

Research paper for the
New Zealand Law Commission

The economics of class actions and litigation funding

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Glossary

Access to justice: In this paper it refers to the barriers to accessing the justice system.	17
Adverse costs: See cost-shifting.	19
Blackmail settlement: Where a defendant feels compelled to settle litigation irrespective of the merits of the claim because of the high costs of the litigation (including impact on their reputation) and the risk of a costly judgment against them.	6
Claim, negative expected value (NEV): A legal claim where the expected cost of litigation exceed expected damages.	13
Claim, positive expected value (PEV): A legal claim where the expected damages of litigation exceed the expected costs of litigation.	13
Class action, extensive: No member would pursue a claim if not part of a class action.	6
Class action, hybrid: A class action with a mix of intensive and extensive class members.	7
Class action, intensive: All members would pursue their own legal claim if they were not part of a class action.	6
Class action: A court proceeding in which a group with similar interests collectively sues one or more defendants, with a representative plaintiff bringing the litigation on behalf of the group.	6
Common law: Law made by judges via the evolution of precedents.	7
Cost-shifting, aka adverse costs: Where an unsuccessful litigant has to pay for some of the costs of the successful party.	19
Damages: The amount of money a court requires a defendant to pay to the plaintiff to compensate the plaintiff for the wrongs inflicted by the defendant.	11
Deterrence incentive, efficient: The deterrence incentive that would lead wrongdoers to take an efficient level of care, which is the level of care where the marginal social benefit of harm reduction equals the marginal social cost of reducing harm plus the marginal social cost of litigation.	14
Deterrence incentive: The damages, settlements and litigation costs wrongdoers can expect to pay because their actions risk harming others, leading to legal claims against them.	14
Diseconomies of scope: When increasing the range of activities increases cost per unit.	33
Economies of scale (aka scale economies): When increasing the scale of operation reduces cost per unit.	32
Efficiency, aka overall efficiency: Occurs when resources cannot be reallocated in a way that would allow the gainers to be better off even if they compensated any losers to leave them no worse off (note the gainers do not necessarily have to compensate the losers). Increasing Pareto efficiency is sufficient to improve overall efficiency.	13
Efficiency, Pareto Occurs when no one can be made better off (by reallocating resources) without making someone else worse off. Pareto efficiency requires productive efficiency plus a requirement that all gains from trade have been exploited.	53
Efficiency, productive: Occurs when a given service level is produced at lowest social cost, or equivalently, when maximum service is produced from a given social cost of inputs.	34
Funder, active: A litigation funder that plays an active role in litigation.	8
Funder, passive: A litigation funder that doesn't seek to influence litigation decisions.	8

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Litigation funding: Funding by a third-party with no pre-existing interest in the litigation (excluding legal aid).....	10
Litigation, frivolous Meritless litigation undertaken to annoy, harass, delay or embarrass the defendant.	55
Litigation, meritless: Litigation that lacks any arguable basis either in law or in fact.	6
Litigation, nuisance: Litigation undertaken to annoy, harass, delay or embarrass the defendant.	6
Over-litigation: Occurs when private parties litigate when it is inefficient to do so.	12
Plaintiff, credit-constrained: A plaintiff that cannot self-finance all of their litigation if they wished to do so, where self-finance includes access to credit from traditional sources.	49
Plaintiff, independent: A plaintiff who can protect her own interests and her interests are well-aligned with the funder's interests.	8
Plaintiff, monopoly: A single class action that arises when class membership is mandatory or when the multiple harms are such that only one class action is PEV.....	37
Plaintiff, reliant: A plaintiff who relies on her lawyer for independent and impartial advice about funding and case management.	8
Plaintiff, representative: The plaintiff for a class action, representing the class members.	6
Plaintiff, risk-averse: A person who prefers to receive less money for certain than the expected value of a gamble (to avoid the risk the gamble leaves them worse off).....	20
Plaintiff, risk-neutral: A person who is indifferent between a gamble and receiving the expected value of the gamble for certain.	49
Principal-agent problems: Problems that a principal has getting their agent to act in the best interest of the principal, which occur when the principal is unable to observe the agent's effort or quality.	22
Recoverables: Damages awarded to the plaintiff or settlements secured, net of costs incurred by the plaintiff.....	6
Social welfare, aka overall welfare: The sum of the utility of all people in an economy or country (utilitarian definition). Under this definition, an increase in efficiency is synonymous with an increase in social welfare.	13
Supervision capability: A principal's capability and expertise for monitoring, supervising and directing an agent.....	57
Supervision incentives: The incentive a principal has to invest the time and effort needed to effectively monitor, supervise and direct an agent.....	6
Threshold probability: The probability at which winning the litigation yields zero expected value.	19
Under-litigation: Occurs when private parties do not litigate when it would have been efficient for them to do so.	12

Executive summary

This paper provides a first-principles analysis of the economics of class actions and litigation funding. Subsequent research may be undertaken to provide empirical research and cost-benefit analysis.

Class actions

A **class action** is a court proceeding in which a group with similar interests collectively sues one or more defendants. In general:

- the litigation is pursued by a representative plaintiff and the remaining class members have no rights to participate or manage the litigation
- class members are bound by the outcome of the litigation and cannot pursue their own individual litigation once a judgment has been made.

Weak supervision incentives are a key problem for class actions

If the action has many class members, the representative plaintiff has weak **supervision incentives**, i.e. weak incentives to invest the time and effort needed to effectively monitor and direct the class lawyer.

The weak incentives occur because the representative plaintiff has to share the **recoverables** (i.e. settlements or damages, net of litigation costs) with all class members. In contrast, plaintiffs in ordinary litigation have strong supervision incentives because they receive 100% of the recoverables.

Similar to ordinary plaintiffs, representative plaintiffs may also have weak supervision capabilities.

Strategic behaviour can be another problem with class actions

Situations can arise where a single (monopoly) class action may be able to extract large settlements from defendants, often called **blackmail settlements**.

This may occur if the class action harms a defendant's reputation or the defendant has limited funds and faces the prospect of bankruptcy from a single unfavourable court decision. With extremely large sums at stake, rather than take the risk of a single judgment, the defendant has strong incentives to pay an oversized settlement to gain the certainty of avoiding bankruptcy.

In this vein, class actions are sometimes viewed as encouraging **nuisance** or meritless litigation.

Class actions are likely to improve access to justice and may improve efficiency, provided the above problems are addressed effectively

To assess the underlying economic effects of class actions it is useful to break them into three types:

- **Intensive class actions:** The members of these class actions would pursue their own litigation if they were not part of a class action because for each of them the expected value of their individual claim exceeds the cost they would incur to pursue litigation.

Intensive class actions do not affect access to justice or deterrence incentives. Their main economic benefit is a lower cost of litigation, because grouping the claims economises on litigation costs. But this gain may come at the expense of a slower development of important legal precedents, and so the impact on efficiency is unclear. If precedents are unimportant then intensive class actions increase productive efficiency.

- **Extensive class actions:** The members of these class actions would *not* pursue their own litigation if they were not part of a class action, because the expected value of their claim is too small relative to the cost of taking litigation.

Extensive class actions are likely to improve equitable access to justice, increase legal precedents and make deterrence incentives more efficient. The main downside is they increase litigation costs to defendants (or their insurers) and the judicial system.

- **Hybrid class actions:** These are class actions with a mix of intensive and extensive class members. Most class actions are likely to be extensive or hybrid.

Hybrid class actions are also likely to improve equitable access to justice but their efficiency effects are unclear. Although they are likely to reduce litigation costs and strengthen deterrence incentives, it is unclear whether stronger deterrence incentives increase or reduce efficiency. Also, hybrid actions are likely to slow the development of legal precedents. Empirical evidence is required to determine each of these factors.

This analysis suggests all three categories of class action are neutral or positive in regard to equitable access to justice. The effects on the productive efficiency of litigation is more nuanced, as summarised in Table 1.

Table 1: Summary of the productive efficiency effects of class actions

Type of class action	Lower costs	More legal precedents	More efficient deterrence
Intensive	✓	x	-
Extensive	x	✓	✓
Hybrid	✓?	x?	?

? No conclusion can be drawn without further empirical evidence

✓? Probably a positive answer and x? means probably a negative answer

This paper often refers to law made by courts via the evolution of precedents (**common law**). Precedents occur when judgments about subsequent cases adhere to the principles and logic of a previous judgment. If the adherence becomes consistent and widespread, then the precedence is strong and a common law is said to exist. This contrasts with laws made by legislators (**statutory law**).

Innovation and productivity growth are important for improving New Zealanders' living standards and overall wellbeing. In general, there do not seem to be any reasonable innovation and productivity arguments for preventing parties accessing the justice system through class actions.

There may be value in developing an overarching statutory class actions regime to address broad policy issues and reduce the costs and risks of undertaking class actions

Based on an initial analysis, the best approach may be to legislate a set of high-level principles and an overarching regime for class actions to deal with factors like:

- whether class membership should be mandatory or voluntary, and if voluntary whether opt-in or opt-out
- improving supervision of class actions (refer also to suggestions in litigation funding section)
- the rights of courts to mitigate strategic behaviour during litigation, to address concerns about blackmail settlements
- basic requirements about paying for court costs, liabilities for costs and distribution of recoverables to class members.

This approach has the potential to provide more certainty and reduce costs earlier than what would occur under the status quo, while leaving significant flexibility for court supervision to be tailored to the circumstances of each case.

Litigation funding

Litigation funding is funding by a third-party with no prior interest in the litigation.

Typically, the funding covers the plaintiff's legal costs and any adverse costs ordered by the courts. In return, the funder typically receives a share of any sum recovered but has no rights to the plaintiff's assets if the case is lost.

The economic effects of litigation funding depend on whether funders play a passive or active role in the conduct of litigation:

- A **passive funder** does not seek to influence the lawyer acting in the case or have any decision rights over the conduct of the litigation.
- In contrast, **active funders** play active roles in the litigation through their efforts to influence the lawyer acting in the case and through decision rights they have in their funding agreement regarding high-value decisions, such as whether to settle the case and at what level to settle etc.

Funders are 'repeat players' and typically have specialised expertise in litigation.

It is not clear from first-principles how litigation funding affects equitable access to justice

At first glance, it seems litigation funding should improve equitable access to justice as it alleviates credit constraints and reduces risk for plaintiffs, and it is likely poorer people and smaller businesses tend to exhibit those characteristics.

However, funders are more likely to direct their funding to high-value cases, which will often be the cases with potentially large damages or settlements. It is not clear from first-principles that litigation funding improves equitable access to justice for individual claimants.

Litigation funding is likely to facilitate extensive and hybrid class actions, which is likely to improve equitable access to justice in these cases.

The economic effects of litigation funding depend on how funders are matched with plaintiffs

It is useful to define two types of plaintiff. An **independent plaintiff** is a plaintiff that has the ability to protect their own interests and their interests are well-aligned with the funder's interests. A **reliant plaintiff** is a plaintiff that relies on their lawyer for independent and impartial advice about funding and case management. Generally, large corporates are likely to be independent plaintiffs, whereas reliant plaintiffs are likely to be individuals, SMEs and representative plaintiffs in class actions.

In essence, active funders are less likely to make a positive contribution for reliant plaintiffs due to additional supervision problems, discussed further below. Litigation funding improves the productive efficiency of litigation, e.g. by reducing litigation costs, provided supervision problems are addressed effectively. Also, litigation funding can be expected to increase choice and competition in the legal services market.

Table 2 (next page) provides an overview of the efficiency effects of passive and active funding.

Litigation funding improves the productive efficiency of litigation, e.g. by reducing litigation costs, provided supervision problems are addressed effectively. Also, litigation funding can be expected to increase choice and competition in the legal services market.

Table 2: Summary of equity and efficiency effects of litigation funding

Funder / plaintiff match	Improves access to justice	Improves productive efficiency
Passive funder to any type of plaintiff	?	✓
Active funder to independent plaintiffs	?	✓
Active funder to reliant plaintiffs	?	✓ ?

? No conclusion can be drawn without further empirical evidence

✓? Probably a positive answer

One item missing from the above table is the effect litigation may have on costs overall. In our view it is not possible to answer this *a priori*, as some factors put downward pressure on costs (e.g. stronger competition in the legal services market) and other factors put upward pressure on costs (e.g. additional litigation activity).

Concerns about increased frequency of nuisance and meritless claims are not greatly supported by economic analysis.

Active litigation funding may distort selection and case management decisions

A key selection issue is about ensuring reliant plaintiffs receive competitive offers of funding. This is critical to address the risk of funders using their expertise to offer unfair terms to plaintiffs, including unfair assignment of risks and shares of recoverables.

Case management problems arise if active funders are able to distort litigation decisions, for example:

- some funders may pressure the plaintiff to settle early
- the funder’s ongoing presence in the legal services market may distort the lawyer’s incentives to always act in the plaintiff’s interests.

Selection and case management issues can be particularly severe in regard to active funding of class actions.

Another concern is the distribution of recoverables to the various parties involved in a suit, which are significantly more complicated in class actions.

Given those possibilities, where a reliant plaintiff chooses an active funder there may be value in having additional protections available during case management, especially for settlement decisions.

Modest regulatory changes may be sufficient to address these issues

Based on an initial analysis, the best regulatory option may be to amend the *Rules of Conduct and Client Care for lawyers* (RCCC) for lawyers, to make it clearer lawyers should:

- seek competitive tenders for funding for plaintiffs unless instructed by their clients not to do so
- invite funders to post security to cover plaintiff’s costs.

With these changes, the courts would be in the best position to decide how intensively to supervise case management of funded litigation.

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In principle, intensive supervision appears to be most beneficial in situations where reliant plaintiffs choose active funding arrangements. In these cases, the courts should consider charging the full cost of court supervision and consider adopting a rule of not charging for supervision if the plaintiff obtains independent supervision.

1 Introduction

The New Zealand Law Commission (Commission) is conducting a review of the law relating to class actions and litigation funding, and has requested Capital Strategic Advisors (CSA) Limited provide an independent analysis of the economics of class actions and litigation funding.

The Commission refers to a **class action** as a court proceeding in which a group with similar interests collectively sues one or more defendants, with the proceeding brought by a representative plaintiff on behalf of the class.¹

For the purposes of this Review, the Commission defines **litigation funding** as funding by a third-party with no pre-existing interest in the litigation.² Clearly, this excludes self-funded claims. The Commission also excludes civil legal aid. Litigation funding is usually provided in exchange for a fee if the claim is successful and nothing if the action is lost. Litigation funding is not limited to class actions, but many class actions would be unable to proceed without litigation funding.

The Commission has published an Issues Paper in December 2020. The purpose of the Issues Paper is to help the Commission reach a final view on whether class actions and litigation funding are desirable in principle. It is also considering in broad terms the pros and cons of alternative regulatory options, including self-regulation in regard to litigation funding.

The Commission will evaluate the submissions it receives and conduct further analysis. If the Commission intends to recommend that a statutory class actions regime and/or regulation of litigation funding is required, it will prepare more detailed proposals for regulation in these areas and may consult further on these proposals. The Commission intends to deliver its final report to the Minister of Justice in 2022.

The purpose of this research paper is to provide the Commission and interested parties with a first-principles economic analysis of the costs, benefits, and other consequences of permitting and regulating class actions and litigation funding. This reflects the Commission's concern that both activities may have significant effects on business and government innovation and risk-taking, with flow-on effects on New Zealand's productivity and economic growth rates. The aim of this research paper is to provide robust economic analysis of these issues.

Consistent with the first-principles approach, this paper provides high-level conceptual analysis and does not discuss empirical research. The next section discusses the economics of individual civil litigation, to provide the base case for considering the consequences of class actions in section 3 and third-party litigation funding in section 4. Section 5 discusses the general pros and cons of alternative regulatory arrangements.

¹ Class Actions and Litigation Funding Project Overview: <https://www.lawcom.govt.nz/our-projects/class-actions-and-litigation-funding>

² Class Actions and Litigation Funding Review Terms of Reference: <https://www.lawcom.govt.nz/our-projects/class-actions-and-litigation-funding>

2 The base case: individual civil litigation and funding

Understanding the efficiency and equity aspects of civil litigation provides the foundations for assessing these matters in regard to class actions and litigation funding.

The rest of this section is organised as follows:

- For readers new to the legal system, section 2.1 provides background information about relevant aspects of civil litigation and justice systems in general.
- Section 2.2 discusses the efficiency of individual civil litigation and efficient deterrence, ignoring equity issues, such as equitable access to justice.
- Section 2.3 considers the funding and allocation of court and legal costs, and issues around equitable access to justice.
- Section 2.4 considers how alternatives to civil litigation affect access to justice and efficiency, focusing on statutory law and the decisions and activities of regulatory agencies.

2.1 A brief backgrounder on civil litigation and judicial remedies

2.1.1 Definitions and terminology

Litigation refers to the process of bringing a claim or dispute to a court for adjudication. The party bringing the legal action is called the plaintiff and the party accused of wrongdoing or causing the harm or injury is called the defendant.

Civil litigation refers to legal processes to resolve disputes between private individuals or legal entities such as corporations, trusts, partnerships, and government agencies.³ These processes can involve hearings at a (publicly funded) court or special tribunal. Disputes may also be privately resolved by arbitration, mediation or negotiation (generally called alternative dispute resolution (ADR) processes).

Finally, note that court-made law is called common law. This occurs when litigation results in court decisions that subsequent courts adhere to, and so the former create a precedence for the latter. This contrasts with laws made by legislative bodies, often referred to as statute law or legislation.

2.1.2 The key types of remedies available to redress harms

The principal *legal remedy* for redressing a harm is for the defendant to pay money to the plaintiff to compensate the plaintiff for the wrongs inflicted by the defendant (called compensatory damages or **damages** for short). Where full compensation is warranted, the aim of the court is to determine the amount of money that will “make the plaintiff whole”.

The other major form of redress for harms is called *equitable relief*. This consists of a court order directing the defendant to undertake an action or to refrain from undertaking an action. For example, an *injunction* may require a defendant to do or to refrain from doing a specific act.

Damages are backward-looking in that they compensate for a harm that has already occurred, whereas an injunction is forward-looking as it prevents a defendant from inflicting a harm on the plaintiff in the future. Courts can combine both forms of relief, awarding damages for past harms and injunctions to prevent future harms.

³ This paper often uses the terms ‘people’ and ‘a person’ generically to refer to private individuals and legal entities.

2.2 The core results about efficient civil litigation and efficient deterrence incentives

The focus of this research paper is on the efficiency of civil litigation activity rather than on the efficiency of the legal rules themselves. In other words, our focus is on the efficiency of the *process* of creating and enforcing legal rules made by courts. For example, what is the efficient level of litigation activity, and in what circumstances might we expect it to occur?

It is useful to first introduce the simplest litigation case in section 2.2.1, which is the enforcement of existing law, which leads naturally to consideration of efficient deterrence in 2.2.2. Section 2.2.3 considers the efficiency consequences of litigation that contributes to creating precedents, which underpins the evolution of common law. The outcome of 2.2.1 is that private parties may have incentives to litigate when it is inefficient to do so (**over-litigate**), whereas the converse occurs in 2.2.3: private parties have incentives to not litigate when it would have been efficient for them to do so (**under-litigate**).

The analysis in these sections broadly follows Polsinky & Rubinfeld (1988), Posner (1988), Kaplow & Shavell (2002), Kobayashi (2015) and Cooter & Ulen (2016).

2.2.1 Enforcement actions are likely to be over-litigated

Civil litigation arises when a potential plaintiff believes she has suffered a wrong and she is unable to convince the potential defendant he has caused a harm and should compensate her accordingly.⁴ As a result, the plaintiff decides whether to initiate litigation and seek compensatory damages from the defendant.

The rest of this subsection discusses when litigation is socially profitable, and then whether private incentives to litigate are likely to achieve socially profitable litigation. Note the law and economics literature often refers to socially beneficial rather than socially profitable, however we prefer the latter term to avoid confusion with the term net social benefit which is also used below.

Litigation is efficient when the social costs of litigation are less than the net social benefits arising from litigation

A successful legal case that causes potential wrongdoers to subsequently take greater effort to reduce the severity and risk of harming others in the future reduces the actual harms borne by others, which is socially beneficial. Producing these social benefits requires using valuable resources, which are a cost to society. Broadly speaking, litigation is efficient when its social benefit minus social cost is positive, that is, when it is socially profitable.

To understand this more clearly, let *HR benefits* denote harm-reduction benefits from litigation. The HR benefits represent the social benefit of litigation.

Taking more effort to reduce the risk or severity of harms may require future wrongdoers to incur additional resource costs, such as more time to complete tasks, undertaking more monitoring and supervisory activity, spending more on protective equipment and so on. Denote these costs as *HR costs*.

Hence, the *net social benefit* from litigation is:

$$HR \text{ benefits} - HR \text{ costs}$$

⁴ For ease of exposition, this paper always refers to the plaintiff as a female and the defendant as a male.

Litigation involves many costly resources. The courts incur costs in managing and hearing each case, and plaintiffs and defendants incur costs obtaining legal advice and representation and they also incur the costs of their time and effort. The *social cost of the litigation* is the sum of these costs.

Box 1: Definitions of welfare and efficiency

Efficiency (aka. overall efficiency) occurs when resources cannot be reallocated in a way that would allow the gainers to be better off even if they compensated any losers to leave them no worse off. Importantly, the comparison of gains versus losses is hypothetical, as the gainers do not necessarily have to compensate the losers. An increase in efficiency is socially profitable (increases social welfare) when social welfare is defined in utilitarian terms.

Litigation is efficient when it is socially profitable, that is, when its net social benefits exceed the social costs of litigation (Kaplow & Shavell, 2002):

$$(1) (HR \text{ benefits} - HR \text{ costs}) - \text{social cost of litigation} > 0$$

Where: *social cost of litigation* = *plaintiff costs* + *court costs* + *defendant costs*

The inequality in (1) is just the standard social cost-benefit calculation for evaluating public sector projects.

In contrast, the private incentive to litigate depends on private benefits exceeding private costs

Now consider the case where a potential plaintiff knows with certainty a successful legal claim will provide damages equal to the actual harm suffered. In other words, the plaintiff believes the court does not make mistakes in assessing the level of harm, and so she claims damages equal to the actual harms she has suffered.

Assume the plaintiff is risk neutral, which means she cares only about the expected value of an action. Then the plaintiff's *expected damages* = *plaintiff's perceived probability of winning* \times *damages*.

For simplicity, assume the plaintiff pays only for her own litigation costs. Under these conditions, the plaintiff has an incentive to pursue litigation when it is privately profitable, that is when:

$$(2) \text{expected damages} - \text{plaintiff's cost of litigation} > 0$$

The inequality at (2) is referred to as a **positive expected value (PEV)** claim, under the assumption the plaintiff is risk neutral. Clearly the reverse applies: she won't pursue litigation if her claim had **negative expected value (NEV)**.

Private incentives to litigate are mis-aligned with the socially profitable incentive to litigate

Comparing the efficiency criterion at (1) with the private decision-making criterion at (2) allows us to consider whether private decision-making is efficient. It is immediately clear there are two circumstances in which private parties would pursue litigation even though doing so would be inefficient:

- the plaintiff's cost of litigation is less than the social cost of litigation
- private benefits from litigation exceed net social benefits, for example, because litigation has little effect on future behaviour.

Starting with the easiest case, suppose the private benefits from litigation equal net social benefits but private cost < social cost because plaintiffs are not required to pay for all of the court's costs and all of the defendant's litigation costs (which is generally the case, see section 2.3). Then inefficient litigation occurs because the plaintiff does not take into account the full costs of its decisions. This means more litigation occurs than is efficient, which we refer to as **over-litigation**.

