable rate of return target based on assessment of investment risks and specialist insurance-type risks under the two components as follows:

- a financial market component - this component is based on the application of specific sub-components:
    - a financial market return based on generally accepted principles of corporate finance
    - an unlisted investment premium based on the example of private equity investment
    - an illiquidity investment premium, reflecting the fact that a litigation investment is unlikely to have a tradeable value, or divisibility, to the same extent as investment in financial securities (which are the cornerstone investments underpinning the generally accepted principles of corporate finance).

  The framework presents a general procedure for determining the financial market component.
- an insurance component - this component is based on generally accepted principles and processes used by actuaries in determining insurance premiums. The framework provides an extensive, although broadly specified, process for determining the insurance premium. The framework’s application of a notional capital at risk value to

costing represents an addition to economic cost of service approaches as typically used in economic regulation (where industries regulated mostly do not have significant capital at risk of recovery).

4.2.2 Application of the model

Notional capital at risk value

The insurance model extends the conventional cost of service perspective to include relevant capital costs relating to the value of avoiding losses:

> *In the case of class actions, litigation funders identify, contact and organise members of the class where it might otherwise be unfeasible for a group of plaintiffs to organise themselves. Moreover, they remove the liability for adverse costs, which is a particularly pronounced disincentive in bringing class actions because non-representative group members are statutorily immune from costs ordered against the representative party (Grave et al. 2012). This means the representative party is normally liable for all adverse costs ordered, but is only entitled to a share of the payout.*[39]

The steps to calculate and apply such a notional capital at risk value within a cost of service approach are not fully set out in the submission, but the submission usefully extends standard costing procedures for application to litigation funding investments.

These costs may be addressed by risk premia or by funders adopting a portfolio approach to managing risks across individual class actions.

For valuing such matters, submission 101 provides a broad process that a regulator or court could adopt in determining such matters that is largely based on reliance upon expert opinion and views.

No basis for the parameter values provided

In relation to the financial component of the rate of return, relevant formulae are not defined and percentage values for the risks associated with individual sub-components - with the general exception of the base financial market return - are best estimates of the author. In relation to the premium values applied for unlisted and illiquid investments, we note that there is limited available data, and absence of a generally accepted theory, in relation to how to measure risks associated with such investments.

The submission includes percentage values or loadings to be applied to base insurance costs calculated, but these percentage loadings are best estimates of the author.

Accordingly, similar to comments made in the preceding section above relation to the DCF model, the input values in relation to the insurance model are not supported in submission 101 by specific formulae or verifiable sources for determining such values.

Because the insurance model appears to be predicated on the application of a building block approach (i.e. so that reasonable, risk adjusted returns are determined in relation to all relevant capital and non-capital costs of the business) to each individual case, the issue of selection bias potentially attendant to the inputs to the DCF model can be considered to be addressed by the insurance model.

4.3 Conclusion

Significant detail is required to be developed for either model to be able to apply with clarity, transparency and verifiability, as would be required by a formal regulatory process.

A lack of specificity of both the models as set out in submissions 100 and 101 respectively is understandable given the requirement for brevity in the submissions to the PJCCFS.

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[39] PC (2014, p.607)

There are elements to commend in both the DCF and the insurance model, but neither provides a fully specified regulatory regime or mechanism.[40]

As a general observation, the DCF model provides a potential overarching regulatory model:

- The model's overarching NPV methodology is soundly based on financial economic principles and reflects standard regulatory practice. As such, the DCF model represents a model of price regulation that in theory could apply to directly regulate prices, or apply as a target or control value on an ex ante basis.

- However, the basic control mechanism of the model, the settlement sum recovery percentage X, if it is to be applied as a general rule, may not reflect the way costs are efficiently incurred by litigation funders in relation to each case.

Similarly as a general observation, the insurance model provides a process for evaluating and costing business risks:

- It provides an extensive, although broadly defined, process for determining risk components of litigation funding costs, and within required rates of return for litigation funders.

- Although the model advances the issue of the determination of relevant capital and non-capital costs for inclusion in costs to be recovered, the process for arriving at underlying costs of business operations is not specified, and risk loadings to base costs (with the exception of percentage market-based investment returns, which are generally standard values from corporate finance), appear to represent value judgements of the author. These matters could be addressed in detailed design.

The following sections provide observations about how the models deal with particular challenges.

4.3.1 Selection bias

The application of a general rule for litigation funding based upon an example successful case outcome (the scenario presented by submission 100) would involve a selection bias for determining whether litigation funders' returns are fair and reasonable. This is because settled successful cases are a subset of the total class actions evaluated and ultimately undertaken by litigation funders, who may adopt a portfolio approach to managing the risk and returns of funding across class actions.

The insurance model is likely to present a lesser issue of selection bias given that it potentially covers capital and non-capital costs of litigation funding on a more comprehensive basis. The insurance model may introduce additional business processes for assessments of prospective class actions and give rise to additional business costs. Such additional processes may however represent relevant additions to litigation funding business models.

