

Models for the regulation of returns to litigation funders

16 March 2021



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.

This disclaimer applies:

- to the maximum extent permitted by law and, without limitation, to liability arising in negligence or under statute; and
- even if we consent to anyone other than Omni Bridgeway receiving or using this report.

Liability limited by a scheme approved under Professional Standards legislation

Contents

Executive summary	4
The DCF model	5
The insurance model	5
A possible blended approach	6
1. Introduction	7
2. The ‘problem’ of litigation funding and how to respond	9
3. The impact of the foreshadowed cap on returns	13
4. Two suggested models for the regulation of returns to litigation funders	18
4.1 Approach one - DCF model	18
4.1.1 Model overview	18
4.1.2 Commentary on the DCF model	19
No basis for the assumed parameter values provided	20
Risk reflected in the rate of return	20
Presumption of direct relationship between costs incurred and settlement value	21
Analysis does not account for the portfolio nature of the litigation funder	21
4.2 Approach two - Insurance model	21
4.2.1 Model overview	21
4.2.2 Application of the model	23
Notional capital at risk value	23
No basis for the parameter values provided	23
4.3 Conclusion	23
4.3.1 Selection bias	24
4.3.2 Rate of return	24
4.3.3 Risk sharing	25
4.3.4 Coverage of relevant costs	25
5. A synthesis of approaches	26
6. Conclusion	27
Appendix A - Sources	29

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.

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 Justice⁶
- the Victorian Law Reform Commission's (VLR's) 2018 review of Litigation Funding and Group Proceedings⁷
- 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).

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 agency²⁰ mean that the decision to settle may be influenced²¹ 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.

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 consumers²⁸
- 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.

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')

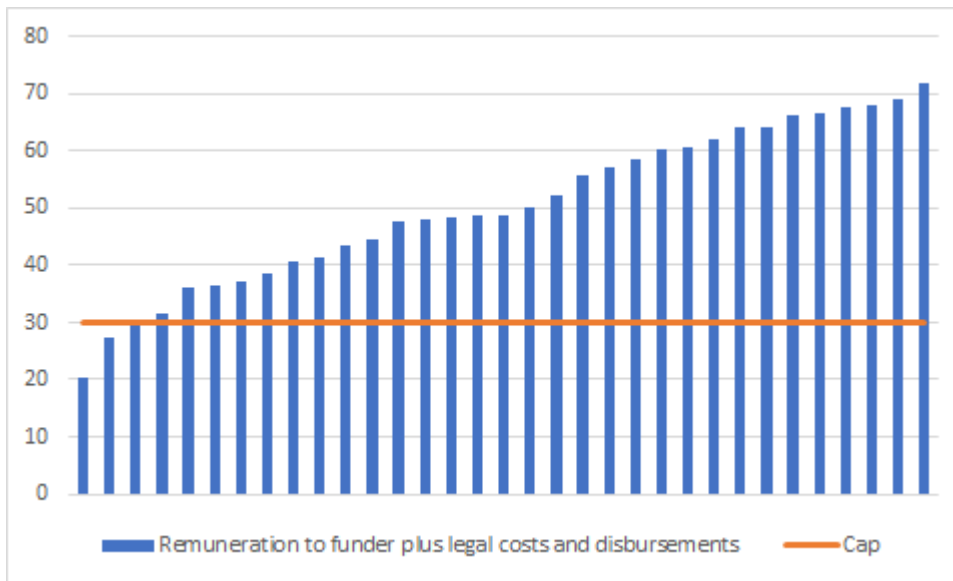
as a percentage of the gross settlement fund. This includes 33 settlements where 'complete' data is available, plus one more where partial data is relevant to the following analysis.

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.

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.

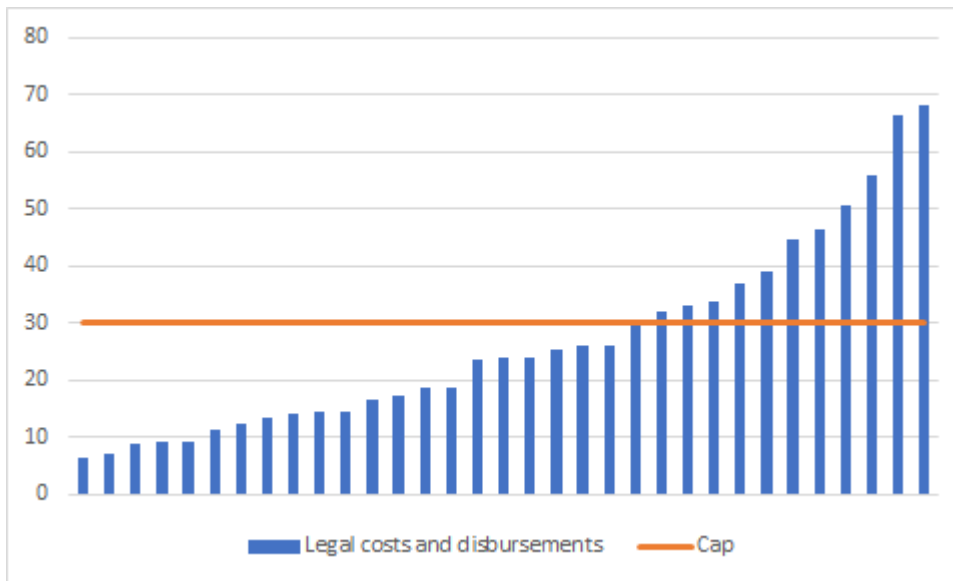
Firstly, litigation funders could seek to reduce litigation costs to bring the total return under the cap. This is challenging in a number of respects:

- 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

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.