Conversely, suppose plaintiffs were charged the full social cost of litigation. Then inefficient litigation would occur whenever their expected damages are larger than the net social benefit of litigation. This generally occurs for *enforcement litigation* – that is, for litigation to enforce an existing law that everyone knows about but some do not abide by for various reasons.

By definition, enforcement litigation fails to deter wrongdoers. This is because, in choosing their risky behaviour, they have already taken into account they will have to pay damages and litigation costs if their behaviour causes harm in the future. Once the harm has occurred, the plaintiff can expect to receive damages equal to the level of harm suffered. But as the wrongdoers fully expected this result anyway, the litigation for a single event does not change their behaviour – hence, the net social benefit of the litigation is zero. But as the litigation creates social costs, society is made worse-off: once again, the litigation is inefficient and over-litigation occurs.

The underlying driver of the inefficiency is that it is socially costly to use litigation to create deterrence incentives. If instead litigation involved zero social cost, then setting damages equal to harm would not cause over-litigation. Intuitively, in this situation setting damages equal to harm would lead wrongdoers to fully internalise the externalities they impose on others and make socially profitable decisions.

2.2.2 Efficient deterrence incentives may not require every wrong to be litigated

In simple terms, the **deterrence incentive** from litigation refers to the damages, settlements and litigation costs wrongdoers can expect to pay because their actions risk harming others, leading to litigation against them. For ease of exposition, we refer mainly to damages unless settlement or litigation costs need to be mentioned for clarity.

The **efficient deterrence incentive** is the deterrence incentive that would lead wrongdoers to take an efficient level of care. When litigation is socially costly, the efficient level of care is where the marginal social benefit of harm reduction equals the marginal social cost of reducing harm plus the marginal social cost of litigation, or where:

$$\text{marginal HR benefits} = \text{marginal HR costs} + \text{marginal social cost of litigation}$$

This is the *efficient level of care* because all social benefits and costs are taken into account.

Fully internalising externalities will not generally provide efficient deterrence incentives

The important point for this research paper is that the efficient deterrence incentive will in general be greater or lower than the harm suffered, or equivalently, greater or lower than the externalities wrongdoers impose on others (Polinsky & Rubinfeld, 1986).

In other words, fully internalising externalities cannot be presumed to provide efficient deterrence incentives. Intuitively, there is a social cost to creating deterrence incentives via litigation, and so this has to be balanced against the net social benefit of the deterrence incentive. Fully internalising the wrongdoer's externalities would increase social costs of litigation too much, and likewise avoiding all social costs would result in no litigation, no deterrence and maximum externalities. The efficient approach is one that balances the social costs of litigation with the externalities (*intensive effect*). But it is even more complicated than that, as the private costs of litigation affect the number of claims (*extensive effect*), which affects the share of externalities covered. Clearly, the extensive and intensive effects interact to determine the overall effect.

The next section discusses the efficiency effects of precedent-creating litigation, for which deterrence incentives are not relevant.

2.2.3 Precedent-creating litigation is likely to be under-litigated

The previous sections presented a bleak assessment of the efficiency benefits of civil litigation, because the private incentives for litigation appear to encourage over-litigation. However, in practice the real world constantly changes due to changes in technology, changes in social and cultural mores, and changes in the natural environment. The court's capability to analyse and understand the effects of existing laws on people's behaviour and on the environment also change over time. These factors often lead to an ongoing evolution of common law (Cooter & Ulen, 2016).

Hence, civil litigation often creates new precedents, or refines existing precedents, to better suit current circumstances. In these cases, the net social benefits from litigation may be very large if they may improve the decisions made by a large number of people or alter behaviour for many decades.

Small changes in behaviour by millions of people will typically yield very large social benefits. Even if litigation improves decision-making in only a narrow field of activity and by only a small amount, if that small improvement occurs repeatedly forever after then the cumulative social gain (eg, reduction in harms) will be extraordinarily large.

In practice, a judgment in relation to a single claim does not create common law, but it can spur its development. As subsequent litigation and judgments adhere to the principles underpinning an original judgment, the original grows in precedent-value and when well-established it will be referred to as 'the law'.

The upshot is that the social benefit from any one case is unlikely to be extraordinarily large, as we indicated two paragraphs above. But the social benefits of litigation could be very large if it advances the creation of a new law faster than it would have otherwise occurred.

This suggests the private benefits from litigation may be far lower than the net social benefits. Some socially profitable litigation will occur because some individuals will have PEV litigation, and some of these will be decided by judgment rather than settlement. But when the gap between private and social benefits is large, there may be many socially profitable litigation that won't occur because they are NEV litigation for individuals. In other words, litigation does not occur but it would be efficient for it to occur (this is referred to as **under-litigation**).

The proposition that under-litigation occurs for precedent-creating litigation is based on analyses in Kaplow & Shavell (2002) and Cooter & Ulen (2016). However, the proposition is not embraced by all law and economics authors. Posner (1988), for example, is sceptical that precedents are produced inefficiently. He argues that precedents are a by-product of the litigation process, and that precedents tend to be produced when there is a demand for them. However, his analysis is entirely consistent with the above discussion about individual claims affecting the speed at which precedents become established.

2.2.4 Settlements have an ambiguous impact on the efficiency of litigation

The above discussion only considered situations where litigation ends in a judgment. But the vast majority of cases are settled prior to court hearings.⁵

In general, settlement occurs when it leaves both parties better off than they expect to be if they proceed to trial. The maximum scope for this to occur is when both parties are risk neutral and they

⁵ Settlements are typically legally enforceable agreements involving a payment from the defendant to the plaintiff in return for the plaintiff agreeing not to pursue the litigation any further. According to the Commission's Issues Paper (p.118), only 9.5% of civil proceedings in the High Court go to trial.

have identical views about the expected damages a court would award. In this situation, both litigants are better off reaching a settlement that divides up the aggregate cost saving (*the pie*) between them.

However, in practice litigants are unlikely to have identical views about expected damages. When the divergence of views exceeds the size of the pie, there isn't any surplus to share and so the case proceeds all the way to judgment (Kobayashi, 2015 and Cooter & Ulen, 2016).⁶

Highly divergent views about trial outcomes are likely when it is unclear how existing common law applies to the facts of a case. This suggests settlements will not occur when the law is unclear, which is good because a trial in that situation may create valuable precedents. However, there will be cases where the divergence of views is not wide enough, and so the parties settle their case when it would have been socially profitable for the case to go to trial (Kaplow & Shavell, 2002).

It is often claimed that settlements reduce deterrence incentives below efficient levels because settlements are lower than the harm caused. However this may be incorrect because, as discussed earlier, the efficient deterrence incentive does not require full internalisation of the externalities imposed on others (refer section 2.2.2). But even if it was efficient to fully internalise the externalities, settlements reduce the total costs paid by a defendant (reducing deterrence incentives) but they increase the chances a plaintiff will pursue litigation (increasing deterrence incentives) as plaintiffs' expected litigation costs are lower with settlements. Overall, it is not clear from first-principles analysis whether settlements are positive or negative for the efficiency of the litigation system.

2.3 How the current funding and allocation of court and legal costs affect access to justice and the efficiency of civil litigation

The previous sections proceeded on the simplifying assumption that plaintiffs and defendants pay their own costs and the government paid for all court costs. In New Zealand, however, litigants pay a portion of court costs and the unsuccessful litigant almost always has to pay for some of the costs of the successful party. Moreover, the government subsidises legal representation for certain types of litigants through a Ministry of Justice service called legal aid.

This section discusses the efficiency and access-to-justice effects of these arrangements. It also discusses the effects of private insurance on a defendant's access to justice and the efficiency of litigation.

2.3.1 Definition of equitable access to justice

Before we consider how current arrangements affect equitable access to justice, it is important to be clear about what we mean by these terms. It is useful to first discuss what we mean by 'access to justice' and then discuss the notion of 'equitable access to justice.'

***Access to justice* is about barriers to accessing the justice system**

The Australian Productivity Commission has published a two-volume report on access to justice arrangements in Australia. The first volume discusses definitions, which we broadly draw on for this paper (APC, 2014a, pp. 74-8).

Access to justice is defined by its two elements: *access* and *justice*.

⁶ This is called the *relative optimism* rationale for why litigation result in trials rather than settlements. The relative optimism refers to the plaintiff being optimistic about receiving high expected damages and the defendant being pessimistic about that outcome.

Turning to the first element, *access* is the ability to approach or make use of something when a person needs or wants to make use of it. In practical terms, it is useful to focus on the converse of access: barriers inhibiting access to something.

As this report is about legal processes, rather than substantive law, a useful definition of *justice* is that it is about *the justice system*. That is, about the resources and processes of the justice system, and how those factors affect people's chances of a fair and effective resolution of their dispute.

Taking both elements together suggests that **access to justice** refers to the barriers to accessing the justice system.

These barriers may be external to the person wanting access to justice, such as:

- costs and delays associated with accessing the system
- complexity of the system and the law which underpins it
- an absence of effective processes and oversight to enforce rights of access, for example to avoid illegal discrimination.

Barriers to justice may also refer to factors specific to a person, such as their personal resources, capabilities and perceptions. Their resources refers to factors like income and wealth, and their capabilities refers to their inherent capabilities as well as to matters like their training and education. Their perceptions can arise from a host of factors, including their experiences and their family and cultural backgrounds etc.

In principle, *equitable* access to justice is about everyone having equal access to justice

The notion of something being *equitable* is a notion about equity or fairness. In this paper, the primary fairness issue is about people of different characteristics having equal access to justice. This derives from the principle that everyone should be subject to the same laws, which will only be achieved in practice if wrongdoers are brought to justice regardless of their wealth or other characteristics, and regardless of the wealth or other characteristics of the wronged person. Inequitable access to justice means unequal application of the law, usually biased against the poor and less able.

But the practical reality is that people have vastly different resources available to them to acquire the legal representation they desire. A wealthy individual, or a large and well-resourced company, can secure the services of the best legal minds in the country, whereas someone earning \$50,000 annual income with four children likely cannot afford any legal representation.

In practice, our focus is on whether equitable access to justice is likely to improve or not

However, this paper does not need to consider whether class actions or litigation funding achieve equitable access to justice. Rather, the focus here is on whether those initiatives are likely to improve equitable access or not. In other words, would those litigation initiatives increase access for those that want it but are currently unable to afford it?

2.3.2 Subsidisation of court and legal costs likely improves access to justice

Subsidising court costs likely improves access to justice

Although the government in New Zealand directly funds courts and tribunals, it also charges fees for civil proceedings heard in the District Court and the High Court.⁷ CSA understands these fees recover less

⁷ The list of fees is available at <https://www.justice.govt.nz/courts/civil/forms-and-fees/>.

than 50% of court costs, which means the government is heavily subsidising dispute resolution through the court system. In contrast, participants pay the full costs of alternative dispute resolution (ADR) services.⁸

As the subsidy for using the courts is not income-related, savings in court fees are likely to have a larger positive impact on the spending power of poorer litigants, likely making access to justice more equitable. For example, suppose a litigant earning \$70,000 income per year brings litigation that results in a three-day trial and a range of interlocutory applications. Suppose the subsidy saves the litigant \$5000 in court costs. Identical litigation by a person earning half the income, i.e. \$35,000, also saves \$5000 in court costs. Clearly the \$5000 saving in court costs has a larger budgetary impact for the lower-income earner relative to the higher-income earner.

Legal aid also improves access to justice but it appears to have modest efficiency effects

In addition to directly subsidising court costs, the government provides legal aid in form of an interest-bearing loan. Section 7 of the Legal Services Act 2011 specifies the civil proceedings for which legal aid can and cannot be provided. In general, legal aid is available for legal representation in most New Zealand courts and tribunals, but it is not available for ADR processes.⁹

Loan repayments depend on how much recipients earn, what property they own and whether they receive any damages from the case. In general, full loan repayments are required when an aided person receives damages exceeding the loan. When the litigation does not award damages to the aided person or when the award of damages is insufficient to cover the loan, the maximum amount repayable depends on the aided person's income and disposable capital.¹⁰ That is, it does not depend on the amount of legal aid received.

Legal aid does not materially subsidise litigation costs for litigants able to repay the debt. The main effect in these cases is to facilitate equitable access to justice by assisting recipients to overcome their limited financial resources. If they believe they have a strong legal case, and the damages are likely to be considerable, then it assists them to hold wrongdoers accountable for their action or inaction.

Of course, legal aid can have a strong subsidy component for litigants who (1) are not sure of their prospects of winning litigation and significant damages and (2) they know they are unable to fully repay their legal aid debt. In that case the extent of the subsidy rises the lower the income and disposable capital of the aid recipients.

2.3.3 Cost-shifting has ambiguous effects on access to justice and efficiency

As mentioned earlier, unsuccessful litigants in New Zealand are almost always awarded costs against them, which means they have to pay for some of the costs of the successful party. This shifting of litigation costs from one party to the other is often called **cost-shifting**, and the shifted costs are often called **adverse costs**.

The amount of cost-shifting can be quite modest in practice, as New Zealand courts award cost-shifting based on schedules that specify how much time can be awarded for each task and the daily fee. The

⁸ For simplicity, the analysis in section 2.2 assumed court costs were 100% subsidised. In principle, the same analysis applies with a 50% subsidy, although of course the magnitudes of the inefficiencies will differ.

⁹ Sections 5 and 6 of the Legal Services Regulations 2011 specify the eligibility limits on income and disposable capital, at <http://www.legislation.govt.nz/regulation/public/2011/0144/latest/DLM3743601.html?src=qs>.

¹⁰ See schedules 1 and 2 of the regulations in the previous footnote.

more complex the proceedings the higher the daily fee.¹¹ Nevertheless, for ease of exposition, the following discussion assumes 100% cost-shifting.

From an efficiency perspective, the key insight is that cost-shifting alters the allocation of the private costs of a litigation among the litigants but it does not directly alter the social cost of a litigation. However, it indirectly alters social costs by altering whether litigation occurs and whether litigants settle prior to trial.

For this paper, the topic is relevant because some authors argue litigation funding dilutes the role cost-shifting plays in reducing incentives for nuisance or meritless claims. The following discussion is intended to provide a useful basis for assessing those arguments in section 4.

Private decisions to litigate can be expressed in terms of a threshold probability

Section 2.2.1 explained that private decisions to litigate are driven by whether the case has a positive expected value (PEV). This occurs when:

$$\textit{probability of winning} \times \textit{damages} - \textit{cost of litigation} > 0$$

Another way of stating the same decision criterion is to express it in terms of a **threshold probability** for the plaintiff. That is, the probability that would make the action breakeven, i.e. yield zero expected value.

For a risk-neutral plaintiff:

$$\textit{threshold probability} \times \textit{damages} - \textit{cost of litigation} = 0$$

or

$$\textit{threshold probability} = \textit{cost of litigation} / \textit{damages}$$

It is useful to think of the threshold as the hurdle probability of winning the suit, much like firms have a hurdle rate of return that investment proposals need to exceed for them to be worth undertaking.

If the plaintiff is risk averse, then her threshold would need to be higher to justify the risk of spending money on litigation for an uncertain pay-off. The threshold for a risk-averse plaintiff is higher than for a risk-neutral plaintiff, just as risk-averse investors require higher interest rates to invest than risk-neutral investors.

Plaintiffs should litigate when they believe their probability of winning exceeds their threshold probability

A risk-neutral plaintiff should litigate when her perceived probability of winning exceeds her threshold probability. For example, if the plaintiff has suffered a harm ten times larger than her cost to litigate, then her threshold probability is 10%. She should pursue a claim if she perceives her chances of winning exceed 10%.

Suppose the plaintiff believed she has a 50% chance of winning, giving her a 40 percentage point margin on the 10% threshold. She can be called a *high-margin plaintiff*. But if she believed she had only a 15% chance of winning, say, then her margin over the 10% threshold is only 5% points. In this case, she would be called a *low-margin plaintiff*.

Clearly, a low-margin plaintiff could easily be persuaded not to proceed with the action. For example, suppose her lawyer re-estimated the cost to litigate the case and said the costs are now double than

¹¹ Details are available at <https://www.justice.govt.nz/courts/civil/forms-and-fees/>.

originally estimated. This would double the threshold probability to 20%. This is kind of what happens when cost-shifting occurs, although it is a little more complicated than that.¹²

Clearly, the low-margin plaintiff would balk at the 20% threshold and decide not to file a proceeding. In contrast, the high-margin plaintiff would proceed with an action regardless of the higher threshold. This gives a hint about how cost-shifting affects access to justice: it can discourage plaintiffs that have low confidence. It can also discourage highly **risk-averse plaintiffs**. A *risk-averse person* is a person who prefers to receive less 'money in the hand' than the expected value of a gamble to avoid the risk the gamble leaves them worse off.¹³

Cost-shifting increases the risk of losing and increases the pay-offs from winning, which does some weird things to threshold probabilities

The above discussion was for a low threshold claim. In essence, cost-shifting increases the threshold, discouraging low-margin plaintiffs. Intuitively, with a low probability of winning, the plaintiff is likely to have to pay for her costs and the defendant's costs, and so she will be less inclined to file a claim. The increase in the threshold represents the additional risk she carries.

Now consider a high threshold claim. For example, suppose the threshold is 80%. Cost-shifting reduces the threshold, which means some potential plaintiffs that would not have taken action will now take action. For example, if the threshold is reduced to 70%, then someone that believed their chances of winning was 75% will now bring a proceeding. This is similar to the above discussion, because the 75% belief was a low-margin below the original 80% threshold. In this example, someone who had only a 60% belief of winning was not going to file an action when the threshold was 80% and still will not bring a proceeding with the threshold at 70%. So again, cost-shifting affects the low-margin plaintiffs.

Why does the threshold reduce? Intuitively, if the plaintiff has a high probability of winning, then she is highly unlikely to have to pay for her own litigation costs, and so she will be more inclined to file a claim. The change in threshold represents the lower risk she carries.

Figure 1 summarises the above discussion. Clearly, cost-shifting increases access to justice for some types of plaintiffs and litigation but reduces access to justice for others. Further analysis would be needed to determine whether the overall effect is more equitable access to justice.

Figure 1: Cost-shifting only affects filing incentives for low-margin claims

	Low-margin plaintiffs	High-margin plaintiffs
Low-threshold claims	Less likely to file a claim	Filing decision not affected
High-threshold claims	More likely to file a claim	Filing decision not affected

¹² See Kobayashi (2015) or Posner (1988, pp. 627-32) for a good mathematical treatment and Kaplow & Shavell (2002, p. 1732) or Cooter & Ulen (2016, p. 408) for non-mathematical analysis.

¹³ A *risk-averse person* is a person that prefers to receive less 'money in the hand' than the expected value of a gamble to avoid the risk the gamble leaves them worse off. For example, suppose a person is offered the choice of \$10 or a gamble in which they have a 50% chance of winning \$100 and a 50% chance of winning nothing. The expected value of the gamble is \$50. People that reject the gamble in favour of the \$10 offer are (strongly) risk averse: they are prepared to lose \$40 to avoid the risk of the gamble. If they were prepared to lose only \$1 to avoid the gamble, for example, then they are only slightly risk averse.

Cost-shifting reduces filing of some nuisance legal claims, improving access to justice for other parties

Nuisance claims are cases pursued by plaintiffs to be a nuisance to a defendant, and include claims that are frivolous or vexatious. They are also sometimes called meritless claims, which implies they have minimal basis in law and so a very low probability of a successful judgment for the plaintiff.

In general, the legal system seeks to stop nuisance legal claims occurring but borderline cases get through the screening system.

The above analysis explained that cost-shifting discourages some low-threshold claims if the plaintiff has a low-margin above the threshold. It turns out that nuisance claims are low-threshold claims because the plaintiff gains satisfaction from taking action regardless of whether she wins or not. Just annoying the defendant is enough, or perhaps extracting a settlement from him.

When the plaintiff receives intangible benefits from litigation, the threshold equation becomes:¹⁴

$$\text{threshold probability} = \frac{\text{costs of litigation} - \text{benefits of litigation}}{\text{damages}}$$

Clearly, the higher the intangible nuisance benefits the lower the threshold probability. Nuisance plaintiffs do not expect to win a court judgment, and so they have low-margins on the low threshold. Hence, cost-shifting should discourage all but the most motivated nuisance plaintiff.

Cost-shifting has ambiguous effects on efficiency

Clearly, reducing the incidence of nuisance legal claims improves efficiency because it reduces social costs for unmeritorious cases. But there are many other efficiency effects arising from cost-shifting, which we do not need to go into here. These are discussed in Kaplow & Shavell (2002), which concludes that the overall efficiency effect of cost-shifting is generally ambiguous due to the wide range of conflicting efficiency effects and because of the divergences between private and social incentives to sue, to settle, and to spend on litigation.

2.3.4 Conditional fees also affect access to justice and efficiency

Lawyers in New Zealand are often compensated at an hourly rate for the time they spend on their cases. This means they are paid regardless of the legal outcome for the client. It is useful to refer to these as *hourly fees* and to the total amount that would be charged under this arrangement as *the normal fee*.

New Zealand lawyers are allowed to charge *conditional fees* for some areas of litigation. This is where the lawyer makes part or all of their charges dependent on the case being successful. The conditional fee is their normal fee plus a premium or uplift to compensate the lawyer for the risk of not being paid at all and for the disadvantages of not receiving monthly payments as the case progresses. Importantly, the premium cannot be calculated as a proportion of the sum recovered.¹⁵

Conditional fees increase access to justice for cases with high chances of successful outcomes

At first glance, conditional fees may be thought to increase access to justice for plaintiffs with costly litigation but low chances of a successful outcome. However, law firms will be unwilling to offer

¹⁴ If a nuisance case involves a high cost of litigation then the intangible benefits must also be high for the plaintiff to prefer to spend money on the case rather than something else. Hence, what may seem to be a high threshold litigation is actually a low threshold one.

¹⁵ Conditional fees are regulated under sections 333 – 335 of the Lawyers and Conveyancers Act 2006.

conditional fees for those cases, as it bears the risk of loss. This suggests conditional fees are likely to increase access to justice for cases with high chances of a successful outcome and reduce access to justice for plaintiffs with low chances of successful outcomes. If lawyers increase their hourly fees to cover some of their risks, then conditional fees may also reduce access to justice for plaintiffs paying hourly fees, as higher hourly fees mean some PEV claims become NEV claims.

Conditional fees affect litigation efficiency through the way they affect the performance incentives of lawyers, which in turn is to do with principal-agent issues

Principal-agent problems refer to problems that principals (clients, in this case) have with getting their agents (law firms, in this case) to act in the best interest of the principals.

Although the contract between the two parties may contain provisions requiring the agent to act in the best interest of the principal, or to act in certain ways and not act in other ways, the reality is that agents naturally have incentives to also pursue their own interests. This is fine when both interests coincide, but it creates problems for clients when the interests are conflicting in some way.

Principal-agent problems arise from two sources of information asymmetry in an uncertain world. The first information asymmetry is that clients cannot perfectly observe lawyers' actions and effort levels, particularly in regard to preparation for important litigation milestones such as identifying and preparing expert witnesses, identifying and executing various interlocutory applications, negotiating settlements and so on. These are often called moral hazard problems in the economics literature.

The other source of information asymmetry arises when a client lacks legal expertise.¹⁶ This can make it difficult for the client to assess the lawyer's quality and suitability for the case prior to contracting, and it can make it difficult for the client to assess the true strength of the case. These are often called adverse selection problems in the economics literature.