4.3.2 Rate of return

The determination of the reasonable rate of return is a material issue for both models. The example of rates of return from Australian economic regulatory regimes has limited applicability to litigation funding investments, given that the generally accepted CAPM model on investment risks and returns, does not have a straightforward application to litigation funding, where systematic market risks are significantly outweighed by unique risks.

The value applied as the reasonable rate of return in the DCF model does not have a clear basis, other than representing the author's opinion, based on investment experience. It is not shown to be the result of applying generally accepted theory, formulae and inputs, as would be required for the settings of an economic regulatory regime. As commented above, the stated opportunity cost of capital value of R should serve as the common discount rate for NPV analysis.

The insurance model builds upon the CAPM basis and provides an additive framework to determine a rate of return that reflects the particular characteristics of litigation funding investments. The details of, and proofs for, the application of the

[40] Additionally, values provided in the submissions (and which in submission 100 derives the settlement sum recovery percentage) appear to rely on value judgements of the authors. The settings of an economic regulatory regime would typically require application of specific accepted theory, formulae and input parameters

framework are not provided in the submission (the percentage loadings provided in relation to the financial market return component of the rate of return, and in relation to insurance costs, are best estimates of the author). We note that there is limited available data, and an absence of generally accepted theory, in relation to how to measure risks relating to non-traded and illiquid investments.

4.3.3 Risk sharing

Although the mechanism of the DCF model, which in effect presumes costs are incurred in direct proportion to settlement sum outcomes, may not reflect the manner in which costs of litigation funding are generated in relation to an individual action, the mechanism could form the basis of practical risk-sharing arrangements between plaintiffs and litigation funders in a way that promotes class actions (where a fixed price calculated by reference only to costs may discourage prospective plaintiffs from obtaining compensation via class action).[41]

A fixed price basis established without reference to settlement values can be considered an expected consequence of the direct application of the insurance framework in submission 101. Such an approach could, for example, result in a price to plaintiffs in excess of the ultimate settlement amount. The potential for such an outcome to arise may provide disincentive for consumers in pursuing class actions as an efficient mechanism for obtaining compensation.

4.3.4 Coverage of relevant costs

Both models in their current general forms appear to provide coverage of costs as would be relevant for a regulatory cost of service framework, although the insurance model provides express consideration of actual or notional costs relating to capital at risk and insurance. The latter costs may be addressed by risk loadings or by the operation of a portfolio approach to managing risks across individual class actions.

In the case of the DCF model, although costs are not prescriptively defined, the details of component costs could be considered a matter to be addressed at a later stage, in developing such a model into a working regime.

[41] In its JPCCFS submission the ACCC commented that class actions are an efficient and appropriate mechanism for obtaining compensation that generally and appropriately supplements public enforcement

5. A synthesis of approaches

While there are limitations in both the suggested models, (DCF and insurance), not surprisingly, there is also much to commend in them. Indeed, if there is to be a cap on returns of some form then we suggest that a way forward is to consider basing such a cap on an aggregated approach.

The DCF model is a useful overarching framework. Its basic mechanism is straightforward and consistent with general financial economic principles, and can give rise to a risk sharing arrangement between plaintiffs and litigation funders in a manner that could promote welfare through facilitating class actions.

However, because the mechanism (the presumed fixed proportion of settled sums to efficient costs incurred) need not be true in individual cases, any proportion value applied should be in the nature of general guidance rather than an absolute control value (or if an absolute control value, the proportion should be variable to account for specific circumstances).

The costs to be included should incorporate appropriate amounts or loadings for business development and encompass business capital, operating and overhead costs consistently with cost of service models applied under economic regulatory regimes (such as those administered by the ACCC).

Consideration should be given to whether the capital value should include an amount for capital at risk, based on insurance industry principles outlined in the insurance model. It is recognised that coverage of capital at risk could be generally addressed by funders applying a portfolio approach to managing risks across individual class actions.

Also, given limitations to the financial market-based perspective applied to rate of return determinations under standard regulatory models (as generally applied to investments by regulated monopoly companies, which have relatively high certainty of recovery), any rates of return developed for a litigation funder regulatory model should expressly address risks attendant to unlisted and illiquid investments, as are generally explained in the insurance model.

6. Conclusion

Recommendation 20 of the PJCFS provided a roadmap for further consultation on:

> *13.62 The committee recommends the Australian Government consult on:*
> - *the best way to guarantee a statutory minimum return of the gross proceeds of a class action (including settlements);*
> - *whether a minimum gross return of 70 per cent to class members, as endorsed by some class action law firms and litigation funders, is the most appropriate floor; and*
> - *whether a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case is appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases.*[42]

There is nothing inherent to the litigation funding market that does not suggest that, in the longer, run the best form of consumer (i.e. plaintiff) protection would be the maturation and deepening of the market, aided by standardised disclosure requirements in the short term.