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.

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 PJCCFS 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

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

Submissions:

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

David S Abrams & Daniel L Chen (2013), 'A market for justice: A first empirical look at third party litigation funding' 15(4) *U. of Pennsylvania Journal of Business Law* 1075, available at http://publications.ut-capitole.fr/19908/1/Abrams_19908.pdf

ALRC (Australian Law Reform Commission) (2018), *Integrity, Fairness and Efficiency — An Inquiry into Class Action Proceedings and Third-Party Litigation Funders*, available at https://www.alrc.gov.au/wp-content/uploads/2019/08/alrc_report_134_webaccess_2.pdf

Asirifi-Otchere v Swann Insurance (Aust) Pty Ltd (No 3) [2020] FCA 1885

Christine Caulfield (2021), 'Concerns about courts wading into funding commission rates 'exaggerated' judge says', available at <https://www.lawyerly.com.au/concerns-about-courts-wading-into-funding-commission-rates-exaggerated-judge-says/>

Council of Australian Governments (1991), *Report of Task Force on Other Issues in the Reform of Government Trading Enterprises, Released as Part of the First COAG Communiqué*

Darby & Karni (1973), 'Free competition and the optimal amount of fraud' 16 *Journal of Law and Economics* p.111

Michael Duffy (2016), 'Two's company, three's a crowd? Regulating third-party litigation funding, claimant protection in the tripartite contract, and the lens of theory' 39(1) *UNSW Law Journal* 165, available at <http://www.unswlawjournal.unsw.edu.au/article/twos-company-threes-a-crowd-regulating-third-party-litigation-funding-claimant-protection-in-the-tripartite-contract-and-the-lens-of-theory/>

Financial Systems Inquiry (1996), *Discussion Paper*

Bruce Hay (1997), 'Fee regulation in class action settlements' 46 *American University Law Review* 1429, available at <https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1407&context=aulr>

Kenneth M Hayne (2018), Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Interim Report, available at <https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf>

J.B. Heaton (2019), 'The Siren Song of Litigation Funding', 9 *Michigan Business & Entrepreneurial Law Review* 139, available at: <https://repository.law.umich.edu/mbelr/vol9/iss1/4>

Independent Committee of Inquiry (1993), *National Competition Policy*, available at <http://ncp.ncc.gov.au/docs/National%20Competition%20Policy%20Review%20report,%20The%20Hilmer%20Report,%20August%201993.pdf>

IPART (Independent Pricing and Regulatory Tribunal) (2019), *Pricing Regulation of Electronic Conveyancing Services in NSW*, available at <https://www.ipart.nsw.gov.au/Home/Industries/Special-Reviews/Reviews/Electronic-Conveyancing/Pricing-regulation-of-electronic-conveyancing-services-in-NSW?qDh=2>

Peter Kell (2016), 'ASIC and behavioural economics: Regulating for real people' presented at *The Impacts of Behavioural Economics on Financial Markets and Regulations Symposium*, Brisbane, 18 October, p.2

Kuterba v Sirtex Medical Limited (No 3) [2019] FCA 1374

Models for the regulation of returns to litigation funders
PwC

- London School of Economics (2014), *Motivating better consumer decisions through behavioural economics*
- 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
- Hudson Tate Munoz (2019), *The New Black: Third Party Litigation Finance*, available at <https://jscholarship.library.jhu.edu/bitstream/handle/1774.2/62070/MUNOZ-THESIS-2019.pdf?>
- PC (Productivity Commission) (2014), *Access to Justice*, available at <https://www.pc.gov.au/inquiries/completed/access-justice/report>
- PC (2002), *Cost Recovery by Government Agencies*, available at <https://www.pc.gov.au/inquiries/completed/cost-recovery/report>
- PC (2000), *Review of Legislation Regulating the Architectural Profession*, available at <https://www.pc.gov.au/inquiries/completed/architects/report/architects.pdf>
- Charles Smith & J Johns (2018), 'Examining the minimum cost of capital for litigation funding; i.e., constructing the required rate of return to attract capital' 9(9) *International Research Journal of Applied Finance* 414, available at https://media.proquest.com/media/hms/PFT/1/WREV7?_s=v%2BkONSddMCM1HZgJTWUtyurIMZg%3D
- Cass Sunstein (1990) 'Paradoxes of the Regulatory State' 57 *University of Chicago Law Review* pp.407-441
- UK Financial Conduct Authority (2016), 'Occasional Paper 24: Behaviour and Compliance in Organisations',
- VLRC (Victorian Law Reform Commission) (2018), *Access to Justice — Litigation Funding and Group Proceedings*, available at https://www.lawreform.vic.gov.au/sites/default/files/VLRC_Litigation_Funding_and_Group_Proceedings_Report_forweb.pdf
- David L Weimer & Aidan R Vining (1992), *Policy Analysis: Concepts and Practice*, 2nd ed
- J. Weiss (2002), 'Public Information' in L. Salamon (ed.), *The Tools of Government: A Guide to the New Governance*, pp.217–254