The Lawyers and Conveyancers Act 2006 seeks to reduce the severity of both types of information problems by placing obligations on lawyers to be independent in serving their clients, to act in accordance with all fiduciary duties and duties of care to their clients, and to protect the interests of their clients.¹⁷ Other sections of the Act restrict use of the term lawyer and make it a criminal act to make misleading or false statements. However, in reality the Act cannot remove all moral hazard and adverse selection problems.

Principal-agent problems can be affected by the way law firms and lawyers are remunerated

Paying lawyers on an hourly basis could provide excessive incentives for them to encourage clients to pursue litigation and/or encourage them to reject settlement offers in favour of a trial. However, this assumes the hourly rate exceeds the lawyer's opportunity costs. This will be the case if the lawyer has no other work to go on with, as the opportunity cost would be zero in that case. But if the lawyer has other client work to proceed with (at the same hourly-rate) once the case is finished, then their hourly-fee equals their opportunity cost and their incentive would be to provide unbiased advice to their clients (Kaplow & Shavell, 2002).

In addition, reputational incentives are important for professional services firms and practitioners, such as law firms and lawyers. These incentives implicitly reward them for performance because acquiring or maintaining their reputation is important for attracting future business. Lawyers' conduct is also

¹⁶ Large business clients will usually have highly-qualified lawyers on staff, and so the issue of lack of expertise is considerably reduced or eliminated in those cases.

¹⁷ See s4 of the Lawyers and Conveyancers Act 2006 for the fundamental obligations of lawyers providing regulated services. See also the Rules of Conduct and Client Care for lawyers (schedule to the Lawyers and Conveyancers Act (Lawyers: Conduct and Client Care) Rules 2008).

controlled to some extent by the threat of legal action by clients for negligence, by court-mandated penalties, and by disciplinary action (Kaplow & Shavell, 2002).

Relative to hourly fees, conditional fees provide stronger performance incentives in regard to succeeding at trial but alter lawyer incentives regarding which cases to accept and regarding their advice to clients to settle or go to trial. We return to these issues in our discussion of class actions and litigation funding, where principal-agent problems can be particularly severe.

Principal-agent problems are also relevant for considering insurance funding and control of legal defences, discussed in the next section.

2.3.5 Insurance for defendants reduces exposure to litigation and has an ambiguous effect on the efficiency of litigation

The previous discussion of principal-agent issues forms the basis for understanding the efficiency effects that arise when defendants have private insurance to cover their risk of litigation. In this case, the insurer is the agent and the defendant (the insurer's client) is the principal.

Insurance has an ambiguous effect on efficiency

It is well known that insurance reduces deterrence incentives. However, the issue is whether the reduction improves or reduces efficiency. It all depends on whether insurance is shifting deterrence incentives closer to, or further away, from the efficient deterrence incentive discussed in section 2.2.2.

The efficient deterrence incentive for producers is based on risk-neutral wrongdoers because wealth transfers between wrongdoers and the wronged are irrelevant for efficiency. However, producers are risk-averse in practice and so, in the absence of insurance, deterrence incentives would be higher than the efficient deterrence incentive.¹⁸ On this account, by compensating for risk aversion, insurance would reduce deterrence incentives towards the efficient level, improving efficiency.

However, there is another factor that comes into play. Insurers are unable to perfectly observe the actions or attributes of the insured. If they could do so, insurers would adopt perfect experience-rating, which means every insured party would pay annual insurance premiums that match the average of their lifetime insurance pay-outs.

But as insurers are unable to implement perfect experience-rating, for a range of reasons, the provision of insurance creates moral hazard incentives: insured parties have incentives to take less care than they would if they were risk neutral (and had no insurance); that is below the efficient level of care. Taking less care benefits the insured because the insurer pays for the costs of the consequent additional adverse events. So, in practice, insurance may reduce deterrence incentives below the efficient deterrence incentive.

Having said that, insurers are alert to moral hazard incentives, and so insurance comes with 'strings attached'. For example, deductibles and co-pay provisions. Moreover, insurers generally reserve the right to refuse to pay-out, claiming the insured acted in ways that breach the insurance contract. In addition, insurers have incentives to inform insured parties about what is expected of them to manage potential harms and to monitor their precautionary activity when that is likely to be cost-effective to do so. As information and advice prior to adverse events may be more powerful at encouraging efficient

¹⁸ In theory, companies should not be risk-averse as their shareholders can diversify away the non-systematic risk component of its future profits, but almost all companies hold insurance. This implies the companies are risk averse, as there is no other reason to hold insurance. Posner (1988, p. 478) discusses some possible reasons for this discrepancy between theory and practice.

prevention behaviour than learning from a series of adverse judgments, it is not clear whether insurance in practice reduces precautionary activity below the efficient level.¹⁹

Insurance reduces defendant's exposure to litigation and may reduce their need to deal with the complexities of the justice system

Recall in section 2.3.1, we defined *access to justice* as about *barriers to accessing the justice system*. One of these barriers was complexity of the justice system and the law which underpins it. Other barriers were factors specific to a person, such as their resources and capabilities.

As insurance contracts typically cede decision rights over legal claims to the insurer, the insurer acquires in-depth experience with litigation and judicial processes, and they acquire the resources and expertise to manage the defence. Hence, insurance relieves defendants of the need to overcome those barriers.

In addition, insurers may cover the costs of defending a claim, including paying out if a settlement is agreed or a judgment goes against it. This greatly reduces the insured's risk exposure, assisting them to focus on risks and activities that they are better placed to manage.

However, if the level of cover falls well short of the damages likely to be awarded against the defendant, then the defendant can be left with significant exposure even if the outcome is a small settlement rather than a judgment. Box 2 provides an example of how this could occur.

Box 2: Insurer's incentives to settle could conflict with the defendant's incentives²⁰

Suppose there is a 20% chance a trial would find against the defendant and that damages would be \$500k, which means expected damages are \$100k. Also, suppose the defendant's maximum insurance cover is \$150k and a \$75k settlement is offered by the plaintiff.

The defendant would clearly prefer the settlement over going to trial. However, the insurer would prefer to reject the settlement offer as that would result in it paying \$75k for sure whereas a judgment against the defendant has an expected cost of \$30k, as this is 20% of \$150k.

Clearly the insurer may have short-term incentives to make settlement decisions that leave the defendant short-changed. However, in a competitive and well-informed insurance market, the insurer may face longer-term reputational incentives that counteract these short-term incentives.

2.4 How statutory law affects access to justice and efficiency of civil litigation

The previous sections concentrated on civil litigation assuming it was the only option available for resolving disputes, providing deterrence incentives and creating common law by building precedents. This section briefly considers how regulatory agencies and statutory law affect civil litigation. These factors are particularly relevant for our consideration of class actions in section 3.²¹

¹⁹ Posner (1988, pp. 220-24) presents a readable discussion of insurance in relation to the negligence liability standard for accidents.

²⁰ The example is from Kaplow & Shavell (2002, p. 1735).

²¹ Alternative dispute resolution (ADR) refers to agreements by parties to resolve their disputes outside of the litigation process, that is outside of the public court system. However, we omit discussion of ADR as they are not particularly important for our analysis of class actions and litigation funding.

2.4.1 Statutory law and civil litigation interact dynamically, perhaps reducing some of the inefficiencies of civil litigation

Earlier sections noted that over time courts create a body of legal precedents called common law. An obvious substitute (and complement) is **statutory law**, which is law created by legislative bodies.

Statutory law may sometimes fill gaps in common law

There are of course many political forces and vested interests influencing when and what statutes are created and their precise provisions, but one of the possibilities is that statutes are sometimes created or revised to mitigate large inefficiencies persisting or developing under common law (refer section 2.2.3).

Clearly, if the forces driving the creation of statutory law 'fill gaps' in common law more quickly and efficiently than leaving it to the evolution of civil litigation, then the concerns in earlier sections about large inefficiencies from under-litigation may be too pessimistic. Moreover, as large inefficiencies may arise because large numbers of people are affected, the potentially efficiency-enhancing role of statutory law may be of particular relevance for class actions (as they also cover large numbers of affected people).

And civil litigation responds by filling in gaps left by statutory law

Of course, statutes are, by design, top-down creations and so they inevitably fill gaps rather coarsely. No statute can define every term in a way that leaves no room for alternative interpretation and no statute can cover more than a good proportion of circumstances that may arise in the future.

Although private incentives may be weak, civil litigation will occur as uncovered circumstances arise, and so some may end up, over time, developing or refining common law in response to statutory law. In this way, class actions may play a role in improving both access to justice and economic efficiency.

However, this conclusion was based on the proposition that statutes may sometimes be created or refined to mitigate large inefficiencies with common law. Statutes, of course, may be created or refined to serve goals other than improving economic efficiency, such as to improve fairness or to satisfy partisan political interests. Civil litigation naturally responds to these developments too, evolving over time to fill in some of the gaps created by those laws.

How should we judge litigation in those circumstances? Matters of fairness are about welfare just as much as efficiency, and if Parliament has crafted statutes to pursue fairness then, by 'filling in the gaps' of statutory law, civil litigation also works over time to improve welfare by improving fairness.

Of course, one person's claim they are motivated by fairness or efficiency can be another person's accusation they are motivated by partisan political interests. Nevertheless, suppose a new law has no basis other than partisan politics. Civil litigation works to 'fill the gaps' in those laws too, and there is no reason to expect the gap-filling to be in pursuit of inefficiency.

2.4.2 How regulatory agency decisions affect the efficiency of civil litigation

The previous section discussed the broad implications of statutory law on the inefficiencies arising with common law. Regulatory agencies are creatures of statutory law, and so to some extent they are already covered above.

However, in broad terms regulatory agencies are established (and retained) because governments and politicians consider them to be more effective means for pursuing their interests than the alternative of ruling by statute alone. This applies equally to fully independent regulators, as their independence was granted in the belief it will deliver better policy and political benefits than a dependent agency.

Regulatory agency proactivity interacts with retroactive class actions

In broad terms, regulators act *ex ante* to influence behaviour, by specifying rules proscribing undesirable behaviour or prescribing desirable behaviour, and attaching sanctions to breaches of those rules. For example, the Electricity Authority prescribes information disclosure requirements on electricity industry participants to assist the industry to better manage security of supply risks, and the Commerce Commission proscribes anti-competitive conduct.

These proactive regulatory activities are intended to reduce the incidence of mass harms. In contrast, class actions react to undesirable behaviour as observed after the fact (*ex post*), in the hope of preventing it for the future (Mackaay, 2018 p.14).

Regulatory agencies may also pursue collective recovery of losses

In addition to their proactive role, regulatory agencies are often tasked with enforcing statutes by taking legal action. Some statutes provide alternative mechanisms for collective recovery of alleged losses. For instance:

- The Commerce Commission can seek compensation orders on behalf of consumers who have allegedly suffered losses under consumer statutes, such as the Credit Contracts and Consumer Finance Act 2003 and the Fair Trading Act 1986.
- The Financial Markets Authority also has various powers to obtain compensation on behalf of individuals who are alleged to have suffered loss.

Regulatory agency activity reduces the need for private class actions, but it is unlikely to remove the need for them entirely

In essence, regulators often have rule-making and supervisory activity that could be interpreted as a form of *ex ante* class action activity, and they often have enforcement activity that are a form of *ex post* class action activity.

In undertaking both types of activities, regulatory agencies are provided with objectives that should direct them to act in the public interest. However, they face several well-known constraints, including information asymmetry in regard to the regulated parties and politically-determined budget constraints.

In contrast, class actions are motivated by private interests that may be mis-aligned with the public interest, but they have the advantage of not depending on public authority for taking action. In effect, class actions, and litigation funding of them, may serve to fill gaps not covered by regulators, improving efficiency. They may also improve efficiency indirectly, by showing up slack or misguided regulators.

In general, although regulatory agencies reduce the need for class actions it would be heroic to assume they do such a fabulous job that class actions are likely to be socially unprofitable. It seems reasonable to take the view that a *prima facie* case remains for developing an effective and efficient class action regime.

3 The economics of class actions

Drawing on the economic framework in section 2, this section considers in broad terms the benefits and detriments of class action litigation. In this paper, a **class action** is where a single claim is brought against a person or persons to resolve common issues in relation to addressing similar wrongs suffered by multiple people.

The potential for class actions 'to do good' can be illustrated with a simple numerical example. Suppose a wrongdoer has harmed a person by \$10m, and so loses the litigation and has to pay damages of \$10m plus some of the plaintiff's costs. Without class actions, a wrongdoer that causes \$2000 worth of harm to 5000 people, resulting in total harm of \$10 million, is very unlikely to face litigation as the cost of litigation greatly exceeds \$2000. In the first case wrongdoers face incentives to take action to reduce harms on society, whereas in the second case there are no such incentives despite the total harm being the same.

One of the most common policy rationales for facilitating class action litigation is that it may reduce per person litigation costs and so improve access to justice for people with low value claims. However, it is clear from section 2 this could reduce economic efficiency in cases where it exacerbates over-litigation; for example if the class action is merely to enforce existing laws and if this enforcement does not assist with achieving efficient deterrence incentives. However, the opposite conclusion may apply for precedent-creating class actions.

In considering the effects of class actions, it is important to be clear about the counterfactual: that is, the scenario without any form of class action. This is provided in section 3.2, and then sections 3.3 and 3.4 discuss the differences that arise in the presence of class actions and the implications for efficiency. Access-to-justice effects are discussed in section 3.5 and section 3.6 discusses the wider implications for businesses and the economy. Section 3.7 provides concluding comments.

The following analysis draws broadly from ALRC (1988), Posner (1988), Kaplow & Shavell (2002), Ulen (2011), Cooter & Ulen (2016), Chamberlain (2018), Fitzpatrick (2018), Mackaay (2018) and Wayne (2018).

3.1 Definition of class actions

Different authors appear to use slightly different definitions of class actions. A common definition is one proposed by Mulheron (2004, p. 3):

A class action is a legal procedure which enables the claims (or part of the claims) of a number of persons against the same defendant to be determined in the one suit.

In a class action, one or more persons ('representative plaintiff') may sue on his or her own behalf and on behalf of a number of other persons ('the class') who have a claim to a remedy for the same or a similar alleged wrong to that alleged by the representative plaintiff, and who have claims that share questions of law or fact in common with those of the representative plaintiff ('common issues').

Only the representative plaintiff is a party to the action. The class members are not usually identified as individual parties but are merely described. The class members are bound by the outcome of the litigation on the common issues, whether favourable or adverse to the class, although they do not, for the most part, take any active part in that litigation.

In New Zealand, Rule 4.24 of the High Court Rules 2016 allows a person to sue on behalf of others with the same interest in a claim provided the plaintiff has the consent of the other persons who have the

same interest or has the consent of the court to do so (on application made by the plaintiff).²² Claims brought under this Rule are often called *representative actions*.

The representative action in High Court Rule 4.24 provides a scant form of class action

Views differ whether representative actions are class actions, reflecting perhaps that there is no class action statute in New Zealand and no High Court rules referring to class actions. Rule 4.24, for example, is entitled *Persons having same interest*.

Chamberlain (2018) provides a concise history of the origins of Rule 4.24, how judicial interpretation of it has evolved and makes a compelling argument that it is in effect a (scant) class actions provision.

This paper does not treat consolidations as class actions

Importantly, High Court Rule 10.12 allows the courts to order the consolidation of existing proceedings once they are at trial stage, on any terms it thinks just. The court can also order the proceedings to be tried at the same time or one immediately after another, or it may order any of them to be stayed until after the determination of any other of them.

The court can order consolidation under Rule 10.12 if it is satisfied:

- (a) that some common question of law or fact arises in both or all of them; or
- (b) that the rights to relief claimed therein are in respect of or arise out of
 - (i) the same event; or
 - (ii) the same transaction; or
 - (iii) the same event and the same transaction; or
 - (iv) the same series of events;
 - (v) or the same series of transactions;
 - (vi) or the same series of events and the same series of transactions; or
- (c) that for some other reason it is desirable to make an order under this rule.

Consolidation under Rule 10.12 differs from Mulheron's (2004) definition of a class action as it does not convert multiple claims into a single claim. In practice, consolidations in New Zealand are typically in relation to two or three plaintiffs, whereas class actions are typically for hundreds of claimants. Also, consolidations are undertaken for the court's convenience (e.g. to economise on their resources and achieve consistency of legal decisions) rather than for the benefit of the plaintiffs. For these reasons, consolidations are not considered a form of class action in legal discourse in New Zealand.

From an economic perspective, consolidations are very similar to class actions, as they are about multiple claims with common issues arising from the same event or transaction or series of events or transactions. However, as the justice system does not view them as class actions, consolidations are included within the counterfactual in section 3.2 whereas representative actions are excluded.

3.2 The counterfactual: no class actions of any type

Section 2 provided an economic framework for individual claims, where there is only wrongdoer and one injured person. However, class actions are about the same (or similar) wrong alleged to have occurred to multiple parties and the wrongs are alleged to have been committed by the same defendant(s). This

²² See <http://www.legislation.govt.nz/regulation/public/2016/0225/latest/DLM6951329.html> for the precise wording of Rule 4.24.

brings additional complications for situations where the multiple parties seek remedies through individual claims.

The counterfactual considered in this section is that class actions of any type are prohibited. At a very general level, class actions are legal restrictions on the way in which potential plaintiffs can litigate to address alleged multiple wrongs. A class action may be a narrow set of restrictions, such as in relation to combining existing claims into a single suit, or it may be a far broader set of restrictions that mandate a general description of the parties covered by a civil action, how the action is to be managed on their behalf and how any damages and costs are apportioned among them.

In particular, in keeping with Chamberlain (2018), representative actions under High Court Rule 4.24 are assumed in this paper to be a form of class action and so are excluded from the counterfactual. But as mentioned above, consolidations are not class actions and so are included within the counterfactual. This approach provides the foundation for considering in the next subsection the broad effects of class actions generally, without getting into the details of specific types of class actions.

3.2.1 Assumptions

A key assumption is that if an individual claim was brought for each of the multiple wrongs, the claims would have largely the same or similar questions of law and fact, sometimes referred to as *common issues and facts*.

Nevertheless, different potential plaintiffs may have different beliefs about the probability of a successful outcome from filing a claim. For example, some potential plaintiffs may be more risk averse than others. This means, even if they all have the same risk-neutral threshold probability for filing a claim, they will make different decisions about whether to file a claim, reflecting their own degree of risk aversion.

In any case, even if plaintiffs were risk neutral there is no reason to assume all potential plaintiffs have the same threshold probability for filing a claim. Some may believe they will derive satisfaction from filing a claim to hold a defendant to account, whereas others may view it as a hassle or a significant burden. Another source of variation may arise from different expectations they have about the cost of litigation and the damages they would receive if they secured a favourable judgment.

The upshot is there would be a series of claims to right the multiple wrongs. It is useful to refer to the plaintiffs of the early claims as *leading plaintiffs* and the others as *follower plaintiffs*, or more simply as *leaders* and *followers* when it is clear we are referring to plaintiffs or potential plaintiffs.

3.2.2 Potential plaintiffs face significant coordination costs and some may have incentives to free-ride on earlier litigation

In principle, all leaders and followers have incentives to find each other and coordinate their actions to achieve economies of scale and increase their chances of success. For example, they could utilise the same legal representatives and combine their resources to invest heavily in winning the initial case(s), to increase the chances of their future litigation being successful (either a good settlement or judgment).

In practice, coordinating multiple potential plaintiffs is likely to be very costly, especially if some of them retain their own legal representative. For example, different potential plaintiffs may have different views about the various facets of the case, making it time-consuming and costly to reach agreement at each stage of the litigation. The plaintiff may be wary of sharing decision-rights with others if they are largely unknown to her, and it would likely be costly to negotiate the share of costs to be paid by the plaintiff versus the shares to be paid by others.

It may be especially difficult to convince followers to contribute to the leader's costs as they may have incentives to free-ride on the leader's costs. That is, they may prefer to 'wait and see' what happens to the early litigation as that allows them to avoid costs until they learn whether the leaders secure a

successful judgment, which would be one that is not appealed to higher courts or cannot be appealed because all appeals have been exhausted.

This free-rider incentive arises because many of the followers will realise the defendant is much more likely to want to settle with them if the leader wins, in which case they may be able to obtain an acceptable level of compensation for very minimal costs.

Given these considerations, the most likely scenario is that a series of litigation may occur over time in which plaintiffs coordinate minimally or not at all.

3.2.3 When defendants have a limited ability to pay, plaintiffs have incentives to compete to access the defendant's funds

Another factor for plaintiffs to consider is whether the damages and settlements might exceed the defendant's ability to pay. This scenario removes the free-riding incentives discussed earlier. Instead, it creates incentives for leading plaintiffs to race to file proceedings to access the limited funds available.

3.2.4 Defendants have incentives to over-spend to try to defeat leading plaintiffs, which may deter claims that would have been undertaken in individual litigation

The above discussion suggested the defendant may face a series of claims by plaintiffs with similar claims. Compared to individual litigation, the defendant has stronger incentives to invest heavily to win the early cases, including incurring the costs of appealing leading cases if necessary.

The defendant also has stronger incentives to resist settlements if he believes he has a reasonable chance of a favourable judgment, to deter followers initiating claims in the hope of securing settlements at minimal cost. However, if he believes he has a particularly poor chance of a favourable judgment then the defendant has strong incentives to offer a generous (and usually confidential) settlement to the leader to avoid that judgment.²³

3.3 The key economic features of class action regimes

The essence of class action arrangements is that they provide a standardised suite of legally-enforceable arrangements that reduce the costs and risks of resolving essentially the same wrong inflicted on multiple parties.

The legally-enforceable rules cover at least one or more of the following key elements:

1. *Membership rules*: Some way of determining who is legally a class member, or some way of defining who may legally be a class member if the specific members are not known before litigation is initiated. Membership rules also need to be clear about whether membership is mandatory, and if not, rules around the circumstances in which parties can opt-in or opt-out of class membership.
2. *Management rules*: An assignment of legal rights and obligations for overseeing and conducting the litigation. In general, these are assigned to a representative plaintiff and the remaining class members have no rights to participate or manage the litigation.
3. *Money rules (i.e. rules about funding, costs and damages)*: These can include rules restricting how lawyers charge for their services, how (if any) funders are compensated, what collateral (if

²³ ALRC (1988, p. 23) discusses test cases where this appears to become a problem.

any) funders must provide to the court to ensure successful defendants are not left empty-handed, and rules around the apportionment of costs and damages among class members.

High Court Rule 4.24 provides scant rules about management, and no rules about membership or money. The management rules are that a person can sue on behalf of other persons if they consent or if directed by the court. There is nothing in the High Court Rules about any other management rights and obligations (specific to representative actions). However, as Chamberlain (2018) notes, the judiciary has over time developed some simple procedural rules to fill in some of the gaps.

In many respects, class action regimes perform a similar function to the standard sets of provisions made available for people wishing to invest through company, trust or partnership entities. Standardising the provisions and making them legally enforceable greatly reduces the transaction costs and risks with collective action via commercial entities.

At a general level, the parallels with company arrangements are striking. A company has:

- a register of shareholders (the equivalent of a defined set of class members) and rules for buying or disposing shares (opting in and out)
- a board and management to oversee and manage the company's affairs and report back to shareholders; unless shareholders have been appointed to a management role, shareholders have no rights to participate in the management of the company (management rules)
- rules about the distribution of the company's funds to shareholders and other claimants (money rules).