While some justices feel comfortable in assessing the appropriateness of the returns to funders,[43] we consider it a challenging exercise for a number of reasons:

- it is difficult to see that they could alone bring to bear the investigative and analytical skills necessary. This can be addressed by seeking appropriate expert advice

- data required to support the analysis should:

    - be on an industry-wide basis over an extended period of time, rather than just focusing on a specific individual matter at hand and the specific parties involved

    - also reflect the costs associated with researching potential matters, and unsuccessful and successful matters pursued.[44]

As such, if there is to be further consideration of a regulatory cap then we suggest that the task should be undertaken by an existing and experienced regulatory body applying standard regulatory processes.[45]

We believe that the development of the cap should:

1. be undertaken on an industry-wide basis (i.e. rather than on a case-by-case or funder-by-funder basis)

2. be based on a DCF framework as an overarching approach

3. include appropriate amounts/loadings for the full range of costs including:

    a. business development costs

    b. capital costs

    c. operating costs

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[42] PJCCFS (2020, p.206)
[43] See, for example, commentary in: *Asirifi-Otchere v Swann Insurance (Aust) Pty Ltd (No 3)* [2020] FCA 1885 per Lee J; and Caufield (2021)
[44] The need for a portfolio view was acknowledged by Beach J in *Kuterba v Sirtex Medical Limited (No 3)* [2019] FCA 1374
[45] An example of consideration of price caps on an industry-wide basis in a relatively niche industry is provided in IPART (2019), where the NSW Independent Pricing and Regulatory Tribunal (IPART) considered whether price controls should be established regarding the provision of electronic conveyancing services

d. overhead costs

4. involve consideration of actual or notional costs in relation to capital at risk and insurance. Such costs may be addressed by risk premia or by litigation funders adopting a portfolio approach to managing risks across individual class actions

5. the rate of return developed for a litigation funder regulatory model should be founded on generally accepted corporate finance principles but include specific additive factors or adjustments to account for the specific risks associated with litigation funding investments (such factors should be based on verifiable data and tested theory).

In applying the overarching framework of the DCF model, because the model mechanism presumes a fixed relationship between costs incurred to settlement sum, outcomes may not reflect costs incurred in individual cases. Hence, any percentage value applied to settled sums to determine pricing could, for example:

- comprise a guiding value rather than an absolute control value
- involve a sliding scale of reduced proportionality in relation to larger cases, or
- incorporate variations to deal with specific circumstances.

Appendix A - Sources

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- Omni Bridgeway - No. 73
- Professor R.R. Officer AM - No. 100
- Mr Sean McGing - No. 101

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Appendix 3: PwC Supplementary Report

A Possible Approach to the Regulation of Litigation Funding - Supplementary Report

5 July 2021

pwc

Disclaimer

This report is not intended to be read or used by anyone other than Omni Bridgeway.

We prepared this report solely for Omni Bridgeway's use and benefit in accordance with and for the purpose set out in our engagement letter with Omni Bridgeway dated 3 June 2021. In doing so, we acted exclusively for Omni Bridgeway and considered no-one else's interests.

We accept no responsibility, duty or liability:

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Executive summary

In December 2020 the Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) released its report into litigation funding and the regulation of the class action industry.[1] One of its areas of focus was the perception that third party litigation funders were earning an 'excessive' return from successful cases, at the cost of unacceptably lower returns to the plaintiffs.

While not being definitive in its conclusions, the PJCCFS pointed to a future reform agenda focusing on the regulation of returns to third party funders. Specifically, Recommendation 20 provides:

> *The committee recommends the Australian Government consult on:*
> - *the best way to guarantee a statutory minimum return of the gross proceeds of a class action (including settlements);*
> - *whether a minimum gross return of 70 per cent to class members, as endorsed by some class action law firms and litigation funders, is the most appropriate floor; and*
> - *whether a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case is appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases.*[2]

Amongst other questions, the Commonwealth Treasury and the Attorney General's Department are now seeking industry views in response to the following questions arising from Recommendation 20 of the PJCCFS report:

3. *Is a minimum gross return of 70 per cent to class members the most appropriate floor for any statutory minimum return? If not, what would be the appropriate minimum and its impact on stakeholders, the class action system and the litigation funding industry?*
4. *Is a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases?*
5. *How would a graduated approach to guaranteed returns for class members be implemented? This can include how a decision is made that a particular case is straightforward, how cases could best be classified to determine the minimum return applicable to a particular case and at what stage of an action such a determination should be made.*

We have been asked by Omni Bridgeway to comment on regulatory best practice should the Government be minded to consider regulation of funded class action returns. This supplementary report should be read with our original report (March 2021) prepared for Omni Bridgeway.