In essence, a class action regime has the potential to facilitate collective legal action where that is economically efficient, just as the company legal form does for business. Economic efficiency and equity would be greatly harmed if most of the above company rules were not legally enforceable or if they differed depending on which court enforced them. But that is the current situation in regard to representative actions in New Zealand.

Just as collective action via companies leads to principal-agent problems between management and shareholders, so does collective action via class actions. The general approach with respect to companies is to adopt rules that substantially mitigate those problems whilst retaining most of the benefits from collective action. In principle, a similar logic applies to the development of rules for class actions.

3.4 The efficiency effects of class actions

This section discusses how class actions alter the social costs and benefits of litigation relative to the counterfactual in section 3.2. To simplify the analysis, we assume throughout section 3 that class actions do not crowd out other litigation. In effect, we are assuming that legal and justice system resources are adjusted to cater for any increase in litigation. Crowding-out effects are considered in our analysis of litigation funding (section 4), which applies to both individual and class actions.

It is useful to analyse the effects of class actions by categorising them into intensive versus extensive effects. Intensive effects are those that arise from addressing a given number of wrongs through a class action rather than through multiple individual actions. This makes sense for class actions that only cover individual claims that would occur anyway (**intensive class actions**) because the plaintiff expects to be

better off from undertaking them. In the class actions literature, these are sometimes called *individually recoverable claims* or *PEV claims*.²⁴

In contrast, extensive effects refer to the effects class actions have on the number of wrongs addressed through litigation. By making it lower cost or easier to litigate a wrong, class actions may increase the number of claimants covered by civil litigation. These are sometimes called *individually non-recoverable claims* or *NEV claims* and in this paper are called **extensive class actions**.²⁵

Some class actions may comprise a mix of intensive and extensive effects, because their participants comprise some members who would have sued anyway and other members who would not have sued without the class action (**hybrid class actions**).

3.4.1 Intensive class actions occur when there are alleged wrongs that would be litigated anyway in the absence of any class actions regime

To understand intensive effects, it is useful to consider a simple scenario and then add more realism. The upshot of this analysis is that intensive class actions may improve efficiency but the magnitude of the efficiency gain is likely to be modest due to strong incentives for plaintiffs to free-ride in the counterfactual. This free-riding means that only a few of the potential plaintiffs would litigate in the absence of any class actions regime. Moreover, intensive class actions may harm efficiency by slowing the development of precedents.

In the simple scenario, intensive class actions improve efficiency but do not affect access to justice

The primary effect of intensive class actions is that they reduce the social cost of litigation due to **economies of scale** (i.e. reducing duplication of effort across multiple claims). As the class members would have pursued their own claims anyway, intensive class actions do not alter the net social benefits from litigation. In this simple scenario, intensive class actions categorically deliver efficiency gains.

To be more specific, consider the situation where potential plaintiffs can decide whether to join a class action. Similar to the counterfactual in section 3.2, some potential plaintiffs may choose to free-ride on a class action by waiting to see the outcome of the litigation. However, those that would have litigated under the counterfactual, as part of the leading pack of claims, are those that will not free-ride: as the cost per class member is lower for a class action than undertaking their own litigation, and their liability is unaffected by being a member of a class action, these plaintiffs will join the class action and not free-ride.

In regard to social benefits, as the litigations would have occurred anyway, grouping the n claims into a single proceeding does not affect deterrence incentives. As they are the same legal issues and the same set of facts regardless of whether they are grouped or not, the courts would make the same decision about liability. This means future potential wrongdoers face the same deterrence incentives and so the net social benefits from litigation are unaffected in this regard.

For this simple version of intensive class actions, the social costs of litigation are reduced but the net social benefits remain unchanged. Hence, economic efficiency categorically increases. But access to justice is unaffected as the class members would have litigated anyway.

²⁴ Note that it is not strictly correct to focus on PEV claims because NEV claims may occur in the counterfactual (refer sections 2.2.4). However, it is convenient to focus on PEV versus NEV claims with the implicit understanding that we really mean modest- to high-PEV claims and modest- to high-NEV claims.

²⁵ As in the previous footnote, it is not strictly correct to focus on NEV as low-PEV claims may not occur in the counterfactual. However, it is convenient to do so with the implicit understanding that we really mean any claims that would not occur in the counterfactual.

In a more realistic scenario, intensive class actions may improve efficiency if optimal class membership is chosen

In practice, class actions create other costs, such as agency and management costs. *Agency costs* are the costs of inefficient decision-making arising from principal-agent problems, like those introduced in section 2.3.4. These problems arise because of conflicts of interest and information asymmetry between principals and the agent working for them.

Management costs are the costs of managing the class action procedures, such as additional time from the plaintiff's lawyers to promote the class action to prospective class members, conduct due diligence on their claims, and approve each class member. Management costs also include the additional time and resources needed from the plaintiff and the courts to secure court certification of the class action. And although ordinary class members have no participation rights, additional time and resources are required to keep class members informed and to deal with their enquiries.

In essence, management costs arise because of the diversity of preferences of claimants, and because the nature of the claims differ in their details such that they involve different points of law. When all claims and claimants are identical, economies of scale drive down the average cost of litigation. However, in practice increasing the number of claimants introduces diversity in the nature of the claims, which widens the scope of the litigation and increases costs. It is useful to refer to these cost effects as **diseconomies of scope**. Similarly, the inclusion of claimants with diverse preferences and backgrounds creates diseconomies of scope.

Under reasonable assumptions, the optimal class size is where the saving in social costs from economies of scale (by adding another class member) equals the increase in social costs from diseconomies of scope (adding diversity by adding another class member). The presence of multiple class actions regarding the same wrong indicates that diseconomies of scope could be significant.

Intuitively, intensive class actions achieve substantial economies of scale because, with only one proceeding, there is only one fixed cost of litigation. In contrast, if there are multiple proceedings, as in the counterfactual, then total fixed costs are a multiple of those incurred for class actions. But the larger the class, the greater their diversity of interests and legal issues. Eventually, the marginal social cost of diversity overwhelms the marginal social benefit of scale.

In practice it is likely to be difficult to choose class sizes close to the efficient level, and so there may be intensive class actions where classes are so large and diverse that total costs are higher than ideal. These situations, however, are likely more relevant for the extensive class actions (refer s3.4.3).

In practice, intensive efficiencies may be modest because of free-rider incentives in the counterfactual

A key consideration is whether many potential plaintiffs would take their own claims all the way through to completion of costly court proceedings.

Recall from the counterfactual discussion that, if the leading cases are successful and the follower cases are modest- to high-PEV claims, then defendants and follower plaintiffs are highly likely to settle rather than proceed all the way to judgment. As pre-trial settlements save the substantial social costs of trials, the cost savings of class actions relative to the counterfactual may be relatively modest in the intensive scenario, even if optimal class sizes are chosen.

Intensive class actions may harm efficiency by slowing the development of important precedents

A key feature of precedent-creating litigation is that it can create very large net social benefits, making it very likely that under-litigation occurs when new precedents are needed to deal with new developments

in the economy or in society more generally (refer section 2.2.3). Another critical feature is that litigation has to be pursued all the way through to judgment as no precedent occurs if a settlement occurs.

Precedents are established through multiple judgments adhering over time to previous judgments. Hence, for new areas of law where new precedents are needed, anything that increases the chances of claims being filed and judged is very likely to achieve large gains in net social benefits.

In the counterfactual, a defendant has a strong incentive to secure settlements with leading plaintiffs if the defendant believes the plaintiff has a reasonable chance of a favourable judgment. If the defendant believes the opposite, then he has incentives to over-spend to try to secure a favourable judgment and deter follower plaintiffs. In both cases, the counterfactual is not conducive to producing precedent-creating outcomes.

Now consider intensive class actions, which comprise only members that would have taken individual claims in the counterfactual. Ignoring strategic considerations discussed in section 3.4.4, a series of individual claims in the counterfactual has a greater chance of establishing a precedent over time than a single intensive class action. Although the same questions of law have to be considered in both cases, a judgment on a class action carries the view of a single judge. In contrast, multiple judges are involved in the counterfactual.

In other words, intensive class actions may harm economic efficiency by slowing the development of precedents.

It is not clear whether intensive class actions improve productive efficiency

Productive efficiency occurs when a given service level is produced at lowest social cost, or equivalently, when maximum service is produced from a given cost of inputs. Hence, an improvement in productive efficiency occurs when the same service levels are produced at a lower social cost. In regard to litigation, the services are provision of justice for litigants, and provision of deterrence incentives and precedents for society.

If we could ignore the issue of precedents, we could say that intensive class actions increase productive efficiency, as the same deterrence incentives would occur at a lower social cost of litigation. However, if intensive class actions reduce the production of precedents, it is not possible to form a view on productive efficiency from first-principles analysis.

3.4.2 Extensive class actions occur when a class action resolves alleged wrongs that would not otherwise be litigated

The previous section showed that litigating a given number of wrongs through a class action may improve efficiency by reducing social costs. Likewise, efficiency could increase by increasing the number of parties able to seek legal redress for alleged wrongs. This would occur when class actions facilitate precedent-creating litigation (per s2.2.3) and/or achieve more efficient deterrence incentives. However, efficiency could reduce if class actions make deterrence incentives less efficient (per sections 2.2.1 and 2.2.2). In other words, the dichotomy in section 2 is an important consideration for assessing extensive class actions.

Extensive class actions suffer severe principal-agent problems

Recall from section 3.4.1 that agency costs arise because of conflicts of interest and information asymmetry between principals and the agent that works for them. Principal-agent problems between the class lawyer and the representative plaintiff can be particularly severe for extensive class actions, as

they often have large class sizes and low-value claims per member.²⁶ This can lead to litigation costs that are substantially higher than efficient levels.

For example, recall the numerical example at the beginning of section 3, where a wrongdoer harmed a person by \$10m. Assume the lawyer earns an hourly fee for services. The plaintiff in that case faces a 100% return on effort to monitor and direct the lawyer to pursue the interests of the plaintiff. Suppose an opportunity arises during the litigation to gain an extra \$10,000 of damages (or settlement value) if the lawyer pursues an avenue that costs an extra \$6000 of legal time. The net pay-out to the plaintiff would be \$4000, giving the plaintiff strong incentives to take the time needed to understand the opportunity and properly instruct the lawyer.

In contrast, the corresponding extensive class action arose from the wrongdoer causing \$2000 worth of harm to 5000 people, for a total of \$10 million. In this case, for every \$10,000 of additional damages or settlement value, total pay-out for the class (net of legal costs) is \$4000 but the representative plaintiff only receives 80 cents! This is a vastly weaker supervision incentive than the \$4000 in the case of the individual claims.

The very weak supervision incentives on the representative plaintiff potentially place the class lawyer in a strong position to further her own interests rather than the interests of the representative plaintiff.²⁷ These considerations have figured prominently in debates on the costs and benefits of class actions.

Clearly, once class membership exceeds a modest number, say 40, then adding more class members does little to worsen the principal-agent problem or increase agency costs.²⁸ In theory, agency costs influence optimal class size, but beyond a modest size the impact is too small to matter.

Extensive class actions have the potential to improve efficiency by reducing the extent that private incentives are mis-aligned with efficient incentives

As in section 2, private incentives to take extensive class actions are mis-aligned with the efficient incentive. Nevertheless, they are likely to improve efficiency relative to the counterfactual.

To see this, consider precedent-creating litigation. We know from section 2.2.3 that under-litigation is likely to occur in these situations, and so anything that boosts precedent-creating litigation improves efficiency. Extensive class actions boost such litigation because the counterfactual for extensive class actions is that none of the claims covered by the action would have been litigated.²⁹

²⁶ Kaplow & Shavell (2002, p. 1734) discusses these issues in relation to class actions generally.

²⁷ Similar agency costs arise for shareholders monitoring the performance of a company's management. There are no agency costs with one shareholder because the shareholder bears all of the consequences of poor management performance. Introducing a second shareholder modestly dilutes their incentive to monitor management, as both still carry 50% of the costs of poor performance. Company managers know this and so still have strong incentives to behave. But at 100 shareholders, for example, each shareholder has very little incentive to monitor management performance and so managers have far greater scope to act in their own interests rather than in the interests of shareholders. To address these incentive issues, shareholders appoint professional boards of directors, who are paid to monitor and oversee the company's managers and make strategic decisions.

²⁸ In the numerical example, 40 class members would have left the representative plaintiff with an extra \$100, still far smaller than \$4000 in the case of individual litigation. Adding a 41st class member reduces the representative plaintiff's pay-off by a very small amount, to around \$98. But if the class originally had 3 members, then adding a 4th member reduces the pay-off from \$1333 to \$1000.

²⁹ It is possible class actions crowd out individual actions, as discussed in section 4, but there is no reason to presume precedents are significantly crowded out: as extensive class actions are a relatively new development, it would seem reasonable to presume they are more likely to yield precedents than individual actions.

We also know from section 2 that over-litigation is likely to occur for individual claimants seeking to enforce existing law. However, the counterfactual in section 3.2 is that no enforcement actions occur whatsoever for cases where a large number of people suffer small harms. Having zero enforcement implies zero deterrence incentive, which is very likely to be lower than the efficient deterrence incentive.

In practical terms, zero enforcement implies zero deterrence for wrongdoers that pursue activities prone to creating small harms across large numbers of people, such as implementing financial arrangements with a systemic error that under pays interest income to a large group of customers (“skimming”).

Prohibiting extensive class actions would mean zero deterrence incentive for types of activity prone to creating mass harm, in which case the sufferers are reliant on public enforcement agencies to act on their behalf. Clearly, if public agencies did this effectively, and passed on damages to the victims, then wronged parties would see no value in forming a class action to litigate; this implies class actions will only arise where wronged persons are dissatisfied with the status quo. This conclusion, however, depends critically on class action regimes dealing effectively with strategic behaviour by class plaintiffs and defendants (more on this below).

Having some extensive class actions is therefore very likely to improve efficiency by deterring socially harmful skimming activity. The key is to avoid too much class action litigation for these cases.

3.4.3 Hybrid class actions do not necessarily improve efficiency

As described in the counterfactual, potential plaintiffs for essentially the same type of wrong may have different expected values about the same claim and they can be expected to make different litigation decisions. Moreover, some defendants may cause harms that differ substantially in magnitude across wronged parties. In this case, potential plaintiffs with modest- to high-PEV claims are likely to litigate under the counterfactual while those with NEV or low-PEVs may not litigate. A class action comprising these parties is called a hybrid class action.

The previous subsections showed that intensive and extensive class actions should improve efficiency provided they each have optimal class membership. Presumably that means hybrid class actions should also improve efficiency, but that is not necessarily the case.

Hybrid class actions may harm efficiency by slowing the development of precedents

Section 3.4.1 came to the view that intensive class actions may harm efficiency by reducing the opportunity for multiple judges to consider precedents. In contrast, extensive class actions may improve efficiency by creating more opportunities for development of precedents. Both results arise because precedents are established through multiple judgments adhering over time to previous judgments.

Now consider hybrid class actions, which have intensive and extensive class members. Intensive class members are members who would have taken individual claims in the counterfactual, and so their inclusion in hybrid actions reduces the chances, relative to the counterfactual, of establishing a precedent over time.

On the other hand, the presence of extensive members means hybrid class actions will often comprise a greater diversity of legal issues than an intensive class action, the judgment of which could strengthen existing precedents or create new precedents. As extensive members do not bring claims in the counterfactual, the courts in the counterfactual will not have the opportunity to issue judgments on those issues, whereas for a hybrid class action a court will have that opportunity.

The overall impact, therefore, depends on whether the intensive or extensive effect dominates. It is quite possible that hybrid class actions may harm the development of precedents.

Hybrid class actions may harm the efficiency of enforcement litigation and deterrence incentives

By the definition of hybrid class actions, some individuals would litigate to enforce existing law under the counterfactual for multiple wrongs but some will not litigate as they have NEV claims. It is often assumed this means deterrence incentives are inefficiently weak because the defendant is exposed to paying damages far lower than he would if all harmed persons took an action under the counterfactual. But as discussed in s2.2.2, the efficient deterrence incentive may involve smaller damages than needed for full compensation.

As the counterfactual for multiple wrongs has only some of the wrongs being litigated, the deterrence incentives in this case may in fact be more efficient than often assumed. In general, it is not possible to be categorical about the efficiency effects of hybrid class actions unless the efficiency of the counterfactual has been established.

3.4.4 Strategic considerations depend on class membership arrangements and whether multiple class actions are privately-optimal

The counterfactual discussed strategic decision-making by potential plaintiffs and defendants. For example, plaintiffs may compete for access to limited funds, or if funds are plentiful, some may seek to free-ride on the actions of leading plaintiffs; defendants may over-spend to try to defeat leading plaintiffs or they may seek to settle with the leaders to avoid an unfavourable judgment that would encourage followers to pursue legal action.

The strategic aspect of class actions depends critically on the approach adopted for class membership, and on whether multiple class actions are privately-optimal.

The key issue is whether plaintiffs and defendants have effective choice of class action

A single class action arises when class membership is mandatory or when the multiple harms are such that only one class action is PEV. In the following discussion, the term **monopoly plaintiff** is used to represent both situations.

Multiple class actions can occur when the multiple wrongs yield multiple PEV class actions. It is useful to refer to a *duopoly plaintiffs* for the case when only two class actions are PEV and to *oligopoly plaintiffs* when several class actions are PEV. When discussing them more generally, it is convenient to refer to *competitive plaintiff situations*.

To be clear, the above terms refer to the extent of effective choice of class actions for claimants. For example, a single class action may arise with membership initially formed by claimants choosing to opt-in or they have been deemed to be class members. The strategic effects of these circumstances differ if another PEV class action can be formed. To be more specific:

- If all claimants are initially deemed to be in a class action but some can opt-out and form another PEV class action then the plaintiff monopoly is contestable, and therefore competitive. But if another PEV action is not feasible, then the voluntary opt-out arrangement is ineffective and the single plaintiff has monopoly power.
- Similarly, if membership is a voluntary opt-in arrangement, but once claimants are in they cannot opt-out, then the single class action is a monopoly plaintiff if the outside claimants can't form a PEV action. If they can, then the single plaintiff is in a competitive situation.

For simplicity, we typically discuss litigation as having a single defendant, which could be thought of as a *monopoly defendant*. A bilateral monopoly situation arises when there is a monopoly buyer and monopoly seller, or in this case, a monopoly plaintiff and defendant. Of course, there may be competitive

defendant situations, such as when there are two competing defendants (a duopoly) or several competing defendants (an oligopoly), and so on.

Competitive plaintiff situations may provide strategic opportunities for a monopoly defendant

A monopoly defendant situation can arise when there are multiple defendants if they are subject to joint liability. *Joint liability* means the plaintiff must sue all of the injurers jointly and each is liable only for their share of costs and damages. It is easiest to proceed as if a monopoly defendant situation is just a single defendant.

If a defendant has sufficient funds to cover maximum-likely damages, competitive plaintiffs have incentives to try to free-ride on the expenditures of their rival plaintiffs, to avoid high trial costs, similar to the free-riding in the counterfactual.

Similarly, when the defendant has limited funds each plaintiff has strong incentives to progress their litigation speedily and to settle with a defendant if it perceives that other plaintiffs may do so ahead of it. Again, essentially the same issues arise as in the counterfactual.

Conversely, competitive defendant situations may provide strategic opportunities for a monopoly plaintiff

This is largely the converse of the previous case. A competitive defendant situation may arise where the defendants have *joint and several liability* for the harms caused. This is a situation where the defendants are each liable for total damages if the other defendants are not held liable to pay their share or are unable to pay their share. In this case a monopoly plaintiff has incentives to pursue the defendant with the deepest pockets if there is a risk any of the other defendants has limited funds.

An interesting twist in joint and several liability cases is that a monopoly plaintiff may prefer to seek a judgment, rather than settlement, with the richest defendant. This is because the presence of the other defendants provides insurance, in effect, against the risk of an unfavourable judgment. This can make it worthwhile to pursue the big prize of damages equal to the harm suffered, but if that fails then the plaintiff can pursue one or more of the other defendants (Cooter & Ulen, 2016).

Bilateral monopoly situations may also provide strategic opportunities for a monopoly plaintiff

In a bilateral monopoly situation, the most effective strategic choices may be with the plaintiff if litigation harms a defendant's reputation or the defendant has limited funds and faces the prospect of bankruptcy from an unfavourable court decision.

Reputational effects from litigation can be very significant for businesses and businesspeople, and class actions may exacerbate those effects if they attract higher and more prolonged public profiles or they involve very large potential damages. In these situations a monopoly plaintiff may have incentives to try to "blackmail" the defendant, for example by making repeated discovery requests to drive up the defendant's costs to encourage him to settle, and various other methods (Fitzpatrick, 2018, p. 175).

When a defendant has limited funds, a monopoly plaintiff has strong incentives to maximise their class membership to maximise the threat of a court decision bankrupting the defendant. To fully understand this, consider the counterfactual where a defendant faces a series of individual proceedings. This provides the defendant with significant risk mitigation (from erroneous court decisions) as multiple courts make the decisions. Their exposure to any one erroneous decision is limited. In contrast, when there is a class action covering all potential claimants, a defendant can face extremely large risks from an erroneous judgment. With extremely large sums at stake, rather than take the risk of a judgment, the

defendant has strong incentives to pay an outsized settlement to gain the certainty of avoiding bankruptcy (Cooter & Ulen, 2016, p. 426).³⁰

Class actions are sometimes viewed as encouraging nuisance or meritless litigation. The same can occur in regard to individual litigation (refer section 2.3.3), however the situation may be more problematic for class actions due to their higher profile and greater chance of significant financial damage to businesses. As with individual litigation, cost-shifting should discourage nuisance and meritless claims but there may be a case for strengthening those arrangements, for example by requiring a class action plaintiff to pay for all court costs and to allow for a larger share of costs to be shifted.

Monopoly strategic behaviour by either side may reduce the efficiency of class actions

Deterrence incentives depend on the size of damages and settlements, which depend on class size and therefore on membership arrangements. In contrast, precedent-creating effects depend on whether litigation is settled or not, but not directly on the size of settlements.³¹

Whenever a monopoly plaintiff can extract outsized settlements from a defendant, or impose outsized litigation costs on the defendant, it increases deterrence incentives. If the law requires mandatory membership of class actions, then outsized settlements will exceed the efficient deterrence incentive.

Conversely, a monopoly defendant facing competitive plaintiffs may be able to secure cheaper settlements than if it faced a monopoly plaintiff. But while that leaves some claimants out of pocket, the cheaper settlements could drive deterrence incentives closer to the efficient deterrence incentive or further below it. It will depend on the circumstances.

Also, when a monopoly defendant faces competitive plaintiffs there are strong incentives for one of the plaintiffs to settle pre-trial, increasing the chances the other plaintiffs will settle or quit before proceeding to trial. The lower chances of a judgment reduces the chances of precedents evolving, harming efficiency.

3.5 Access to justice and the distributional effects of class actions

Section 3.4 focused on analysing the efficiency implications of class actions. This section first considers distributional matters, such as which parties benefit from class actions and which incur additional costs, and in doing so it discusses how class actions may affect access to justice.

As in the previous section, it is useful to discuss these issues in relation to the three forms of class action: intensive, extensive and hybrid. The previous section also discussed principal-agent issues, which may materially affect the total cost of class actions. However, it is not obvious they systematically alter the distribution of those costs (and benefits) across plaintiffs and defendants, and so this section assumes they do not.

3.5.1 Without strategic behaviour, intensive class actions do not appear to raise any distributional or access-to-justice concerns

By definition, intensive class actions cover claimants who would litigate in the counterfactual.

³⁰ Fitzpatrick (2018, p. 173-4) provides a contrary view.

³¹ But of course the size of settlement offers relative to the expected value of proceeding all the way through to judgment influence whether settlement occurs.

The simple case (no strategic behaviour): intensive class actions do not affect equitable access to justice

In principle, intensive class actions do not materially affect equitable access to justice because the class members would have litigated anyway. Although the per-member costs of accessing justice should be lower than in the counterfactual, costs in the counterfactual were not an effective barrier to any class member accessing the justice system.

Intensive class actions also reduce costs overall for defendants relative to the counterfactual, as they only have to deal with one proceeding. As the class members would have sued them anyway, the lower costs for the defendant improves his – and his insurer's – access to the justice system.

For similar reasons, intensive class actions reduce costs to the justice system.

Overall, without strategic behaviour, intensive class actions should be beneficial for all three parties: the plaintiffs and claimants, the courts and defendants.

Strategic behaviour may alter the distribution of benefits of intensive class actions, but if class members can opt-out then no claimant should be worse-off relative to their position in the counterfactual

The opportunity to engage in strategic behaviour arises from one or other side, or both, being in a monopoly position.

If there is a monopoly defendant, he is likely to engage in strategic behaviour to improve his outcomes. However, provided class members can opt-out at any stage during the litigation,³² a monopoly defendant is better off choosing litigation options that leave class members better off than they would be in the counterfactual. If he pushes his advantage too far, some class members could exit the class action and pursue their own litigation against the defendant, imposing higher costs on the defendant.

If the monopoly defendant has limited funds, he is in a stronger strategic position because class members will have strong incentives to compete to be an early settlor.

For intensive class actions, a plaintiff monopoly can only arise when class membership is mandatory because each member has a PEV claim. A plaintiff monopoly tilts the benefits of class actions towards the plaintiff side. Unlike class members, however, defendants do not have the option of reverting to the counterfactual scenario or simply quitting the litigation. This can empower a monopoly plaintiff to tilt matters to the point of leaving a defendant worse-off than in the counterfactual.

In summary, relative to the counterfactual of no class actions, intensive class actions are clearly beneficial for plaintiffs, and not always beneficial for defendants.

3.5.2 Extensive class actions may improve equitable access to justice

By definition, the members of extensive class actions have individual NEV claims, and so they do not bring individual litigation in the counterfactual.

Extensive class actions probably improve equitable access to justice for class members

The access-to-justice and distributional aspects of intensive class actions were very simple to analyse, for two reasons: the benefit of these class actions is cost-reduction for everyone; and class members always have a valuable exit option that protects them relative to their counterfactual.

³² The opt-out would be subject to paying their share of class costs incurred to-date. As those costs are sunk costs, class members have to pay them regardless of their future litigation decisions. This means their level of sunk costs does not affect their future litigation decisions.

In the counterfactual, extensive class members have zero access to justice unless their case is subsidised sufficiently by a third party. Third-party support could come from crowd-funding, legal aid, pro bono and community law services etc. Low-cost disputes tribunals are also a form of third-party assistance. However, it is reasonable to proceed on the basis that these sources are not generous enough to materially address all parties that could benefit from support.

Ignoring third-party support, extensive class actions clearly improve access to justice for class members, in the sense that their dispute is resolved. Moreover, provided the criteria for class membership do not discriminate on the basis of any attributes unrelated to the wrong suffered, then extensive class actions are also likely to make access more equitable. In fact, extensive class actions may positively boost equitable access if their presence also assists with reducing non-financial barriers to pursuing litigation. For example, a broad-based class membership may encourage particularly risk-averse individuals, and individuals from a wider range of family and cultural backgrounds, to join the action.

However, extensive class actions draw resources from the legal and justice systems. In principle, whether they improve equitable access to justice overall depends on (a) the extent they crowd out other plaintiffs and (b) on the characteristics of the crowded-out plaintiffs vis-à-vis extensive class members. This issue is considered in some detail in section 4.4 in regard to litigation funding, where it is likely to be far more significant. On a first-principles basis, there is no particular reason to expect extensive class members on average to have greater extant access to justice than crowded-out plaintiffs.

Defendants incur additional costs regardless of whether they are really at-fault, and the courts also incur additional costs

In the counterfactual, potential wrongdoers avoid judicial scrutiny for small-to-medium harms they may have imposed on others. In the factual, extensive class actions bring judicial scrutiny to bear on a subset of those wrongdoers: those that may have caused such widespread harm that a class action is PEV.

As cost-shifting covers only a portion of their direct costs and none of their indirect costs, defendants incur the remaining costs to defend their case even if they win a favourable judgment. For a given extensive class action, the higher the fraction of potentially wronged persons included in the class, the larger the remaining costs borne by defendants.

The upshot is that extensive class actions impose additional costs on defendants even when they are not held to be liable. This in turn means defendants offer higher settlements to avoid proceeding to costly trials and subsequent judgments.

Extensive class actions also impose additional costs on the courts, as extensive class members would not have pursued litigation in the counterfactual. However, any policy change that increases litigation activity increases court costs. The underlying driver here is not anything specific with extensive class actions; rather the additional burden on the justice budget arises because court fees are set lower than court costs. A possible solution may be to increase court fees for class actions, so that they fully fund the judicial resources used.

The situation in regard to strategic behaviour is reasonably straight-forward. If one side has a monopoly position and the other does not, then the distribution of costs and benefits alter along the lines discussed in section 3.4.4.

In summary, relative to the counterfactual of no class actions, extensive class actions are clearly beneficial for plaintiffs and will often impose additional costs on defendants.

Consideration of liability insurance for defendants does not alter the above conclusions

Many business defendants will have insurance to cover their liability risks. This serves the same purpose as discussed earlier for individual litigation (section 2.3.5), and has the same effects for class actions. In

particular, insurance reduces deterrence incentives but not necessarily below the efficient deterrence incentive as insurers substitute various monitoring, reporting, and practice requirements to encourage precautionary behaviour and investments.

Introducing extensive class actions will likely increase insurance premiums for businesses operating in industries susceptible to imposing systemic harms on others. But as explained in section 2, from a business-wide perspective, the insurance aspect is irrelevant as businesses largely pay 'the averages' regardless of whether they are insured or not.

3.5.3 Hybrid class actions appear to bring many of the benefits of extensive class actions

Hybrid class actions are a mix of intensive and extensive class actions, and so their access and distributional effects are a combination of both.

For example, hybrid class actions with optimal class membership improve access to justice overall, as they provide a vehicle for their extensive members to pursue justice without affecting access for their intensive members. They also have the potential to reduce litigation costs per class member, improving access to compensation (net of litigation costs) for all members of a successful class action.

But the addition of extensive members may increase the costs of managing the class action. Whether this occurs in practice will depend on adopting arrangements that deal well with diversity and deal well with principal-agent issues that arise when from an action having a large number of class members.

Unless the addition of extensive members is particularly costly, hybrid class actions reduce the social cost of litigation per intensive-class-member. In this case, defendants and the court system also benefit from cost reductions, although not by as much as for intensive class actions.

3.6 Wider economic implications of class actions

3.6.1 Deterring small but widespread harms is likely to have wider implications for confidence in markets

The discussion of extensive class actions focused on the efficiency gains from increased deterrence of skimming activity, which may bring about wider social benefits such as improving confidence in markets, in turn increasing opportunities for business and flow-on benefits in terms of overall economic performance.

Sims (2019), for example, argues that misleading and deceptive conduct – which typically impose small harms on large numbers of consumers – can undermine trust in the operation of markets, discouraging participation and reducing opportunities for mutually beneficial gains from trade. If the conduct is allowed to go undeterred, it may lead to a 'race to the bottom,' where other firms are encouraged to engage in similar practices, further reducing participation in markets, and undermining the key tenets of liberal market economies like New Zealand.

3.6.2 Implications for innovation, productivity and New Zealand's economic performance

Improving productivity requires innovation, which involves businesses experimenting by trialing new technologies and processes, failing, and refreshing their experiments until they have discovered what works well. Experimentation and failure can be very costly, and so businesses need to experiment thoughtfully and with discipline (CSA, 2019a, pp. 11-13).

Fundamentally, then, it is successful innovation by New Zealand businesses that collectively drives the productivity of the wider economy. It is critical the civil litigation system fosters disciplined innovation and avoids punishing businesses for reasonable trial and error decisions and processes.

Posner (1988) and Cooter & Ulen (2016) discuss how various product liability standards encourage businesses and consumers to optimally trade-off the cost of harm reduction with the cost of harm. In short, different standards are efficient in different circumstances. In some circumstances it is efficient for businesses to be discouraged from risky activities and in other circumstances not. There is not any cardinal rule that favours innovation and risk-taking no matter the consequences and circumstances.

However, the important point for our analysis is that courts apply the same liability rules regardless of the choice of legal vehicle for pursuing claims. It does not matter whether claims are pursued through class actions or individual actions. If existing law works well for claims made under individual litigation then there is no reasonable basis to argue the same laws should not be able to be enforced through class actions. And if existing law is not working well, then that is an argument for changing the law, not for inhibiting wronged parties from accessing the justice system through class actions.

Putting aside strategic behaviour issues, intensive class actions cannot create any additional costs and risks for business defendants as their class members would take individual litigations anyway. Provided strategic behaviour is addressed effectively, then there isn't anything to see here.

As discussed in section 3.4.2, extensive class actions will make deterrence incentives more efficient for activities prone to creating small harms across large numbers of people. In the absence of extensive class actions, these types of wrongdoers face zero deterrence incentives from civil litigation as none of the wronged persons has sufficient value at stake to pursue litigation.

Without these class actions, the wronged parties are reliant on public agencies to pursue enforcement actions on their behalf. Provided public agencies do their enforcement role well, and forward any damages to the wronged parties, then wronged parties have no reason to form a class action to litigate. In general, putting aside concerns about strategic behaviour, there does not seem to be any reasonable innovation and productivity arguments for inhibiting wronged parties from accessing the justice system through class actions.

3.7 Concluding comments

The previous sections have provided, in some detail, a first-principles analysis of how class actions may affect access to justice, the efficiency of civil litigation, and implications for efficient deterrence, innovation and New Zealand's productivity performance.

Our high-level conclusion is that class actions are very likely to improve access to justice and may improve efficiency

Without the problems discussed above, the general conclusion is class actions are very likely to improve access to justice and may improve efficiency. This is illustrated in Table 3 (next page), which summarises the equity and efficiency effects of class actions assuming the principal-agent problems (aka supervision incentive problems) and strategic behaviour problems are addressed effectively.

Table 3 focuses on productive efficiency, as increases in productive efficiency are sufficient for increasing overall efficiency and social welfare. However, as discussed above and summarised in the table, class actions do not necessarily improve productive efficiency, limiting our conclusions about efficiency. A quantitative cost-benefit assessment is likely to provide a clearer view on the overall efficiency effect, if robust empirical parameters are available.

Table 3: Summary of equity and efficiency implications of class actions

Type of class action	Equity implications		Implications for productive efficiency		
	More equitable access to justice	Costs spread evenly	Lower social costs	More precedents	More efficient deterrence
Intensive	-	✓	✓	x	-
Extensive	✓	x ?	x	✓	✓
Hybrid	✓	✓ ?	✓ ?	x ?	?

? No conclusion can be drawn without further empirical evidence

✓ ? Probably a positive answer and x? means probably a negative answer

As argued earlier, the primary focus should be on the evaluations for the extensive and hybrid class actions as intensive class actions will occur rarely. The primary negative with extensive class actions is that they foster socially unprofitable litigation – that is, litigation for which the social costs exceed the net social benefits. In CSA’s view, the uneven spread of costs is not as important as the other criteria, as that is a characteristic of most policy initiatives. That is, it is unusual to find policy initiatives where the costs are spread evenly. Hybrid class actions score positively on all criteria bar the issue of precedents.

Outstanding issues can only be sensibly evaluated when more details have been developed

The big caveat to the above conclusion are the outstanding principal-agent and strategic behaviour issues, where the former refers to weak supervision incentives/capabilities and the latter includes concerns about blackmail claims and also nuisance and meritless claims.

In regard to weak supervision, effective mechanisms have evolved to address exactly the same problem affecting widely-held companies, and CSA sees no reason to think an effective solution cannot be found for class actions. The strategic issues seem more intractable, as the general approach with respect to monopoly business entities is to have an independent agency regulate them. But that has not come without its own problems and is no panacea. Section 5 discusses high-level regulatory options for addressing these issues.

4 The economics of litigation funding

As mentioned in the Introduction, the Commission defines **litigation funding** as funding by a third-party with no pre-existing interest in the litigation, excluding civil legal aid. This funding is usually provided in exchange for a fee if the litigation is successful and nothing if the action is lost.

The Commission is examining litigation funding generally, rather than solely in regard to class actions. In keeping with this approach, this paper tends to discuss the implications for litigation generally and then in regard to class actions.

The analyses in sections 2 and 3 assumed all litigants were risk neutral and plaintiffs had sufficient wealth or credit to finance any PEV claim. Of course, in practice many plaintiffs will be credit-constrained and/or risk averse, and most will have imperfect information about the quality of lawyers available to them and their chances of success. By alleviating those situations, litigation funding offers efficiency gains and more equitable access to justice. However, on the flipside it introduces another party to the transaction, increasing transaction costs and divergent motives and incentives.

Drawing on the economic framework in section 2, this section considers in broad terms the benefits and detriments of litigation funding. Section 4.1 outlines the key economic features of ordinary litigation funding arrangements, and then sections 4.2 – 4.4 analyse the efficiency benefits, detriments, access to justice effects. Section 4.5 provides concluding comments.

The legal torts of maintenance and champerty are highly relevant for legal and policy discussion of litigation funding. However, as CSA was tasked with considering the economics of litigation funding to assist the Commission with its analysis, this paper leaves the legal issues to the Commission.

4.1 The key economic features of litigation funding and close substitutes

The key economic features of litigation funding are discussed in section 4.1.1, and contrasts and parallels with the main substitutes are covered in sections 4.1.2 (conditional fees), 4.1.3 (contingency fees) and 4.1.4 (insurance).

For close substitutes, the plaintiff retains her legal claim and receives financing to assist with carrying out the litigation. However, more distant substitutes are also available in situations where parties can transfer some or all of their legal rights to a third party, such as occurs for insurance contracts with subrogation clauses. In some jurisdictions, legal claims can be sold to third parties, who are then free to pursue litigation against wrongdoers. These developments have led to debate in the law and economics literature about the pros and cons of markets for legal claims.

4.1.1 The key economic features of litigation funders and funding arrangements

In this paper, litigation funding provides finance to cover the costs of litigation in return for a share of recoverables. The funding is provided on a non-recourse basis, which means the financier has no rights to the plaintiff's other assets if the case is lost. Throughout the paper, we assume funders are not a party to the litigation.

The allocation of risk depends on which types of costs are covered by funding, any limits on that coverage, and the allocation of decision rights, for example in regard to litigation and settlement decisions.

The economic effects of litigation funding depend on whether funders play a passive or active role in the conduct of litigation. The economic detriments largely arise when funders have an active role, however

activism also brings economic benefits too. To provide clarity on these issues, section 4.2 assumes funders are passive participants and section 4.3 assumes funders are active participants.

Passive funding has strong parallels with equity stock options and active funding has strong parallels with venture capital financing

At a high level, passive funding can be likened to equity funding of a widely-held company, where the shareholders have no decision rights over the management of the business and stock options are granted to a salaried chief executive. In effect, litigation funding covers the plaintiff's legal costs, leaves them with the equivalent of "stock options" and the funder has no decision rights over the conduct of the litigation. The stock options give the plaintiff the right to exercise her option for a share of payoffs when they are positive but no obligation to exercise the option if the payoffs are negative.

Steinitz & Field (2014) believe venture capital arrangements provide an apt analogy for litigation funding, because venture capitalists and funders face similar risk profiles for individual investments and rely on their portfolio of investments to diversify risks and earn an overall return. Also, in both cases the success of each investment depends greatly on the efforts of others (entrepreneurs, the plaintiff and her lawyer), and there is significant information asymmetry and mis-aligned interests, creating significant agency problems in both cases.

In CSA's view, the 'equity plus stock options' analogy is apt for passive funders and the venture capital analogy is apt for active funders.

Litigation funders are repeat players with specialised expertise

Steinitz & Field (2014) suggest that funders are typically founded and managed by lawyers with expertise in litigation. Their expertise, and their interest in an ongoing business, provides active funders with strong bargaining capabilities in relation to understanding the law, litigation tactics and engaging with the plaintiff's lawyer. These factors may bring substantial efficiency benefits or detriments, depending on whether they improve or worsen principal-agent problems (covered in section 4.3).

Litigation funding arrangements for class actions

As above, funding for class actions can also be categorised according to whether the funder has a passive or active role in litigation decisions. In general, funders take a more active role in class actions because the representative plaintiff has weaker monitoring and directorial incentives than normal plaintiffs.

In class actions, the representative plaintiff is usually formally responsible for meeting adverse costs if the case is lost. However, in practice the representative plaintiff is usually indemnified by whoever is funding the case.

In this paper we assume the representative plaintiff is formally responsible for approving all settlements and funding agreements on behalf of the class. In effect, class members are the principal, and the class lawyer and representative plaintiff are their agents.

4.1.2 Conditional fees mean law firms may provide bundled legal and financial services

Self-funding of litigation involves plaintiffs drawing down their liquid assets or taking out interest bearing loans of some form to pay for the litigation costs allocated to them. The plaintiff's risk depends on the arrangements in place for her lawyer's fees and on the extent that courts implement cost-shifting (refer section 2.3.3).

Conditional fees provide a limited amount of litigation finance

As discussed in section 2.3.4, New Zealand lawyers are allowed to charge conditional fees, which is where plaintiffs pay their lawyer's fees (plus an *uplift for risk*) if the case is won at trial or if the plaintiff agrees a settlement with the defendant.

In these cases, law firms are providing a bundled service (i.e. legal and financial services) to their clients. Without other available sources of finance for plaintiffs, law firms have incentives to offer conditional fees to increase demand for their services. Although this transfers risks from clients to the law firm, large law firms diversify their risks by running a portfolio of litigation (Trebilcock & Kagedan, 2014, p. 55).

Conditional fees do not usually cover all of a plaintiff's litigation costs and risks. For example, they do not typically cover a plaintiff's personal costs from pursuing a legal action, such as perhaps any income forgone from work and additional 'out of pocket' expenses such as for travel, and so on. In addition, they generally do not cover adverse costs from cost-shifting.

Credit constraints are likely to be particularly relevant for large class actions, such as tends to occur with extensive and hybrid class actions. The larger the class size, and the greater the diversity of class members and legal issues, the larger the litigation costs. Some law firms may be unwilling to offer a conditional fee arrangement and if the action is lost then the representative plaintiff would be left with large defendant costs too.³³

Conditional fees may modestly reduce or exacerbate principal-agent problems

As discussed earlier, principal-agent problems arise from the concurrence of information asymmetry and conflicting interests between the lawyer and client. These problems matter because the quality of the lawyer's advice, and the diligence with which they carry out their client's instructions, may influence the timing and size of the net pay-outs to the lawyer (and the client).

Principal-agent problems exist regardless of the fee structure adopted, but the fee structure can certainly affect the nature and severity of the problem. The following paragraphs discuss conditional fees relative to charging standard hourly fees on an hours-worked basis.

In principle, conditional fees may better align lawyer-client interests by aligning the circumstances of the lawyer's pay-out with circumstances in which the plaintiff receives a positive pay-out. However, as with all incentive schemes, 'the devil is in the detail'. The detail in this case is that often the lawyer and client face very different net marginal benefits and risks from litigation decisions.³⁴

In particular, the lawyer's net marginal benefit from a litigation decision depends on the accuracy of the uplift for risk and on the lawyer's opportunity cost of hours worked. If the uplift is accurate and the lawyer has other billable work available at standard rates, then the lawyer faces a zero net marginal benefit and has no financial incentive to act contrary to the client's interests. The same occurs for standard hourly fees when the lawyer has the opportunity to undertake other billable work at the same hourly rates.

However, if the uplift is inaccurate then the net marginal benefit could be positive. A positive net marginal benefit over-rewards litigation decisions that involve more billable hours, and the converse occurs if the lawyer's net marginal benefit is negative.

³³ Presumably a class action may sometimes be initiated by a wronged person with sufficient wealth or credit to cover all of the costs, and so that person becomes the representative plaintiff and self-finances the class action. But this will not necessarily be the case.

³⁴ Net marginal benefit equals marginal benefit net of marginal costs, where marginal costs in this case are largely opportunity costs. Unless lawyers have no billable work to proceed with for other clients, then their hourly opportunity cost can be very high due to forgoing their normal hourly fee or forgoing work on another conditional fee contract.

In general, relative to hourly fees, conditional fees may modestly reduce or exacerbate conflicts of interest with clients. The main caveat to this conclusion is in relation to the lawyer's willingness and capacity to absorb risk. If the lawyer becomes very risk averse, perhaps due to cashflow issues or a sudden loss of reputation in the market, then conditional fee arrangements may greatly exacerbate conflicts of interest with clients.

4.1.3 Contingency fees have strong parallels with litigation funding

The Lawyers and Conveyancers Act 2006 prohibits lawyers charging contingency fees in New Zealand. Nevertheless, it is worth briefly mentioning them as most of the international literature on litigation funding assumes contingency fees can be charged.

Contingency fees can create far stronger conflicts of interest than conditional fees

Contingency fees are similar to conditional fees in one respect, and that is they are both charged only if the litigation is successful. But contingency fees differ fundamentally, as the lawyer is paid a percentage of the damages or settlement, rather than paid an uplift based on billed hours. This greatly affects the net marginal benefits lawyers may receive, making them materially different from conditional fees.

Unlike with conditional fees, contingency fees create incentives for lawyers to care about how their advice and actions affect the timing and size of damages or settlements (as they are paid on that basis), and also to care about the opportunity cost of their litigation decisions (as their fees are not a function of hours worked). In general, relative to hourly fees, contingency fees may reduce or exacerbate conflicts of interest with clients.

Contingency fees have much stronger parallels with litigation funding than conditional fees

From a financing perspective, contingency fees have strong parallels with litigation funding, as they are both specified as a proportion of damages and settlements and the funder pays for the plaintiff's litigation expenses, including the hourly fees charged by her lawyer.

However, a key difference is that contingency fee arrangements bundle together the legal and financial services. On one hand, this may have the advantage of leveraging the lawyer's fiduciary duty to her client to cover the financial component of the service. On the other hand, it may have the disadvantage of increasing the financial conflicts faced by the lawyer, potentially reducing the willingness of some lawyers to faithfully discharge their fiduciary obligations to the plaintiff.

Relative to contingency fees, litigation funding brings another source of expertise into the equation, and also another suite of potential conflicts arising from funder's objective to maximise profit for the benefit of its shareholders. These issues are explored further in section 4.3.

4.1.4 Insurance companies also finance plaintiff litigation

Insurance companies offer legal-expenses insurance to both plaintiffs and potential plaintiffs. After-the-event (ATE) insurance covers situations where an event causes a party to take legal action against a known wrongdoer. Before-the-event (BTE) insurance may also be available to potential plaintiffs.

ATE is typically used to cover the risk of adverse costs from losing a proceeding, under the assumption the plaintiff's legal costs are covered by a conditional fee arrangement. ATE insurance can also cover the plaintiff's own expenses, and in some cases it can cover the plaintiff's legal costs if a conditional fee is unavailable. The insurance premium is charged only if the plaintiff is successful; essentially the same arrangement as litigation funding.