With respect to Question 3, we note that:

- The mooted 70% return to class members does not appear to be based in any empirical analysis of actual case outcomes. The Commonwealth Treasury has an opportunity to take an empirical approach. To do so it will need to:
  - seek confidential commercial data from litigation funders to enable a whole of industry perspective on the actual level of returns for class members relative to the capital invested and risk borne by litigation funders
  - apply an analytic methodology consistent with regulatory best practice. We have provided additional insight as to what this might look like (see section 2.1).
- Evaluation of the Morabito dataset used in our original assessment, extended by the addition of case results obtained from the Law Council of Australia (LCA), reinforces our prior conclusion that a guaranteed 70% return to class members would mean substantially fewer class actions. Specifically, analysis of prior cases in the LCA dataset shows that, phrased in two alternative ways:
  - 30.8% of the class actions would not have occurred because there was no net return to the litigation funders (i.e. the legal costs alone exceeded 30% of the gross returns). In total, 24 out of the 26 cases in each database would be impacted (92.3% of cases covered by this industry-wide data)

[1] PJCCFS (2020)
[2] PJCCFS (2020, p.206)

- in general, class actions that provide a gross return of less than $25 million would be unviable and would not be funded. Such cases comprise 11 of the 26 cases used for each dataset (i.e. 42.3% of the cases from the new expanded data set).

With respect to Questions 4 and 5, we note that:

- There are some advantages in applying a graduated scale rather than a flat cap on returns. A graduated scale that incorporates a number of variables according to size of settlement can preserve the inherent risk sharing and incentive benefits of a single factor approach to pricing (e.g. relative to straightforward cost-based pricing), while also addressing potential limitations of a single factor approach (i.e. a potential windfall profits to a funder where the amount awarded or settled is a significant value; and a single, averaged value approach could make smaller cases unprofitable given that some case establishment and operating costs associated with a litigation will be fixed in nature).
- In designing a graduated approach we suggest that the scheme should seek to meet the following objectives

If a graduated approach were to be adopted then it should:

- be developed based on an analysis of a comprehensive assessment of previous class action outcomes
- not be too complex to understand and apply. In particular, we note that many of the factors that the PJCCFS noted (e.g. complexity, time, risk, etc) are likely to be correlated to some degree and so building a graduated approach with every possible variable is likely to be unnecessarily complex with little incremental benefit over a simpler graduated approach
- support the operation of existing portfolio business models of litigation funders
- achieve a more uniform recovery across cases by magnitude of settlement (while maintaining differentiation for larger cases with higher risk)
- support continued viability of the industry as a means supporting an important legal avenue for obtaining compensation, particularly for claimants with relatively small claims
- embody a minimum return to claimants in smaller cases, where costs are generally the highest in proportion to settlement values
- achieve a marginal allocation rate to claimants in the highest award value cases, in respect of the component of award value which exceeds a predetermined threshold value for such cases
- incorporate potential demand responses (to address the concern that the graduated approach is constructed off historic class action outcomes).

Contents

1 Introduction

1.1 The parliamentary review of litigation funding

In December 2020 the Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) released its report into litigation funding and the regulation of the class action industry.[3] One of its areas of focus was the perception that third party litigation funders were earning an 'excessive' return from successful cases, at the cost of unacceptably lower returns to the plaintiffs.

On the basis that perceived 'excess returns' were being generated by litigation funders, and correspondingly lower returns were provided to the litigants, the PJCCFS considered broad options as to how to address this concern. The focus was on how to guarantee a minimum return to successful class action plaintiffs (i.e. how to cap returns to litigation funders).[4] For example, submissions to the PJCCFS provided a range of ideas as to:

- the basis on which to set a regulated cap (i.e. a guaranteed minimum percentage of the resolution for plaintiffs, or a maximum percentage of the resolution for litigation funders which includes reimbursement of investments made, etc)
- the structure of the cap (i.e. whether there should be a single 'cap' or some form of graduated (i.e. sliding) scale based on certain factors).

While not being definitive in its conclusions, the PJCCFS pointed to a future reform agenda focusing on the regulation of returns to third party funders. Specifically, Recommendation 20 provides:

> *The committee recommends the Australian Government consult on:*
> - *the best way to guarantee a statutory minimum return of the gross proceeds of a class action (including settlements);*
> - *whether a minimum gross return of 70 per cent to class members, as endorsed by some class action law firms and litigation funders, is the most appropriate floor; and*
> - *whether a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case is appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases.*[5]

The matters directly raised by PJCCFS Recommendation 20 relate to the apportionment of litigation outcomes between class action industry participants and class members.