Steinitz & Field (2014) note important differences between litigation funding and legal expenses insurance. The insurer can subrogate the insured, which means control of the legal case transfers to the

insurer. Also, in contrast with litigation finance, insurance is a heavily regulated industry, with capitalisation requirements that ensure they can fulfil their obligations.

However, there are some parallels for active litigation funding, in regard to issues around lawyer-client privilege, control over selection of the lawyer and over settlement decisions, and also asymmetric information regarding detailed knowledge of the event and around securing effective cooperation from a plaintiff. These parallels need to be kept in mind when considering the principal-agent problems covered in section 4.3.

4.2 Passive litigation funding is likely to create significant efficiency benefits

As mentioned in the previous section, the economic effects of litigation funding depend on whether funders play a passive or active role in the conduct of funded litigation. The analysis in this section assumes funders are passive participants.

4.2.1 The counterfactual for this analysis is zero third-party litigation funding

The counterfactual for this analysis is zero third-party litigation funding. This approach is similar to the counterfactual for class actions, as it allows a first-principles analysis of the potential economic benefits and detriments of litigation funding.³⁵

The counterfactual also assumes zero funding from litigation expenses insurance. This approach has been adopted because insurance without subrogation is a close substitute for passive funding and insurance with subrogation is a close substitute for active funding.

The counterfactual includes hourly and conditional fees. The analysis in section 4.1 suggests conditional fee arrangements, if well calibrated for risk, should generally have similar impacts on principal-agent issues as hourly fee arrangements, and so we assume no differences in that regard. The counterfactual also includes cost-shifting but excludes contingency fees.

We assume legal action occurs in the counterfactual to the extent plaintiffs can afford the fees they are charged and any adverse costs ordered by courts. This also applies to class actions – that is, they occur if a representative plaintiff can afford the fees and adverse cost orders arising with those actions.

4.2.2 Litigation funding alleviates credit constraints

In this section not all plaintiffs can access enough savings or credit to fund a PEV legal claim. Clearly, the amount of credit a plaintiff needs depends on their lawyer's fees and the size of any adverse costs. These cases are variously referred to as the "poor plaintiff" or "access to justice" scenarios in the law and economics literature.

Alleviating credit constraints allows some PEV cases to be pursued that would not have been pursued

Credit-constrained plaintiffs are plaintiffs who cannot self-finance all of their litigation if they wish to do so, where self-finance includes access to credit from traditional sources. *Unconstrained plaintiffs* are plaintiffs that can fully finance their litigation.

³⁵ A more complicated counterfactual would be needed for a quantitative assessment of the costs and benefits of altering litigation funding rules.

Heaton (2019) shows that fully-informed **risk-neutral plaintiffs** will only accept funding for PEV cases if they are credit-constrained. Intuitively, as funding requires the plaintiff to share some of her surplus from winning a case, she will only do so if the funder provides some additional value to compensate her for forgoing some of her surplus. But for fully-informed risk-neutral plaintiffs, the funder in Heaton's model can only provide additional value if the plaintiff is credit constrained.³⁶

Funding allows some unconstrained PEV cases to be pursued that the plaintiff believes are NEV

An interesting situation arises where the plaintiff is relatively pessimistic and believes her case is NEV. A *relatively pessimistic plaintiff* is a plaintiff who has a lower subjective probability of success than believed by one of the other parties, e.g. the funder or defendant.

Because of their wider experience and more specialised knowledge of litigation, a funder may assess some NEV cases to be PEV and offer funding to the plaintiff for those cases. The plaintiff will accept the funding offer as she has nothing to lose (Heaton, 2019).

Intuitively, the plaintiff thinks the case is NEV because she has pessimistic probability beliefs and so she will not pursue it regardless of whether she is credit constrained or not. But provided the funder agrees to cover all of her litigation costs, then she has "nothing" to lose if she is unsuccessful and will receive some of the proceeds in the event the case is won.³⁷

It is useful for later discussion to refer to these cases as *perceived-NEV*, to indicate a more informed assessment makes them PEV.

Class actions are more likely to receive funding than individual actions

Credit constraints are more likely to arise for costly litigation, and this is particularly likely to occur for class actions as class members are not normally required to contribute funds to the action, leaving the funding burden with the representative plaintiff. This suggests class actions are more likely to be funded by third parties than individual actions.

Litigation funding may displace self-funding for cases that would have been pursued anyway

The above analysis identified that funding would only occur in two circumstances: either the plaintiff was credit-constrained or the plaintiff was overly pessimistic relative to the funder. In both cases, funding would occur only to the extent the plaintiff is credit-constrained in the first circumstance and only for perceived-NEV cases in the second circumstance.

These results reflect a restriction Heaton (2019) imposes on the rewards from funding, which is that plaintiffs do not receive any inducements or additional benefits from funding during litigation. The funding just covers litigation costs.

However, in practice funding may provide additional benefits. For example, Kidd (2016) reports claims that funding provides plaintiffs with more resources and time to bargain during settlement negotiations, without the anxiety of tight budget constraints. Similarly, de Morpurgo (2011) reports claims that funding may provide additional benefits during negotiations if it bolsters the plaintiff's credibility of proceeding to trial and judgment. In these situations, litigation funding may displace self-funding of PEV cases that unconstrained plaintiffs would have pursued anyway.

³⁶ This analysis ignores cost-shifting, however the same results will occur with cost-shifting. de Morpurgo (2011, pp. 373-5) provides a more rudimentary analysis, covering cost-shifting and non-cost-shifting scenarios.

³⁷ The quote marks in the sentence are intended to acknowledge the plaintiff will still need to be actively involved in the case, and so may incur some personal costs such as time preparing and time away from work.

4.2.3 Litigation funding reduces risk for plaintiffs

A person is **risk averse** if she prefers to receive less 'money in the hand' than the expected value of a gamble. For example, suppose a person is offered a gamble in which she has a 50% chance of winning \$100 and a 50% chance of winning nothing. The expected value of the gamble is \$50. A risk-averse person is someone that prefers to receive less than \$50 (e.g. \$40), rather than gamble.

Risk aversion does not just apply to individuals. Small- and medium-sized enterprises (SMEs) can also be risk averse, especially if they are owner-operated, have limited retained earnings or liquid assets, and/or its managers are highly specialised in a small market. Risks can be large relative to a firm's capacity to absorb adverse shocks, and so even large corporates take out insurance to cover their risks.³⁸

Some risk-averse investors perceive their PEV cases to be NEV

Using their own funds or lines of credit to finance a PEV case will often be a significant gamble for plaintiffs, as they may be left with zero damages and large costs relative to their self-financing capacity. Whereas risk-neutral plaintiffs will pursue legal claims whenever they are PEV, risk-averse plaintiffs require PEVs well above zero; that is, their threshold PEV exceeds zero.

Business investment provides a useful analogy. Business investors require the expected returns on investment proposals to exceed their hurdle rate of return before they will consider investing. The more risk-averse the investor, the higher the hurdle rate of return they require (over and above returns on risk-free assets). Investments below their hurdle rate of return are viewed as subtracting value from their business; that is, they are negative value investments.

The same applies to risk-averse plaintiffs: the more risk averse they are, the higher their threshold PEV, and any cases with PEVs below their threshold level are, in their eyes, NEV cases. It is useful to include these cases in our concept of *perceived-NEV cases*, in this case to indicate they are PEV cases when evaluated on a risk neutral basis. Hence, we use *other-PEV* to refer to all other PEV cases.

Funding will often be used for perceived-NEV cases

Litigation funders have portfolios of cases and their owners may also have diversified investments and interests. Funders also have considerable expertise in litigation and judging the expected value of cases. As a result, they are likely to be less risk averse with respect to litigation than many plaintiffs. This means perceived-NEV cases for plaintiffs can be PEV cases for litigation funders.

The previous section focused on risk-neutral plaintiffs, and showed that unconstrained plaintiffs may accept litigation funding if they believe they have an NEV case but the funder believes it is PEV. In a straight-forward extension of this result, Heaton (2019) shows the same result applies for unconstrained risk-averse plaintiffs, for the same 'nothing to lose' reasons provided in the previous section.

Heaton (2019) also shows that litigation funding allows the plaintiff to make litigation decisions as if she were risk neutral. This is likely to be particularly significant for costly litigation, because the larger the risk relative to a party's ability to absorb it, the higher the risk aversion.

Risk aversion may be a significant factor driving litigation funding of class actions

Representative plaintiffs are usually required to pay a significant portion of defendant's costs if their class action is unsuccessful after a hearing. As this risk is typically large, class actions will often be perceived-NEV by potential representative plaintiffs. By removing that risk, funding may make many potential class

³⁸ In theory, companies should not be risk-averse as their shareholders can diversify away the non-systematic risk component of its future profits, but almost all companies hold insurance for various risks.

actions high-PEV cases in the eyes of the representative plaintiff. Hence, once again it should not be surprising to observe litigation funding being weighted towards class actions.

Litigation funding may displace self-funding for cases that would have been pursued anyway

The above analysis identified risk-aversion as a reason why funders may provide value to plaintiffs, and it reported results from Heaton (2019) that funding would only be accepted for perceived-NEV cases. That is, risk averse people with PEV cases would not accept funding. These results reflect a restriction Heaton imposes on the rewards from funding, which is that plaintiffs do not receive any inducements or in-kind benefits from funding during litigation. The funding just covers litigation costs.

However, for many plaintiffs carrying the risk of litigation for the period of litigation could be very costly if it distracts them from focusing on high-return activities. For example, top sports people need to remain focused on their 'day job' to remain successful, and so they will typically hire others to manage matters that are distracting to them or contract in the required service.

Similarly, litigation funding may allow many businesses to keep their managers focused on the company's core business, as they do not have to worry about adverse financial outcomes from litigation.³⁹ This could be particularly valuable to businesses facing significant shocks from litigation and who do not have in-house legal expertise or trusted external legal counsel.

In effect, litigation funding may provide an 'internal dividend' during the litigation process, by facilitating greater specialisation of activity compared to self-funding of litigation. This reduces the plaintiff's personal cost of litigation, or the in-house cost of litigation if the plaintiff is a business. In these situations, plaintiffs will choose litigation funding for PEV cases, displacing the self-funding they would have used to undertake the case. This displacement improves productive efficiency (refer section 4.2.5).

4.2.4 Litigation funding may increase choice and competition in the legal services market

By offering conditional fees to plaintiffs, law firms are offering a bundled legal/financial service. They do this because it enables some credit-constrained and/or risk-averse plaintiffs to pursue litigation, increasing demand for their legal services.

Clearly, the larger the number of conditional-fee cases served by a firm, the greater the diversification of the risks with providing conditional fees. Smaller litigation practices will be less diversified, making it riskier for them to offer conditional fees for larger litigation, or if they do offer to handle the litigation, riskier for them to offer competitive fees.

Litigation funding unbundles the legal and financial services, making it easier for smaller litigation practices to compete with larger practices. This increases the choice of legal services available to plaintiffs, putting competitive pressure on legal fees charged by incumbent suppliers of bundled services.

In addition, litigation funding covers a broader range of costs than conditional fees, enabling more credit-constrained and/or risk-averse plaintiffs to pursue litigation than situations where only conditional fees are on offer. This may also facilitate competitive supply by smaller practices. For example, if consumers and SMEs are more credit-constrained than larger corporates, then the limited cost coverage with

³⁹ Although companies may be risk neutral when viewed as a vehicle for shareholders, the company's managers may be risk averse. They may perceive that large adverse financial outcomes are punished more severely than positive outcomes are rewarded, and so they strive to avoid adverse outcomes that may harm their career within the company.

conditional fees may disproportionately disadvantage smaller-value clients. If litigation funding opened up more of this market it may benefit smaller litigation practices relative to larger practices.

4.2.5 Efficiency benefits from passive litigation funding

The previous subsections discussed the impact that passive funding may have on credit-constrained and risk-averse plaintiffs, and on litigation activity generally. In both situations, litigation funding displaces self-funding of some cases that would occur anyway (a *displacement effect*) and it results in some cases being pursued that would not otherwise be pursued (an *increment effect*). The increment effect may crowd out other litigation that would have proceeded (a *crowding out effect*), resulting in net increase in litigation (a *net increment effect*).

This section considers the efficiency consequences of these effects, and then discusses the efficiency gains arising from greater choice and competition in the legal services market. Often a first-principles analysis is unable to conclude an initiative will improve efficiency overall, and that is also the case for litigation funding. However, we can make categorical statements about productive efficiency, which we define in Box 3 below.

The definitions in Box 3 are presented in regard to goods and services. In regard to litigation, the services are provision of justice for victims, and provision of deterrence incentives and precedents for society.

Box 3: Key efficiency concepts relevant for this analysis

Productive efficiency occurs when a given service level is produced at lowest social cost, or equivalently, when maximum service is produced from a given social cost of inputs. An improvement in productive efficiency occurs when the same service levels are produced for a lower social cost.

Pareto efficiency occurs when no one can be made better off by reallocating resources without making someone else worse off. Pareto efficiency requires productive efficiency plus a requirement that all gains from trade have been exploited (i.e. at prevailing prices, no two individuals would like to trade their allocation of goods and services with one another).

Efficiency (aka. overall efficiency) occurs when resources cannot be reallocated in a way that would allow the gainers to be better off even if they compensated any losers to leave them no worse off. Importantly, the comparison of gains versus losses is hypothetical, as the gainers do not necessarily have to compensate the losers. An increase in efficiency increases **social welfare** when social welfare is defined as the sum of everyone's utility.

Broadly speaking, increasing productive efficiency is sufficient to increase Pareto efficiency, as more services can be provided to some consumers without reducing services to anyone else. Likewise, increasing Pareto efficiency is sufficient to improve overall efficiency, as someone is made better off while no one else is made worse off and so no compensation needs to be contemplated. Both statements ignore the effects of envy, which is where someone feels worse off because someone else has gained something they have not gained.

Litigation funding displaces self-funding, which improves productive efficiency

As mentioned in section 4.2.3, transferring risk from the plaintiff may displace self-funding for some litigation that would have occurred anyway (a *displacement effect*). This can occur in situations where the funding allows a plaintiff, for example, to concentrate on their core business rather than spend their time overseeing and managing the risks of litigation.

The displacement effect improves productive efficiency because (a) it facilitates greater specialisation of business activity and (b) as the plaintiff was going to litigate anyway, there is no reduction in access to justice, and no loss of deterrence or precedents. In the litigation funding literature, the displacement effect is sometimes referred to as achieving greater capital efficiency.

Note, a similar displacement effect was identified in the discussion on credit constraints (section 4.2.2). However, in that case the displacement occurs because it improves settlement negotiations for the plaintiff, which is mostly about wealth transfers between plaintiff and defendant. Hence, as in section 2.2.4, first-principles analysis does not provide clear indications of the efficiency effects of policies that affect settlements.

Litigation funding results in some litigation crowding out other litigation, improving productive efficiency

As discussed earlier, alleviating credit constraints and transferring risk from plaintiffs is likely to result in some plaintiffs pursuing litigation that they otherwise have not pursued (increment effect). This increment effect has two flow-on effects:

- a *crowding-out effect*: this occurs when resource constraints in the legal and justice system result in funded litigation crowding-out self-funded litigation
- a *net increment effect*: this is the net increase in litigation overall, after accounting for crowded-out litigation.

Crowding out occurs if the supply of legal and justice system resources do not adjust fully to increased demand for legal redress. At one extreme, if the supply side adjusts fully in the long run, then there's no crowding out and the net increment effect matches the increment effect.

At the other extreme, suppose no additional resources are provided to the justice system to cater for the additional demand for hearings. At first glance, a fixed amount of resources implies 100% crowding out, but that is not necessarily the case. Crowding out will be less than 100% if the additional litigation leads to higher legal fees, longer waiting times for hearings and higher rates of settlement:

- The higher fees reduce demand for litigation, with some of the reduction due to substitution to ADR services and some of it reflecting decisions not to pursue redress of any kind. Law firms increase lawyer salaries to attract more people to train and become litigators, increasing the supply of litigation services. The net effect is likely to be less than 100% crowding out of incumbents.
- The longer hearing wait times, and higher legal fees, increases the costs to litigants of going to hearing versus agreeing a settlement, and so a higher number of cases are settled. It is also possible that with longer wait times, poorer scrutiny of cases occurs leading to more judgment errors (Kidd, 2016). Once again, the net effect is likely to be less than 100% crowding out.

Rather than these extremes, it is likely governments will respond to longer hearing waiting times by increasing the resources available to the justice system. In this case, crowding out is likely to be positive (but significantly below 100%) in the long run.

The crowding out effect is very likely to improve productive efficiency because at least one of the service levels can be produced at a lower social cost without affecting the provision of the other services. For example, deterrence incentives can be produced at a lower social cost without affecting access to justice or precedents.

To see this, recall that deterrence incentives arise from the damages wrongdoers expect to face if their behaviour is found liable. Consider each legal proceeding's damages and express those damages as a ratio of the social costs incurred to litigate those damages (the *damage ratio*). Clearly, the higher the damage ratio the greater the productivity of litigation for producing deterrence incentives.

To continue the analysis, imagine stacking all litigation in order from lowest to highest damage ratio. Alleviating credit constraints allows some litigation to proceed that would not proceed without litigation funding. It is extremely unlikely that all of this (newly) funded litigation would sit at the bottom of the

stack. Provided at least one of the funded proceedings has a higher damage ratio than a self-funded litigation, then the same level of damages (deterrence incentive) can be produced for lower social costs.

As one legal proceeding was swapped for another, the number of proceedings is unchanged and so aggregate access to justice has not changed. Without knowing the legal details of each proceeding, there is no reason to presume the replaced litigation was more likely to contribute to precedents than the added proceeding, and so, *a priori*, the production of precedents is unaffected.

Net increment effect: Alleviating credit constraints may or may not improve efficiency overall

The second component of the increment effect is the *net increment effect*. This is the net increase in litigation due to litigation funding, after taking into account the crowded-out litigation.

However, a first-principles analysis cannot categorically determine whether the net increment effect increases or reduces productive efficiency or overall efficiency. This is because the overall increase in litigation increases social costs and potentially increases net social benefits, and we do not know *a priori* which effect is the largest. Net social benefits potentially increase because an increase in litigation increases deterrence incentives and precedents.

However, an argument could be made that if government increases justice system resources to avoid an increase in waiting times for trials, then the government – on behalf of society – values that outcome more highly than the other outcomes it could have purchased with its funding. In that sense, the increased litigation improves society's welfare overall (i.e. improves *overall welfare*).

Greater choice and competition increases efficiency overall

The above analysis focused on credit-constrained and risk-averse situations. As discussed in section 4.2.4, litigation funding may also increase choice and competition in the legal services market, which can be expected to yield efficiency gains too.

Concerns about increased frequency of nuisance and meritless claims are not greatly supported by economic analysis

Opponents of litigation funding often express concerns that more funding will increase the frequency of frivolous or meritless claims. These discussions often use those terms rather loosely and typically with negative connotations.

The following is a brief sample of definitions of frivolous or meritless claims from other sources:

A frivolous claim, often called a bad faith claim, refers to a lawsuit, motion or appeal that is intended to harass, delay or embarrass the opposition. A claim is frivolous when the claim lacks any arguable basis either in law or in fact (<https://www.law.cornell.edu/wex/frivolous>)

... a *frivolous* case is one that has no support in existing precedent, either directly or as a reasonable extension. Every lawsuit is subject to some uncertainty, so the existence of uncertainty regarding the outcome cannot be the standard; instead, a lawsuit is frivolous if a truly ethical lawyer could not attest that the claim meets the requirement of Rule 11 (Kidd, 2012).⁴⁰

In general, the economic analysis of litigation funding is not supportive of concerns about frivolous or meritless claims. In essence, litigation funders are in the business of making profits from financing litigation, and so funding frivolous or meritless claims would mean investing in unprofitable claims (ie, claims with low probabilities of success). In CSA's view, as funders have an ongoing presence in the market, they face strong financial and reputational incentives to avoid meritless actions.

⁴⁰ Rule 11 refers to Rule 11 in the Federal Rules of Civil Procedure, which govern civil proceedings in the United States district courts.

The earlier conclusions that plaintiffs will accept funding for perceived-NEV claims does not imply those claims are lacking in merit or are frivolous. This is because claims can be low-PEV or NEV if they are costly to litigate. In other words, these claims may still be meritorious in the sense of having a good probability of victory, but litigation costs may be high relative to potential damages.

Kidd (2016) considers the issue of frivolous or meritless claims in quite some detail, and identifies the possibility that funders may seek to exploit the fact that courts are imperfect at screening out frivolous or meritless claims. In CSA's view, if this is a serious concern then additional resources could be directed at improving screening processes and decisions, as the economic benefits from litigation funding are likely to dwarf the additional screening costs.

Trebilcock & Kagedan (2014) express concern that litigation funding may subvert the role of cost-shifting in discouraging less meritorious and speculative claims. They state “[b]y repackaging the risk as a long-term investment in a diversified portfolio, third-party funders may undermine this element of civil procedure, although only for profitable claims attractive to third-party investors.”

However, in CSA's view, Trebilcock & Kagedan are making too much of the 'long-term diversified portfolio' aspect of third-party funding. Minimising the risk of adverse-cost awards by carefully selecting cases will be one of the most fruitful ways for funders to maximise portfolio profits. Although the funder's portfolio may be long-lasting, shareholders in the fund will certainly be interested in the short-term returns on their investments. Indeed, in discussing other matters in relation to litigation funding, for example, Steinitz & Field (2014) express concerns that publicly-traded funders may have short-termism problems, being evaluated on a quarterly performance basis.

4.3 Active litigation funding brings other efficiency benefits and detriments as well as the efficiency benefits provided by passive funding

The above analysis focused on passive funding because it enabled a clear focus on the economic benefits of litigation funding absent principal-agent issues that arise with active funding. The results of this analysis apply equally to active funding, but other benefits and detriments also arise with active funding.

In practice, a mix of passive and active litigation funding is likely to occur in New Zealand. For example, reviewing the impact of litigation funding on Canadian class actions, Trebilcock & Kagedan (2014) assume funders have minimal involvement with class lawyers when funding covers adverse costs, and quite an active role when their funding extends to financing the class lawyer's fees and disbursements.

In regard to active funding, some authors take the view that funders improve lawyer performance by monitoring them better than plaintiffs would do. However, other authors express concerns and examples of active funders exacerbating principal-agent problems between the funder and lawyer, and between plaintiff and lawyer (Steinitz & Field, 2014). Sections 4.3.1 to 4.3.3 cover these arguments in more detail, and section 4.3.4 discusses the efficiency implications.

4.3.1 Under certain assumptions, litigation funding may reduce legal representation costs

Section 2.3.4 discussed principal-agent problems, explaining they arise from the concurrence of information asymmetry and conflicting interests. Information asymmetry arises in regard to the quality and skill attributes of lawyers and in regard to difficulties observing their actions and effort.

Active funders may bring significant knowledge and monitoring advantages to litigation decision-making, reducing principal-agent problems

Repeated interactions between a principal and agent can reduce information asymmetry problems. Moreover, funders may generate more innovative case management by introducing more voices into the litigation process (Kidd, 2016).

Because of their in-depth knowledge of the legal services market, funders have strong incentives to make their investment decisions on the basis of their knowledge of the lawyers handling each case. Trebilcock & Kagedan (2014), for example, report that funders in Canada decide to finance class actions based predominantly on the identity of the class lawyer.

As funders influence how much litigation work lawyers receive, lawyers have incentives to build close relationships with funders and to build their reputation for quality and work effort. Although the lawyer has no duties to the funder, they are likely to internalise the funder's interests to some degree. At worst, the funder becomes the lawyer's client.

Funders also have strong financial incentives to spend time and resources trying to influence litigation decisions. Where they can, funders negotiate agreements that grant them some decision rights over matters with substantial financial value, such as settlement decisions. This mitigates the funder's exposure to the risks that plaintiffs pursue unnecessarily protracted litigation, as they no longer bear the litigation costs or they have become emotionally invested in the conflict.

Hence, funders are likely to have a comparative advantage in overseeing litigation with respect to individuals and SMEs. Large corporate plaintiffs, on the other hand, are likely to have good information and incentives for selecting, monitoring and directing their lawyer appropriately, as they have their own in-house legal team and, because of the breadth and continuity of their business, they are likely to know the litigation services market far better than individuals or indeed SMEs. Moreover, corporate lawyers have strong incentives to perform to the satisfaction of their large corporate clients, for the same reasons they have strong incentives to perform to the satisfaction of active funders.

Lower litigation costs result in active funding displacing self-funding of litigation

Clearly, knowledge and monitoring advantages provide an opportunity for litigation funders to offer value to potential plaintiffs. Similar to the displacement effect with alleviating credit constraints and risk aversion, lower litigation costs result in litigation funding displacing self-funding of litigation when funders offer upfront inducements to use their services (Hylton, 2012).

Principal-agent problems are likely to be particularly severe for class actions, providing more opportunity for active funders to improve efficiency

Section 3.4.2 explained that principal-agent problems are likely to be particularly severe for large class actions (i.e. a large number of class members), because in these situations representative plaintiffs have weak incentives to carefully monitor class lawyers and invest in the time and independent professional advice needed to properly direct the class lawyer (weak **supervision incentives**). Also, as the case for most ordinary plaintiffs, representative plaintiffs are likely to have very weak **supervision capabilities**. In contrast, litigation funders have strong supervision capabilities, and if their funding contracts provide for a significant share of recoverables, strong supervision incentives.

For example, in section 3.4.2 (page 35), the representative plaintiff for 5000 class members stood to gain only 80 cents from legal decisions that yielded net gains of \$4000. In contrast, a funder with rights to 50% of damages (net of costs) would receive \$2000, rather than 80 cents. Clearly, funders will generally have far stronger monitoring and directorial incentives than representative plaintiffs.

Hence, Hylton's (2012) analysis suggests mitigating principal-agent problems may be another reason for funding to be weighted toward class actions, as the principal-agent problems are more severe and so the cost-efficiency benefits of an independent funder are correspondingly larger.

4.3.2 Litigation funding may create principal-agent problems between the funder and plaintiff

Section 4.3.1 suggested that funders could reduce information asymmetry problems for plaintiffs, by bringing the funder's expertise to bear on the performance of the lawyer and thereby reduce litigation costs. However, that analysis implicitly assumed the funder's interests were aligned with the plaintiff's interests.

One of the problems with funders influencing or having decision rights over litigation is their fiduciary duty is to maximise their portfolio profits for their shareholders. Unlike the plaintiff's lawyer, funders do not have any fiduciary duty to the plaintiff. This may affect litigation decisions in several ways, as discussed below.

Funders may pressure the plaintiff to settle early or push for monetary remedies over non-monetary ones

In principle, a litigation funder of a single proceeding would have incentives aligned with the plaintiff's financial interests, as both parties would seek to maximise the monetary pay-off from litigation. In these cases, funder involvement in case management and settlement decisions would generally be beneficial. However, complications arise from the fact that funders fund a portfolio of litigation, which can mean the funder's incentives are not always aligned with the plaintiff's interests.

As indicated above, funders have strong incentives to directly influence the plaintiff in regard to her litigation decisions, for example her decisions about when to pursue settlement versus proceed to trial, what level of settlement is acceptable and so on.

As discussed in section 2.2.4, settlement is more likely the closer are the views of the plaintiff and defendant regarding the plaintiff's chances of succeeding at a hearing. In general, there is no particular reason to think funders push the plaintiff's views closer to the defendant's views. This is because, although the presence of the funder may lift the plaintiff's optimism of winning, it may also lift the probability the defendant applies to the plaintiff winning; hence gaps in their relative views may widen or shrink.

However, funders may exert pressure on plaintiffs to settle early, because like venture capitalists they sometimes gain from 'early harvesting' of their investments. For example, early harvesting may boost the funder's recent returns on investment ahead of seeking additional funds from investors (Steinitz & Field, 2014).⁴¹

Similarly, funders have strong financial incentives to push for monetary remedies over non-monetary ones that a plaintiff may value highly. For example, a plaintiff may place substantial value on injunctive relief, declaratory relief, a public apology, a change of an internal policy, or a change in the law (Steinitz & Field, 2014).

⁴¹ To be clear, early harvesting delivers positive financial returns for the plaintiff, but the plaintiff would have been better off if harvesting occurred later. The funder engages in early harvesting for portfolio timing reasons that bring other benefits not available to the plaintiff.

Conversely, funders may discourage settlement to optimise portfolio returns in certain circumstances

The funder's portfolio focus can also create incentives for them to try to influence litigation decisions to create favourable precedents, rather than optimally resolve each case at hand (Steinitz & Field, 2014). This is often called *path manipulation* in the literature and is generally perceived to be a negative development.

Steinitz & Field also suggest new funders may seek to avoid a reasonable settlement to try to win a symbolic victory to enhance their reputation ahead of seeking new capital. Or they may try to avoid settlements in low value cases to increase the credibility of threats in later cases that they will litigate through to trial and pursue appeals; the greater this credibility the stronger their bargaining position in settlement negotiations in higher value cases.

They also suggest a funder may try to influence a lawyer to underinvest in a case if that allows the funder to achieve a higher portfolio value. For example, if the fund has limited funds then maximising the value of a portfolio requires trading-off the marginal profits of the cases in the portfolio. The plaintiff, on the other hand, wants optimal investment in its own case (Steinitz & Field, 2014).

Funders may also have incentives to profit from the plaintiff's private information

In principle, funders may be able to profit from selling a plaintiff's private information or using it to their own commercial advantage or even to the plaintiff's disadvantage (Steinitz & Field, 2014). The terms of the funding contract should prohibit this kind of behaviour, however transgressions would often be difficult to detect.

4.3.3 Litigation funding may exacerbate principal-agent problems between the plaintiff and lawyer

This section outlines the ways in which funders, to the extent their interests are mis-aligned with the plaintiff's, may alter the lawyer's incentives to act in the interest of the funder. This is slightly different from section 4.3.2, which focused on the funder's *direct* influence over litigation decisions, under the assumption the plaintiff's lawyer remains a loyal and dedicated agent of the plaintiff. In contrast, this section discusses the funder's *indirect* influence on litigation via his influence on the plaintiff's lawyer.

Information asymmetry for the funder is a key driver of their incentive to build a close relationship with the plaintiff's lawyer

Venture capitalists face considerable information asymmetry problems in their role of funding entrepreneurs. Likewise, litigation funders face information asymmetry problems because it is difficult for them to know the plaintiff's proclivity for truthfulness, cooperation, and good judgement, which are important for maximising the chances of success with the litigation (Steinitz & Field, 2014).

Lawyers have clear obligations and strong incentives to act in the best interests of the plaintiff

As noted earlier, the Lawyers and Conveyancers Act 2006 places obligations on lawyers to be independent in serving their clients, to act in accordance with all fiduciary duties and duties of care to their clients, and to protect the interests of their clients. Other sections of the Act make it a criminal act to make misleading or false statements.

In addition to the obligations in the Act, law firms generally have strong reputational incentives to look after the interests of their clients by diligently monitoring and addressing problems with their partners or employees that affect their clients.

Nevertheless, if lawyers are paid by funders then it risks undermining their obligations to act in the plaintiff's interests

The most obvious way in which funders may distort lawyer incentives and judgment is to pay them referral fees and/or success fees.

According to Steinitz & Field (2014), funders in the US often shape how the plaintiff's lawyer is paid. Funders, apparently, give lawyers a financial incentive to settle early and they are often required to have "skin in the game," working on at least a partial contingent fee basis. They also state that funding agreements may make the lawyer's compensation depend on whether a case is settled before trial, settled during a trial, or went all the way to judgment.

It is widely accepted in the law and economics literature that contingency fees may incentivise lawyers to settle early (Kaplow & Shavell, 2002). This is because settlements apportion savings in future litigation costs from ceasing the litigation. With their fees specified as a percentage of settlements, lawyers receive a portion of those savings and avoid the future litigation costs.

As mentioned earlier, the Lawyers and Conveyancers Act 2006 allows New Zealand lawyers to charge conditional fees for some areas of litigation, but not contingency fees. The effects of conditional fees on performance incentives and on their advice to clients to settle or go to trial depends on the accuracy of the uplift for risk (refer s4.1.2). In general, relative to hourly fees, conditional fees may modestly reduce or exacerbate conflicts of interest with clients.

The funder's ongoing presence in the litigation market may distort the lawyer's incentives to always act in the plaintiff's interests

As funders and lawyers are both repeat players, they are likely to develop ongoing relationships that may reduce the lawyer's incentives to fulfill their fiduciary duties to her plaintiff. For example, the lawyer may have a particularly good working relationship with a funder, or they may provide each other with mutually beneficial work and assistance.

These incentives could encourage a lawyer to refer a client to a suboptimal funder, such as one that is not the cheapest or the most competent, and it could encourage the lawyer to have too much regard for a funder's wishes regarding case management (Steinitz & Field, 2014).

Some authors claim these concerns are more serious with class actions

Kidd (2016) states that representative plaintiffs are often chosen by the class lawyers, who largely control the case. In addition to the larger value at stake with class actions, the more pivotal role of class lawyers creates strong incentives for funders to find ways to influence them.

4.3.4 Efficiency could be harmed if principal-agent issues are not addressed effectively

Displacement of self-funding may improve productive efficiency in litigation

The efficiency analysis in section 4.2.5 discussed three sources of productive efficiency gains from passive funding, and these also occur with active funding. However, active funding may also bring an additional source of productive efficiency, in the form of lower legal representation costs when funders have a comparative advantage over plaintiffs in selecting, monitoring and directing lawyers acting in litigation. Hylton (2012) provides a formal analysis of the situation.

Intuitively, if litigation costs are more efficient when litigation funding is used, then funders can use some of the cost savings to offer risk-neutral plaintiffs a better deal than they can achieve with self-funding. As the funding is used for PEV cases, the cases were going to proceed anyway, and so the lower social

cost is achieved for no loss of deterrence or precedents *in regard to individual litigation*.⁴² This represents a clear increase in productive efficiency, which is commonly referred to in the legal literature as allowing businesses to use their capital more efficiently.

Conversely, displacement of self-funding may reduce productive efficiency when funders have different interests than plaintiffs

The analysis in Hylton (2012) assumed the funder's interests are aligned with the plaintiff's interests, which may often be the case but not always, as discussed in section 4.3.2. The efficiency implications of non-alignment are not straight-forward, however, as the plaintiff's interests are not generally aligned with pursuing efficiency anyway (refer section 2.2).

For example, the net efficiency effects of the funder's influence on settlement decisions are unclear as the welfare gains for the plaintiff are mostly 'wealth transfers' from the funder or defendant, rather than efficiency effects (refer section 2.2.4). Conversely, the mis-aligned interests may manifest in the form of a funder pursuing path manipulation, which could have significant (positive or negative) efficiency implications.

Similarly, section 4.3.3 considered the situation where the funder influences the lawyer acting in litigation to pursue the funder's interests, rather than act in the plaintiff's interests. By depriving plaintiffs of the truly independent counsel they need to make well-informed decisions, it may drive plaintiffs to seek the services of an additional legal advisor. This would increase the social cost of litigation and reduce productive efficiency.

Of course, not all plaintiffs are created equal. Funders are likely to view larger corporate plaintiffs as repeat clients, in which case they may have strong reputational incentives to eschew short-term considerations in favour of longer-term business gains through repeat business. And in any case, corporate plaintiffs, especially the larger ones, often have the internal legal counsel and access to the external legal resources needed to adequately protect their interests against a self-interested funder.

These considerations suggest it would be beneficial to pursue flexible measures for strengthening protections for reliant plaintiffs, to preserve flexibility for large corporate plaintiffs that can protect their own interests (**independent plaintiffs**). **Reliant plaintiffs**, in this context, are plaintiffs who are not regularly involved in litigation and are wholly reliant on their lawyer to protect their interests. Individuals, SMEs and representative plaintiffs for class actions will often be reliant plaintiffs.

4.4 Access to justice and the distributional effects of litigation funding

Sections 4.2 and 4.3 focused on analysing the efficiency implications of litigation funding. This section considers access to justice and distributional matters, such as which parties benefit from litigation funding and which incur additional costs.

The section is organised around two main aspects of equity: how litigation funding may affect plaintiff access to the justice system (section 4.4.1) and how funding may affect the distribution of costs and benefits for those involved in the justice system (section 4.4.2). Section 4.4.3 discusses the impact of litigation funding on the costs of the justice system and how additional costs are distributed across litigants.

⁴² As discussed in section 3, the efficiency analysis of class actions is not so straight-forward. If litigation funding leads to the formation of intensive class actions – rather than each case pursued individually – then precedents may be reduced, potentially reducing efficiency overall.

In regard to distribution of benefits in section 4.4.2, we consider distribution between funder and plaintiff and between the plaintiff side and the defendant side, and we consider these issues separately for passive and active funders.

4.4.1 Plaintiff access to justice may not become more equitable

Section 2.3.1 concluded that access to justice is about barriers to accessing the justice system. The barriers may be specific to a person such as their personal resources and capabilities, or they may be external to a person such as costs and delays with accessing the system, and so on. In broad terms, litigation funding improves access to justice if it enables more claimants to pursue claims without raising other barriers to such an extent that it crowds out more claimants than it facilitates.

However, the issue is whether litigation funding is likely to make access to justice more equitable. In section 4.2.5 (p. 54) we identified litigation funding as having displacement, increment and crowding out effects. Ascertaining the equity impact of litigation funding requires considering the characteristics of plaintiffs for the increment in litigation (*increment plaintiffs*) vis-à-vis the characteristics of plaintiffs for the litigation that is crowded-out of the system (*crowded-out plaintiffs*). For example, if increment plaintiffs are poorer on average than crowded-out plaintiffs, then litigation funding may make access to justice more equitable.

One way of evaluating the various factors is to break them into demand, supply, and the interaction of supply and demand.

Demand

In regard to the demand side, poorer people and smaller businesses will overwhelmingly be more credit-constrained than wealthier people and larger businesses. This suggests litigation funding *could* disproportionately assist poorer people and smaller businesses to become increment plaintiffs.

A similar impact may occur in regard to alleviating risk aversion, although not necessarily. Risk aversion reflects a person's personality, and so it is not directly about a person's income or wealth or the size of their business. However, for risk-averse people, the larger the potential adverse shock relative to their capacity to absorb the shock, the larger they value certainty over the risk. For example, a poorer person will generally be far less willing to take the risk of a \$1000 shock than a wealthier person.

On the face of it, if the size of adverse shocks were not related to people's income or wealth, or the size of their business, then litigation funding to overcome risk aversion could disproportionately assist poorer people and smaller businesses. But in practice, adverse shocks are somewhat related to people's income, wealth and size of their business. The net effect is unclear, but there is no reason to think the reverse: that risk aversion is a more significant problem for wealthier people and larger businesses.

Overall, then, it seems reasonable to assume the availability of litigation funding could disproportionately assist poorer people and smaller businesses to become increment plaintiffs. Whether it will do so depends on the interaction with the supply side, which we discuss next.

Supply

Funders are in business to maximise profits. If they have unlimited funds available to them, they would offer financing for any litigation they expect would earn them a profit.

In practice, there will be positive transaction costs involved in arranging the finance and undertaking the transaction through to completion of the case. This suggests funders would reject cases with very low PEVs. Based on a quick search, it appears minimum transaction sizes in New Zealand exceed \$100,000.

In general, it appears funders may be mostly investing in cases costing hundreds of thousands or millions of dollars, with potential damages in the tens or hundreds of millions. Of course, to the extent small claims are part of class actions that meet funding criteria, then litigation funding may be indirectly assisting them with accessing the justice system.

The net effect on equitable access to justice

On a first-principles basis, it is not obvious that litigation funding facilitates more equitable access to justice for individual claimants. For example:

- a. If the cost of legal action and the size of claims increase more than proportionately with claimant income or wealth, then litigation funding may be offered disproportionately to wealthier people or larger businesses – call this the *offer pattern*.⁴³
- b. But the offer pattern in (a) does not distinguish between displacement funding and funding for increment plaintiffs, and it is only the latter that affects equitable access to justice.

For example, suppose wealthier people and larger businesses are more likely to self-fund their litigation if litigation funding was not available – call this the *self-funding pattern*. Then it is possible the self-funding pattern either counters or exacerbates the offer pattern. That is:

- If the self-funding pattern is stronger than the offer pattern, the net result could be that litigation funding disproportionately fosters poorer increment plaintiffs over richer ones.
- Conversely, the offer pattern may be stronger than the self-funding pattern, which would give the opposite result.⁴⁴

However, the net result in (b) just tells us about the characteristics of increment plaintiffs. The final piece of the puzzle is to compare their characteristics with the characteristics of crowded-out plaintiffs. Given the counterfactual is ‘no litigation funding’, it may be reasonable to presume increment plaintiffs are proportionately poorer than crowded-out plaintiffs.⁴⁵

The net effect could be that litigation funding facilitates more equitable access to justice for individual claimants. But determining whether that is likely to be the case in practice requires empirically testing the above factors.

Class actions and equitable access to justice

The above focused on individual claimants. The analysis in sections 4.2 and 4.3 indicated that litigation funding is likely to be offered disproportionately to class actions. This funding probably improves equitable access to justice, for two reasons. First, the increment effect is likely to be significant because the very high cost of class actions means representative plaintiffs are less likely to be able or willing to self-fund class actions. Secondly, class actions, especially extensive class actions, are likely to comprise

⁴³ Or, to pick a more complicated possibility, if wealthier people are disproportionately involved in legally contentious activities – e.g. being a businessperson and/or investor versus being a worker – then litigation funding may be provided disproportionately to wealthier people.

⁴⁴ Neither result would be directly observable because litigation funding finances entrants and displacement cases. Econometric analysis would be required to identify the net effect.

⁴⁵ There appear to be two factors to consider here from the earlier crowding-out discussion: (i) higher legal fees and (ii) higher interest costs of pursuing litigation because of longer trial waiting times. Both factors would convert some risk-neutral low-PEV claims into risk-neutral NEV claims, and it is these NEV claims that are crowded-out.

claimants from a wide range of socioeconomic backgrounds.⁴⁶ Hence, class actions probably crowd out individual litigations that on average have more privileged litigants.

4.4.2 Distribution of benefits among justice system participants

The previous sections considered whether litigation funding would alter the type of participants accessing the justice system. This section considers how funding may affect the distribution of recoverables between plaintiff and defendant and between plaintiff and funder. Implications for the cost of the justice system is deferred to the next section.

Litigation funding is likely to strengthen plaintiff settlement bargaining positions against defendants

As mentioned in section 4.2.2, funding is generally considered to strengthen the plaintiff's settlement bargaining position vis-à-vis defendants. One of the reasons advanced for this view is that funding provides plaintiffs with more resources and time to bargain during settlement negotiations, without the anxiety of tight budget constraints (Kidd, 2016). A similar reason is that it bolsters the plaintiff's credibility of proceeding to trial and judgment (de Morpurgo, 2011).

Shepherd (2012) expresses strong concerns about the additional bargaining strength for plaintiffs, claiming the cases in the US with the largest potential returns for funders have been cases where the existing substantive law advantages the plaintiff over the defendant. She instances patent infringements and price-fixing as areas where defendants face exorbitant damages at trial, due in part to the possibility of treble damages, and costs of defence are very high. She also identifies concerns about class actions, similar to the 'blackmail settlement' concerns expressed in section 3.4.4 above.

In CSA's view, Shepherd's (2012) real problem is with the substantive law and rules around class actions, and seeking to address them by restricting funding is likely to be suboptimal and have ad-hoc effects on plaintiffs with meritorious cases. Moreover, Shepherd's data analysis does not attempt to distinguish between displacement funding and funding that induces litigation that would not otherwise occur, making it difficult to know how much weight to place on her arguments.

Any additional recoverables from defendants are shared by funders and plaintiffs

Stronger settlement bargaining positions will of course benefit plaintiffs at the expense of defendants, and in the longer term may affect deterrence incentives and thereby benefit future potential victims. It is not feasible within the scope of this paper to explore the likely magnitude of these effects.

Of course, any additional wealth transfers from stronger plaintiff settlement bargaining (or from having a stronger case at trial) will be shared between funders and plaintiffs, with the exact portions depending on the specific terms of the funding agreement. In other jurisdictions, the plaintiff's lawyer would also benefit significantly if on a contingent fee contract.

Effective competition by funders will be important to counter informational disparity so that plaintiffs receive broadly fair shares of recoverables and cost-efficiencies

Section 4.3 outlined informational advantages funders may have over individual and SME plaintiffs, arising from their litigation expertise and their ongoing involvement with the litigation industry. This leads some authors to express concern about plaintiffs gaining a fair share of recoverables, etc.

In most markets, suppliers know far more than consumers about their product and the industry they operate. However, effective consumer choice and competition generally levels the playing field well

⁴⁶ Intensive class actions, by definition, are actions that would have occurred anyway and so without litigation funding they would have used self-funding.

enough to maintain consumer confidence. This is particularly the case in the finance sector for plain vanilla products, such as demand and term deposits, loans and so forth.

Conceptually, litigation funding is a relatively easy financial product to comprehend, being an undertaking to cover litigation costs and take a specified share of recoverables. However, the devil will be in the details, for example around assessments of the expected costs of litigation, the chances of success at settlement or trial, and the likely size of recoverables at settlement or judgment.

It is critical that ordinary plaintiffs can rely on their lawyers fulfilling their fiduciary duties at the beginning and during the litigation process. At the beginning of the process, it is critical lawyers provide independent and impartial advice on the funding options open to plaintiffs and facilitate competitive offerings from funders. Similarly, during the litigation process it is critical plaintiffs are able to rely on independent and impartial advice from their lawyer about the funder's arguments around settlement and other case management matters.

These considerations lead naturally to consideration of when it would be fair and efficient for funders to play active versus passive roles. The more active their role, the more important it will be for plaintiffs to have a sophisticated understanding of legal and commercial matters or have access to that advice from trusted sources other than the lawyer.

A more in-depth assessment of the competitiveness of litigation funding in New Zealand would be useful to form a firmer view about whether competition is currently sufficient, and if not, consideration of steps that could be taken to enhance competition and protect reliant plaintiffs.

4.4.3 It is not clear that litigation funding increases or reduces litigation costs overall

The previous two sections considered access to justice and the allocation of recoverables. This section considers how litigation funding may affect the cost of legal services and the justice system, and how any cost effects may be distributed among participants.

On one hand, litigation funding may reduce costs through cost efficiencies (per sections 4.2 and 4.3). Also, funding allows for more unbundling of legal and financial services, which would likely foster greater competition in the litigation services market and put downward pressure on their charges (section 4.2.4). These factors can be thought of as supply-side factors.

On the other hand, litigation funding may increase costs by facilitating additional litigation activity. Ignoring the supply-side factors just discussed, additional litigation would increase total costs incurred by plaintiffs, defendants and the judiciary. Greater litigation activity also puts upward pressure on legal fees, working against the cost-efficiencies discussed in the previous paragraph. These factors can be thought of as demand-side factors.