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[3] PJCCFS (2020)

[4] This was despite particular reference by the PJCCFS to the Productivity Commission's view (see PC 2014, pp. 22, 61, 627) that a cap is not appropriate (particularly compared to caps on lawyers) as:

> *litigation funders provide a different service to lawyers — they provide funding and manage claims on behalf of clients rather than providing legal advice. As noted above, current commissions charged by funders appear commensurate to the services offered. … Therefore, the Commission considers that there is no need to place a limit on the fees of litigation funders.*

[5] PJCCFS (2020, p.206)

1.2 Additional consultation on the PJCCFS recommendations

On the back of Recommendation 20 of the PJCCFS, the Commonwealth Treasury and the Attorney General's Department recently published a consultation document entitled *Guaranteeing a Minimum Return of Class Action Proceeds to Class Members*. In it a series of questions were posed to stakeholders, seeking their views.

In this document we address the following questions posed in the consultation document:

3. *Is a minimum gross return of 70 per cent to class members the most appropriate floor for any statutory minimum return? If not, what would be the appropriate minimum and its impact on stakeholders, the class action system and the litigation funding industry?*
4. *Is a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases?*
5. *How would a graduated approach to guaranteed returns for class members be implemented? This can include how a decision is made that a particular case is straightforward, how cases could best be classified to determine the minimum return applicable to a particular case and at what stage of an action such a determination should be made.*

Question 3 was directly addressed in our original March 2021 report (PwC 2021). In this supplementary report we extend that original analysis in Chapter 2 through the application of a new dataset of case outcomes.

In Chapter 3 of this report we address Questions 4 and 5 by considering what a graduated approach could look like, but stress that additional research is required by Treasury to determine the appropriate returns on an industry-wide basis rather than supposition.

2 Is a 70% Minimum Gross Return to Class Members Appropriate?

A challenge here, largely due to confidentiality arrangements, is that there are few cases where there is complete public information about the relative return to the plaintiffs, lawyers and funders.

2.1 There is a need for a stronger evidence base to substantiate an appropriate minimum return

In the report we prepared following the release of the PJCCFS's inquiry report we stressed the need for any price regulation of litigation funders to be based on a strong evidence base using established regulatory tools and techniques.

Our comments in relation to these matters are from the perspective of established economic regulatory regimes in Australia.

Firstly, as we noted in our earlier report, there has been an acceptance since the mid-1990s, that government interventions in markets should generally be restricted to situations of market failure and that each regulatory regime should be targeted on the relevant market failure or failures. This is built from the principle that, as a general rule, efficiency is maximised when markets are allowed to operate unhindered, but in certain circumstances, some markets fail, creating a legitimate reason for government to step in and correct the 'market failure'. The PJCCFS inquiry report does not establish the existence of a pervasive market failure in the case of litigation funding that would justify price regulation.

Secondly, the price regulation proposals mooted in Recommendation 20 are not based on a consideration of economic returns or economic efficiency in a conventional regulatory sense, but are instead directly based on considerations of proportionality and allocation. Indeed, this approach advanced by the PJCCFS is not consistent with regulatory theory and does not provide a balanced economic basis for the form of price regulation proposed in the report.

Specifically, in our original report we suggested that a balanced regulatory regime - consistent with regulatory best practice - could be developed from the principles and procedures of the models in:

- submission 100 by Professor RR Officer, which sets out a discounted cashflow (DCF) model, which sets the foundational approach, which would be complemented by
- submission 101 by Mr Sean McGing, which sets out an actuarial/insurance approach.

As such, if there is to be further consideration of a regulatory cap, we believe that the task should be undertaken by an existing and experienced regulatory body applying standard regulatory processes. Given that the Commonwealth Treasury is tasked with assisting in the preparation of a response, we suggest that it needs to act as though it is an impartial economic regulator in developing any specific model.

Specifically, we suggest that in suggesting any cap the Commonwealth Treasury should:

- undertake the analysis on an industry-wide basis (i.e. rather than on a case-by-case or funder-by-funder basis).
- be based on a DCF framework as an overarching approach, reflecting the often significant time-lag between the provision of funding and allocation of any returns
- include appropriate amounts/loadings for the full range of costs ('Indirect Funder Costs') including:
    - business development costs
    - capital costs
    - operating costs
    - overhead costs
- involve consideration of actual or notional costs in relation to capital at risk and insurance.

- the rate of return developed for a litigation funder regulatory model should be founded on accepted corporate finance principles, and include specific factors or adjustments to account for risks associated with litigation funding investments (such factors could be based on principles from the insurance industry and should be derived from the application of verified data).

The key challenges here are that:

- this may require the Treasury seeking from individual litigation funders, presumably under a non-disclosure agreement, information on all the class actions which they have supported.
- it does not appear that many of the Indirect Funder Costs noted above are collected in a manner allowing easy attribution to specific cases, and so allocation of common costs will become a more pointed issue.

In applying the overarching framework of the DCF model, because the model mechanism presuming a fixed relationship between costs incurred to settlement sum outcomes may not reflect costs incurred in individual cases, any percentage rate applied to settled sums to determine pricing could:

- represent a guiding value rather than an absolute control value
- allow for variations to deal with specific circumstances, or
- comprise a graduated (i.e. sliding) scale of percentage values according to the size of the settlement or award.

2.2 A broader dataset confirms the conclusion that a 70% minimum gross return will have considerable implications for access to justice

In our March 2021 analysis (PwC 2021) we analysed publicly available data compiled by Professor Morabito regarding class action outcomes,[6] concluding that:

> the PJCCFS's mooted approach (i.e. effectively a cap of 30% of gross returns for litigation funders), is projected to result in 36% fewer class actions (i.e. cases where the litigation costs alone would not have come within the proposed 30% cap, meaning the funder would have made a loss or been in a break even position and made no profit at all). This demonstrates the tradeoff inherent in any cap on litigation funder returns; it would provide higher returns to some class members, but some members would not receive returns they would have otherwise expected as fewer actions would be undertaken.

We have been requested to apply the same analytic approach to an alternative database of class action outcomes to test whether our original results are a function of the data used, or are more generally applicable.

Hence, we have used the Morabito dataset for the purposes of the analysis in this paper. In parallel with this dataset in respect of corresponding cases, we have also used a dataset derived from Attachment A of the Law Council of Australia (LCA) submission to the PJCCFS dated 16 June 2020. The process for aligning the datasets is described in Box 1 (next page).

In this way we have sought to establish, as close to as possible, an industry-wide perspective, using the information in Morabito as the base, and using the LCA database generally as a cross-check to calculations based on the Morabito data.

In relation to the industry-wide data of 26 cases simply assembled from the two separate databases:

- the Morabito data presents that the average percentage allocation of dollar settlement values to funders and lawyers combined is 42.9%; accordingly, on average, claimants would be allocated 57.1%
- the same cases assessed from the LCA database show a combined allocation to funders and lawyers of 42.8%, so that 57.2% would be available to claimants.

[6] See Morabito (2020)

Box 1 General synthesis of the Morabito and LCA data sets

The Morabito database covers a period from 2017 to 2020 and contains information on 35 cases. Of these, the cases immediately below do not in our view contain sufficient information for our basic analysis in relation to returns to funders (and the reciprocal values in relation to settlement sums, of returns to claimants):

- *Hardy v Reckitt Benckiser (Australia) Pty Ltd*
- *Cantor v Audi Australia Pty Limited* and the related class action
- *Andrews v ANZ Bank*. This case contains some relevant monetary information, but the data appears incomplete and inconsistent. We excluded this data from our analysis and note that this case would only have a small weight in relation to the total cases covered.

Based on removal of the above cases, the Morabito database yields 32 cases. Of these, six cases do not appear in the LCA database, leaving a base list of 26 cases. These Morabito cases that appear not to be included in the LCA data are:

- *Court v Spotless*
- *Webster v Murray Goulburn Co Operative Co Limited*
- *Smith v Sandhurst Trustees Ltd*
- *Kenquist Nominees Pty Ltd v Campbell*
- *Basil v Bellamy's Australia Limited*
- *El-Zein v Barton Nine Pty Limited*.

We then undertook selection of cases from the LCA database that correspond to the adjusted list from Morabito. The LCA database covers a period of 2001 to 2020 and contains information on 86 cases.

Of the 86 cases, 45 cases in the LCA database are excluded from our analysis given that the source data in Attachment A of the LCA submission presents in relation to these cases:

- that the case has no funder
- that funding information is not available, or
- the parties are to bear their own costs (with no dollar values shown for funding)

The same reason for excluding *Andrews v ANZ Bank* from our analysis of the Morabito data, also excludes it from the LCA data for assessment. These combined adjustments to the LCA base data result in a revised list of 40 cases.

Because the LCA data covers a broad time period, from 2001 to 2020, versus 2017 to 2020 for the Morabito data, aligning the LCA data with Morabito also provides in our view a current perspective from the LCA data.

In the LCA database, 10 cases appear to have concluded before the period covered by Morabito. Exclusion of these cases results in a revised list of 30 LCA cases.

A further four cases in the LCA database do not appear to be present in the Morabito database, so the adjusted total for the parallel cases in the LCA database is 26 cases.

It is important to note that such base data derived from these sources, by relating only to dollar settlement values and to the allocation of such values to specific parties, can only provide only a partial perspective of litigation funder activities, costs and financing. **Other actions that are funded, but are not successful; actions assessed, prepared for, but not progressed; and an entity's business development and operating costs, are relevant considerations for an assessment of the costs of litigation funding. These matters are not covered by our analysis.**

Allocation factors relating to the combined remuneration to the funder and legal costs,[7] as a percentage of gross settlement fund value, are expressly calculated and displayed in the Morabito base data. The LCA data shows only the specific allocations to the funder (as Litigation Funding Fees percentage of settlement) and to cover legal costs (Legal Fees as a percentage of settlement). Based on the Morabito procedure, such component fees or costs from the LCA database are simply added to form the combined remuneration factors for LCA within our analysis.

The two databases yield practically the same results: there are differences in treatment of individual cases between the Morabito and LCA tables[8] but it appears that any potential differences in accessibility to, or interpretation of, underlying source data do not have a meaningful effect, in terms of derived aggregate results. Importantly, subject to the comments in the preceding paragraph, both databases present consistent categorisation and application of underlying source information. Our parallel modelling of the two databases may provide a degree of confidence in the data and analysis encompassing a recent industry-wide perspective.

In the historical data, in very broad terms, the percentage of returns to funders reduces with increasing magnitudes of the settlement value. However, the costs that can be obtained from the data comprise only legal costs. The costs of funders will however include other direct costs, and indirect costs. Such costs will incorporate some elements that will be fixed in nature, so that the limited forms of return that can be inferred from the base data indicate that a material proportion of low dollar settlement value cases may present low rates of return.

The higher settlement value cases generally achieve higher returns, based on the direct costs only, of legal fees. It could be presented that such cases may provide support to litigation funding businesses overall, but also there is a correspondingly high business risk associated with individual large cases.

Although the application of a pricing regime involving a single allocation factor of 42.9% or 42.8% would in theory preserve recoveries based on the simple analysis of the historic data from the Morabito and LCA databases respectively, this would exacerbate differences between direct cost recoveries for cases below $25 million and above $50 million settlement values. If a perspective based on associated operating and other costs (in addition to the directly attributable costs of legal fees) is used, cases below $25 million could become unprofitable to funders. Cases generally above $50 million would achieve higher returns, but this may not be reflective of risks associated with such cases.

If the mooted 70% return to class members (a flat rate funder and legal costs allocation of 30%) is applied, this would reduce gross revenue to litigation funders by about 30% based on the historical data. Under this scenario, cases below $25 million would in general not recover the direct costs of legal fees and provide an appropriate margin for other funder costs incurred.

In the Morabito data set, under a 30% allocation to funder/legal costs scenario, nine of the 26 cases would not recover the legal fees expended (without any consideration of the Indirect Funder Costs).

One case is in the middle band of cases, *Inabu Pty Ltd v CIMIC Group Limited*. The remaining eight cases are in the band of 11 cases with settlement values below $25 million. Of the three cases that would cover the direct costs of legal fees, two would only cover them marginally. We note that the third case, *Santa Trade Concerns Pty Ltd v Robinson (No 2)*, is treated differently in the two databases. It would cover direct costs based on the Morabito data, but it would significantly under recover such costs based on the LCA data. Putting the *Santa Trade Concerns Pty Ltd v Robinson (No 2)* case to one side, with any even moderate allowance for cases making some contribution to other costs incurred, it is reasonable to present that, in general, cases below $25 million would be unprofitable, and would not be undertaken.

The LCA dataset presents a similar position. There are eight cases based on the LCA data that would not cover direct legal costs under this scenario. As in the calculations from the Morabito data, one case is in the middle band of cases, shown as *Inabu Pty Ltd as trustee for the Alidas Superannuation Fund v CIMIC Group Ltd* and presenting almost identically to the middle band entry in the Morabito data set.

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[7] Legal costs comprise complete lawyers' fees and disbursements (which are the other costs to bring the proceedings such as court fees and expert fees).

[8] We note that the LCA observes (footnote 5) that they included some 'approved costs' in their analysis of litigation funding fees. This may explain some of the differences in the treatment of specific legal cases by Morabito and the LCA

In the LCA dataset, seven of the 11 cases with settlement values below $25 million are shown not to recover the specific direct legal cost. Of the four cases that can be shown to recover their direct legal costs, three of those cases would only do so marginally. The fourth case, *Petersen Superannuation Fund Pty Ltd v Bank of Queensland Ltd (No 3)*, presents a reasonable gross margin under this scenario in the LCA database, while in the Morabito database under the same scenario would not cover direct legal costs. Hence, based on our analysis and comparison of the data sets, and recognising that direct legal costs are a limited cost item, we consider it reasonable to present that, in general, cases with settlement values below $25 million would be unprofitable and accordingly would not be viable and would not be funded. Such cases comprise 42.3% of the cases in each dataset.

While cases with settlement values in the range $25 million to $50 million would in general cover the narrow range of direct legal costs used for our analysis, if full costs are considered (i.e. including Indirect Funder Costs), these cases may not yield a sustainable risk-adjusted commercial return over fully allocated costs. Cases with settlement values over $50 million would continue to present a return over direct legal costs and potentially also of other indirect funder costs, but cases of this general order of magnitude alone are comparatively infrequent and may not comprise a sustainable business.

3 Consideration of a Graduated Approach

The PJCCFS queried 'whether a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case is appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases'.[9]

The Commonwealth Treasury and the Attorney General's Department subsequently asked:

4 *Is a graduated approach taking into consideration the risk, complexity, length and likely proceeds of the case appropriate to ensure even higher returns are guaranteed for class members in more straightforward cases?*

5 *How would a graduated approach to guaranteed returns for class members be implemented? This can include how a decision is made that a particular case is straightforward, how cases could best be classified to determine the minimum return applicable to a particular case and at what stage of an action such a determination should be made.*

If constructed off a solid evidence base (see Chapter 2), a graduated model could possibly be developed to regulate the returns to litigation funders in a manner that provides higher returns to class members.

A graduated scale incorporating a number of variables according to size of settlement can go some way to preserving the inherent risk-sharing and incentive benefits of a single factor approach to pricing (e.g. relative to straightforward cost-based pricing), while also addressing potential limitations of a single factor approach.

Potential limitations of a single factor approach can include, for example:

- potential windfall profits to a funder where the amount awarded or settled is a significant value and the cost expended is low
- a single, averaged value, approach could make smaller cases unprofitable given that some case establishment and operating costs associated with a class action will be fixed in nature (i.e. the Funder Indirect Costs).

If smaller cases became unprofitable this would lead to a reduction in class actions as a means of obtaining compensation for such cases. This would be a negative outcome given that the Australian Competition and Consumer Commission (ACCC) considers the current *Competition and Consumer Act* framework for class actions to provide an efficient and appropriate means of obtaining compensation, particularly for smaller cases:

> *Class actions play a particularly important role in obtaining compensation in circumstances when individual action by plaintiffs is unlikely or uneconomical. In many competition and consumer enforcement matters the harm suffered by an individual consumer is too small to justify individual litigation but the collective loss to all affected consumers is substantial.*[10]

In its 2014 *Access to Justice* report the Productivity Commission (PC) considered that a single rate approach would not adequately protect consumers and that a sliding scale to setting lawyers' contingency fees should apply to ensure that fees for large claims are not excessive relative to costs, while also allowing a fair return to lawyers across cases.[11] While the PC specifically rejected a graduate/sliding scale approach for litigation funders,[12] we consider that the principles considered in the development of a sliding scale for setting lawyers' contingency fees is illustrative in considering the PJCCFS's mooted graduated scale.

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[9] PJCCFS (2020, p.206)
[10] ACCC, Submission 15
[11] PC (2014, p.269)
[12] PC (2014, pp.633-635)

The mechanism presented in the PC report involves a reducing marginal percentage rate for allocating contingency fees to lawyers based on award values exceeding increasingly higher thresholds of award value. This mechanism is conceptually equivalent to the Australian Taxation Office income tax rate schedules for individuals, which apply increasing marginal taxation rates to income in excess of corresponding higher income threshold values.

Based on the economic merits of such a marginal rate sliding scale mechanism, the PC recommended in general that lawyers should be permitted to apply damages-based pricing (contingency fees) and that the percentage values for such pricing should be capped on a sliding scale for retail clients with no percentage restrictions for sophisticated clients.

In the PC's recommendation, the graduated scale approach is presented as being determinative of lawyers' pricing in each case for retail clients. That is, such pricing in these cases cannot be combined with or replaced by other bilaterally agreed pricing arrangements. In effect, the PC considered, therefore, that bilaterally agreed pricing would be appropriate for non-retail (i.e. sophisticated) clients

If a graduated approach were to be adopted then it should:

- be developed based on an analysis of a comprehensive assessment of previous class action outcomes
- not be too complex to understand and apply. In particular, we note that many of the factors that the PJCCFS noted (e.g. complexity, time, risk, etc) are likely to be correlated to some degree and so building a graduated approach with every possible variable is likely to be unnecessarily complex with little incremental benefit over a simpler graduated approach
- support the operation of existing portfolio business models of litigation funders
- achieve a more uniform recovery across cases by magnitude of settlement (while maintaining differentiation for larger cases with higher risk)
- support continued viability of the industry as a means supporting an important legal avenue for obtaining compensation, particularly for claimants with relatively small claims
- embody a minimum return to claimants in smaller cases, where costs are generally the highest in proportion to settlement values
- achieve a marginal allocation rate to claimants in the highest award value cases, in respect of the component of award value which exceeds a predetermined threshold value for such cases
- incorporate potential demand responses (to address the concern that the graduated approach is constructed off historic class action outcomes).

Appendix - Sources

Submissions:

- ACCC - No. 15
- Omni Bridgeway - No. 73
- Professor R.R. Officer AM - No. 100
- Mr Sean McGing - No. 101

Vince Morabito (2020), *POST-Money max Settlements in Funded Part IVA Proceedings*

PJCCFS (Parliamentary Joint Committee on Corporations and Financial Services) (2020), *Litigation Funding and the Regulation of the class Action Industry*, available at https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Litigationfunding

PwC (2021), *Models for the regulation of returns to litigation funders*

PC (Productivity Commission) (2014), *Access to Justice*, available at https://www.pc.gov.au/inquiries/completed/access-justice/report

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