On a first-principles basis, it is not possible to indicate whether demand or supply side factors will likely be largest, and further empirical work is required to provide an indication of which way costs would swing.

In terms of the distribution of any cost saving or increment, standard analysis of economic incidence shows it does not matter whether the cost change is sourced from the supply side or the demand side. The distribution of cost savings/increments across parties depends on relative supply and demand elasticities, among other factors. Again, further empirical analysis would be required to provide an indication of where the cost savings or cost burdens would be borne.

4.5 Concluding comments

Section 3 has provided a first-principles analysis of how litigation funding may affect efficiency and equitable access to justice. Where relevant, each section analysed the issue generically and then briefly discussed the implications for class actions. The modest volume of words on the interaction of litigation funding and class actions risks leaving the impression they are ‘a side dish,’ whereas in practice they may be the ‘main course’ in regard to their effects on equity and efficiency.

With that in mind, Table 4 summarises the equity and efficiency effects of litigation funding with the effects of active funding of class actions shown explicitly.

Table 4: Summary of equity and efficiency effects of litigation funding

Funder / plaintiff match	Improves equitable access to justice	Improves productive efficiency
Passive funding of all types of plaintiff	?	✓
Active funding of independent plaintiffs	?	✓
Active funding of reliant plaintiffs	?	✓?
Passive funding of class actions	✓?	✓
Active funding of class actions	✓?	✓?

? No conclusion can be drawn without further empirical evidence

✓? Probably a positive answer

5 The pros and cons of alternative regulatory options

Sections 3 and 4 identified some potential problems with class actions and litigation funding that may be resolved or alleviated by regulation of some sort. This section considers two broad approaches for regulating class actions and three for litigation funding. The aim is to provide a high-level basis for readers to comment on the alternatives without getting caught up in the specifics of potential regulatory regimes.

5.1 The performance characteristics of different types of regulators

This section provides a quick overview of regulation. It explains some key differences between standard regulation and regulation by the courts in section 5.1.1, briefly introduces different types of regulators in section 5.1.2 and summarises their strengths and weaknesses in section 5.1.3.

5.1.1 Background

By way of background, regulators have two primary tasks:

- specifying rules or guidance about what is required or expected of the regulated parties
- enforcing or encouraging adherence to those rules or guidance.

The strongest form of guidance is through the provision of rules that regulated parties are required to comply with or incur sanctions of one sort or another. Weaker forms of guidance occur in the form of guidelines and model arrangements, for which adherence is voluntary.

Regulation by courts differs from standard regulation

The above discussion is framed for statutory regulators and industry self-regulators. The courts also create regulations, but they do so by establishing precedents from hearing cases and making decisions in regard to the facts and circumstances of the case. In other words, the regulatory effect of a ruling depends on the extent to which it becomes a well-established precedent.

Whereas standard regulation is made in the abstract for a wide range of potential circumstances, court supervision and regulation relates to the facts and circumstances of the case before the judge. Fulsome empirical analysis and wide-ranging cost-benefit assessments are not generally undertaken for court regulation as that would go beyond the judge's mandate to decide on the basis of the facts and circumstances before the court.

Court regulation versus court supervision

In this paper, *court or judicial regulation* refers to court decisions affecting the conduct of people and organisations. In contrast, in this paper, *court or judicial supervision* refers to court decisions affecting the legal conduct of a case before the courts.

Of course, court decisions can also create precedents, which then end up regulating the way judges supervise cases in the future. For example, once a supervision precedent has become well-established, a subsequent decision which does not follow this precedent may be able to be successfully appealed to a higher court. This means future litigants can reliably predict how courts will likely administer their cases, allowing them to make more efficient litigation decisions.

Court supervision occurs in real-time, or what might be called just-in-time. For example, in regard to class actions a judge is likely to rule on class membership arrangements before allowing the action to proceed. Similarly, in regard to litigation funding, a judge may review funding arrangements before allowing the case to proceed. This real-time feature of court supervision is important for assessing the pros and cons of court supervision versus other forms of regulating the conduct of litigation.

5.1.2 Introducing the different types of regulators

Self-regulators are typically industry or professional associations (option 1)

Industry or professional associations typically have a board elected by members of the industry or profession, who employ and oversee a chief executive and staff. Industry members are typically invited to be significantly engaged in the association's regulatory activities, often through working groups on particular topics.

Associations are typically voluntary and so have relatively weak powers for dealing with errant members, with suspension and expulsion their strongest enforcement actions. They are not able to impose fines or penalties. The rule-making and enforcement decisions of associations are typically contestable in court.⁴⁷

Statutory regulators (options 2 & 3)

In this paper, statutory regulation refers to statutes and to regulation empowered by statute. It may include just the statute and regulations administered by a government department or ministry (option 2), or it could also include a regulatory agency established under a statute, which itself may have rule-making powers. If the agency makes decisions independently of the Executive,⁴⁸ then it is called an *independent regulator* (option 3).

Co-regulators are industry self-regulators with regulatory powers granted by statute (option 4)

In practice, associations or professional bodies may be granted regulatory powers by statute, and in return they are usually required to regulate their members in the public interest and report to Parliament. These are co-regulatory bodies and their regulatory activities are called co-regulation rather than self-regulation. Co-regulation is a hybrid of industry self-regulation and statutory regulation.

The New Zealand Law Society is a co-regulator, as The Lawyers and Conveyancers Act 2006 provides for it to make the *Rules of Conduct and Client Care for lawyers* (RCCC), which all lawyers are required to abide by.

Another co-regulator is the Rules Committee, which comprises representatives of the judiciary, government, and the legal profession. It is currently established under the Senior Courts Act 2016 for the purpose of making procedural rules to facilitate "the just, speedy, and inexpensive dispatch of the business" of the courts, including the High Court Rules.⁴⁹ Neither the Committee nor the Executive has the power to make those rules unilaterally.

The courts as supervisors and regulators (option 5)

The courts have a broad mandate to consider cases on a wide variety of issues and are not subject to any restrictions on these matters from the Executive.

⁴⁷ As discussed in section 2.4, an important feature of common law is that it interacts dynamically with statutory law, which means it will evolve to address gaps and overlaps with statutory regulation. Likewise, industry self-regulation evolves in response to statutory and judicial regulation. Hence, it is best to avoid a mindset that the choice is either all statutory regulation or all judicial regulation or all industry self-regulation. In reality, the issue is the best balance of statutory, judicial and self-regulation.

⁴⁸ The Executive is the Cabinet, Ministers outside Cabinet, government departments and ministries.

⁴⁹ The Rules Committee was originally established under the Judicature Act 1908.

The courts are more independent from the Executive than any other regulator and they are not answerable to Parliament. Moreover, judges are independent of each other and cannot be directed in their judicial work by any other judge.

5.1.3 The strengths and weaknesses of different types of regulators

Each type of regulator has different strengths and weaknesses for making and enforcing regulations, or making statutes and regulations in the case of Ministers through their Government. Table 5 (next page) compares the performance of each option in regard to eight performance dimensions. The first six are about efficiency:⁵⁰

- Rows 1 – 3 are about the productive efficiency of the regulator itself. For example, a highly productive regulator produces clear guidance and effective enforcement for a low cost.
- Rows 4 & 5 (regulatory risk) are about the inefficient impact of the regulator on the economy due to over-regulating or under-regulating aspects of the regulated activity.

Over-regulation occurs when an activity is regulated when it was inefficient to do so (type 1 error). Under-regulation occurs when an activity was not regulated when it would have been efficient to regulate it (type 2 error).

These errors occur because regulators have imperfect knowledge about the regulated industry and their impact on it, or they may have poor incentives to get their regulation right or they may be constrained from doing so.

- Row 6 (adaptability over time) is about the dynamic efficiency of the regulator. This is about how well the regulator corrects for the errors mentioned above and how well it adapts as external circumstances change, such as in regard to changes in technology or industry structure, the environment, and community preferences and social norms. “How well” refers to speed and quality of adaptation.

The ability of a regulator to consider fairness (row 7) and to act independently of partisan interests (row 8) are both very important criteria for choosing the type of regulator to regulate an activity. Further explanations for the strengths and weaknesses in Table 5 are available from CSA.

Note that option 4 (co-regulator) applies to the Law Society and the Rules Committee, with exceptions noted at the bottom of the table. In the last column (option 5), R and S refer to court regulation and supervision, respectively. For example, court decisions about the capital adequacy of litigation funders would be an R-activity whereas a court decision to require a litigation funder to post security for a case in front of the court would be an S-activity.

⁵⁰ NZPC (2014, p. 25) provides a useful list of factors that make for successful regulators, and Coglianese (2012) discusses a wide range of regulatory performance measures. However, the focus in this paper is on the choice of regulator, which is slightly different than optimising the performance of existing regulators.

CAPITAL STRATEGIC ADVISORS

Table 5: The strengths and weaknesses of each type of regulator

		Option 1 Industry self-regulator	Option 2 Statute	Option 3 Independent regulator	Option 4 Co-regulator	Option 5 Courts
1	Cost	Low	Medium	Medium	Medium	High for R Low for S*
2	Forward guidance to regulated parties	Strong	Modest	Strong	Strong	Weak for R until precedents form Strong for S
3	Scope and power of enforcement	Narrow and weak	Broad and strong	Broad and strong	Broad and strong**	Broad and strong for both R and S
4	Risk of under-regulation	High	Low for areas with widespread support, otherwise High	Medium	Low for areas with widespread support, otherwise High	High for R in new areas, otherwise Low Low for S
5	Risk of over-regulation	Low	Generally high	Medium	Low	Low for R in new areas Low for S
6	Adaptability over time	Mixed	Slow and haphazard	Mixed	Slow and haphazard	Modest and piecemeal for R Timely for S*
7	Mandate to deal with fairness issues	Sometimes	Yes	Sometimes	Sometimes	Yes
8	Independent of partisan interests	No	No	Yes	No [#]	Yes

* Unless appealed to a higher court ** The Rules Committee does not have any enforcement powers # Yes for the Rules Committee

5.2 Comparative analysis of the options for regulating class actions

The discussion of class actions in section 3 identified two areas for potential regulation. This section briefly recaps those issues and, drawing on the different performance characteristics of regulators in section 5.1, discusses the general pros and cons of statutory regulation versus court supervision and regulation.⁵¹

5.2.1 Recap of the key regulatory issues with class actions

Standardising membership, management and money rules

Section 3.3 noted that the lack of a comprehensive class actions regime in New Zealand left litigants with unnecessary levels of uncertainty and cost.

The analysis in section 3.4 suggested that providing a standard set of membership, management and money rules for class actions could improve efficiency however it was not possible to be categorical about that from first-principles analysis.

Section 3.5 suggested class actions would likely improve equitable access to justice, which means overall welfare may increase even if class actions impose a net social cost on society.

Principal-agent problems and inefficient strategic behaviour could be mitigated

Section 3.4 explained that even modestly-sized classes provide very weak incentives for a representative plaintiff to properly monitor and direct the class lawyer. Mitigating these problems could reduce social costs and potentially achieve better and fairer outcomes for class members.

Section 3.4 also identified there is likely to be value in mitigating strategic imbalances, for example, in regard to a monopoly defendant versus competing plaintiffs, or in regard to a monopoly plaintiff versus a defendant or defendants.

Overall

In essence, there are two types of problems:

- problems that may be reduced by making available a set of standardised class action arrangements
- problems that appear to be situation-specific, and that sometimes evolve during the course of a class action, suggesting a high-level of flexibility and context may be advantageous.

Both types of problems are about the legal conduct of class actions, and therefore they are about court supervision rather than court regulation.

5.2.2 The pros and cons of statutory regulation versus court supervision

The Law Commission has requested CSA consider the general pros and cons of two options:

- specifying a comprehensive set of arrangements for class actions in a statute, with detailed technical matters specified in the High Court Rules (ie, combination of options 2 & 4 in Table 5)

⁵¹ Posner (2010) provides a comparative analysis of regulatory agencies versus courts, and Kaplow (1992) touches on these issues too. However, neither paper is specifically about class actions or litigation funding.

- the status quo, which means relying on High Court Rule 4.24 and leaving it to the courts regulate class actions through precedents (ie, option 5 in Table 5).

Developing a comprehensive and detailed statute is unlikely to be the best approach if it provides insufficient discretion for the courts, (option 2 only)

The primary advantage of comprehensive and detailed statutes is that they provide parties with a high degree of certainty about what is required of them, but in practice statutes cannot cover every situation and there are practical limits to their level of detail without making errors and causing unintended consequences. Clearly, there is a balance to be struck between providing certainty and leaving the courts with discretion to achieve fit-for-purpose outcomes.

In the case of class actions, developing a comprehensive and detailed statute is unlikely to be the best approach if it gives the courts insufficient discretion to manage class action proceedings. Discretion is important for the courts to cater well for the evolving and highly situation-specific issues of the cases in front of them. If insufficient discretion is provided, a comprehensive and detailed statute carries a high risk of inefficient regulation, with typically slow and haphazard opportunities to improve the regime over time.

Both Australia and Canada have enacted comprehensive and detailed class action statutes at the federal level but with the courts granted general discretions: the Australian class actions statutes contain a provision allowing courts to make any order they consider appropriate to ensure that justice is done and the Canadian statutes allow the courts to make orders necessary to ensure the fair and expeditious determination of the proceeding. So far, these approaches appear to strike an acceptable balance between certainty and court discretion.

Developing a comprehensive and detailed regime in the High Court Rules is also unlikely to be the best approach (option 4 only)

This approach is the same as above, but with the provisions developed by the Rules Committee and placed in the High Court Rules. This appears to be the approach in the United States, where the class actions regime is covered by Rule 23 of the Federal Rules of Civil Procedure.⁵²

Relative to the previous option above, the specialised knowledge of the Committee may achieve better detailed rules, reduce regulatory risk and reduce risks of undermining judicial independence.

However, it is questionable whether the Rules Committee – which is charged with addressing procedural matters – has the mandate to develop rules that carry such significant policy issues for Government, the business sector and for society generally, particularly in regard to dealing with strategic imbalances.

In any case, adaptability would be haphazard under this approach, sharing one of the key drawbacks of option 2.

Leaving it entirely to court supervision (option 5) also has significant drawbacks

This option involves leaving it entirely to the courts to develop, on a case-by-case basis, a comprehensive and detailed approach to supervising class actions. This is effectively the status quo where courts have to decide the rules applying to representative actions.

As supervision decisions are made in real-time, the litigants have clear forward guidance before they invest further in the case. However, the main advantage of the option is that it leaves maximum scope for supervision decisions to adapt over time as circumstances change.

⁵² Refer <https://www.uscourts.gov/rules-policies/current-rules-practice-procedure/federal-rules-civil-procedure>

The main drawbacks are that supervision decisions are costly. It will take considerable time, and many costly interlocutory applications, for precedents to become well established to provide a standardised suite of supervisory rules for class actions. Whereas individual litigation is voluminous, very few class action cases are initiated each year, they take years to complete to the point where no appeals are forthcoming and if the parties decide to settle then valuable precedents may be forgone for a lengthy period.

A better approach may be to formulate high-level principles and an overarching regime in statute and leave the remaining details to the courts to develop as the situation evolves (a 'light touch' option 2)

The evolving and situation-specific features of class actions are in regard to strategic imbalances and principal-agent problems. It is likely to be better to address these issues with high-level principles in a statute, with the details left to court supervision.

Similarly, an over-arching regime could be developed to standardise membership, management and money arrangements, with more detail placed in a default or model arrangement (such as model court orders) placed in a schedule to the statute. This would further reduce costs and uncertainty whilst preserving significant scope for adaptation.

For example, the over-arching arrangements and principles could deal with factors like:

- whether class membership must be mandatory, opt-in or opt-out
- how principal-agent issues between class lawyers and representative plaintiffs are mitigated, and between class members and the representative plaintiff/class lawyer
- the rights of courts to mitigate strategic behaviour during litigation, to address concerns about nuisance claims and blackmail settlements
- requirements about distribution of recoverables to class members.

This approach utilises the Government's mandate for dealing with fairness issues regarding litigation rights and improving access to justice. It also allows the Government to protect its interest in containing the risk of class actions harming business competitiveness, innovation and the performance of the wider economy.

This approach has the potential to provide more certainty and reduce costs earlier than would occur under the status quo of court supervision and regulation, while leaving significant flexibility for court supervision to be tailored to the circumstances of each case.

Including default class action arrangements in a statute may inhibit timely revisions to it, and so a model arrangement may be a better option.

The best approach may be to have a statute but leave it to the Rules Committee to develop detailed procedural rules regarding class action arrangements (combination of options 2 & 4)

Rather than append default or model arrangements to a statute, an alternative approach would be to leave it to the Rules Committee to develop procedural and administrative rules for the formation, management and dissolution of class actions. In effect, this approach combines options 2 & 4.

The Rules Committee has considerable specialised knowledge about procedural and supervision matters to do with class actions, and how they tie in with court procedures more generally. This approach would be relatively low cost, and forward guidance could be provided far quicker than leaving all of the details to the courts to evolve (option 5 only).

The main drawback is the Rules Committee is unable to amend the Rules unilaterally as it has to gain the approval of the Executive. But if an overarching statute has been adopted, changes to default/model

arrangements should be relatively technical and uncontentious. And concerns about the Committee encroaching on matters of government policy would have been addressed with the creation of the statute. Finally, to the extent the Rules Committee is unable to secure Executive approval, the courts would still be free to supervise as they see fit for aspects covered by model arrangements.

5.3 Comparative analysis of the options for regulating matters arising from litigation funding

The discussion of litigation funding in section 4 identified a suite of principal-agent issues that could be addressed through regulation. This section briefly recaps those issues and then draws on the performance characteristics of the different regulators in section 5.1 to discuss the general pros and cons of addressing the issues with industry self-regulation, statutory regulation or court oversight and regulation.

5.3.1 Recap of matters arising from litigation funding that may warrant regulation

Recall that a **reliant plaintiff** is a plaintiff that is wholly reliant on her lawyer for independent and impartial advice about funding arrangements and case management. Individuals, SMEs and representative plaintiffs for class actions will often be reliant plaintiffs.

Large corporate plaintiffs are unlikely to be reliant plaintiffs if they deal with litigation frequently or have their own source of independent litigation expertise. We referred to these as **independent plaintiffs** if they have the capability to make litigation decisions independently of the lawyer conducting the litigation.

Selection decisions

A key selection issue is about matching plaintiffs with the best type of funding arrangement for their circumstance. For example, reliant plaintiffs are best being matched with passive funders.

Another key selection issue is about ensuring reliant plaintiffs receive competitive offers of funding. This is critical to address the risk of funders using their expertise to offer unfair terms to plaintiffs, including unfair assignment of risks and shares of recoverables.

Case management decisions

Active funders are likely to offer better terms and conditions than passive funders, particularly for large cases like class actions. Hence, a reliant plaintiff may prefer active over passive funding for price reasons.

Section 4.3.2 outlined a range of case management decisions that could be influenced by active funders in ways that are not beneficial to the plaintiff. These mostly related to the timing and size of settlements, but active funders may be able to influence other aspects of case management.

Given those possibilities, where a reliant plaintiff chooses an active funder there may be value in having additional protections available during case management, especially for settlement decisions.

Another concern is the distribution of settlements and damages to the various parties involved in litigation. These decisions are significantly more complicated in class actions.

Capital adequacy and ‘trade credit’ issues

The key concern here is about plaintiffs becoming exposed to insolvent litigation funders and unable to meet their financial commitments, such as to pay for the plaintiff’s costs and adverse costs if the plaintiff loses the case. These issues arise regardless of whether the funder is passive or active.

Overall

The first two groups of issues – selection and case management – are about the legal conduct of parties involved in litigation and once again they are situation-specific because they depend on the type of plaintiff (reliant vs independent) and funder (passive vs active). In contrast, the capital adequacy and trade credit issues are financial rather than legal issues. As the matters are quite different, it is useful to consider the selection and case management issues in section 5.3.2 and the capital management/trade credit issues in section 5.3.3.

5.3.2 The pros and cons of the regulatory options for matters of legal conduct

The Law Commission has requested CSA consider the general pros and cons of three options:

- industry self-regulation (option 1 in Table 5)
- statutory regulation (option 3)
- supervision and regulation by the courts (option 5).

Before considering those options, it is useful to understand in some detail how lawyer conduct is currently regulated.

Importantly, the conduct of all lawyers is subject to detailed and effective co-regulation

To achieve efficient and fair selection of funders for reliant plaintiffs, it is important that lawyers facilitate competitive funding processes, and advise their clients impartially about the best type of funder (active or passive) for their circumstances.

As discussed earlier, a schedule to The Lawyers and Conveyancers Act 2006 contains the Rules of Conduct and Client Care for lawyers (RCCC), which are made by the Law Society and approved by the Minister of Justice under provisions in the Act.

Among other matters, the RCCC requires lawyers to:⁵³

- act competently, in a timely way, and in accordance with instructions received and arrangements made:
- protect and promote the client's interests and act for the client free from compromising influences or loyalties:
- discuss with the client her/his objectives and how they should best be achieved:
- give the client clear information and advice:
- and various other matters.

Clearly competitive tendering of funding is in the best interests of reliant plaintiffs, and so it is implicitly covered by the RCCC, as is the requirement to provide impartial advice on the best type of funder for each client's circumstances. Nevertheless, it could be useful to amend the RCCC to make explicit the expectation that funding should be sought through a competitive tender process.

With one exception, this co-regulatory approach for regulating lawyer conduct has similar performance characteristics as the Rules Committee in Table 5. The exception is in regard to the scope and power of enforcement, which in CSA's view is relatively strong.⁵⁴ For example, the Law Society has serious and

⁵³ Refer <http://www.legislation.govt.nz/regulation/public/2008/0214/latest/DLM1437811.html>

⁵⁴ Refer <https://www.lawsociety.org.nz/news/law-society-statements/law-society-response-to-media-criticism-of-regulatory-system/>

independent disciplinary processes for sanctioning lawyers that breach the RCCC. On top of that, it is a criminal offence for lawyers to breach the obligations specified in The Lawyers and Conveyancers Act.

Industry self-regulation may be sufficient for regulating passive funders but may not be for active funders

In regard to the conduct of litigation funders themselves, one option is to rely entirely on industry self-regulation in a manner similar to what occurs in the United Kingdom, where a Code of Conduct for Litigation Funders was published by the Association of Litigation Funders of England and Wales.

Among other matters, the Code sets out requirements on funders to:⁵⁵

- ensure the funded party has obtained independent advice from the lawyer about the terms of the funding arrangements
- not seek to influence the lawyer.

Interestingly, the second bullet point above implies the England and Wales Code is only for passive funding, for which the principal-agent concerns from litigation funding are modest.⁵⁶

As identified in section 5.1.4, self-regulation has a higher risk of under-regulation and weaker enforcement power than other regulatory options, but it is a low-cost approach and reduces the risk of over-regulation which could inhibit innovation and dynamism in the litigation funding industry.

Overall, there is a good case for relying on industry self-regulation for passive funding, with the proviso that the RCCC encompasses the competitive tendering expectation and it is suitably enforced by the Law Society. The reason for the proviso is that funders will not be able to harm the plaintiff if the plaintiff's lawyer does her job well.

Similarly, industry self-regulation should be sufficient for active funding provided to independent plaintiffs, such as large corporates, as those plaintiffs have their own legal resources to protect their interests and the funder's interests will more naturally align with the interests of a corporate that is more likely to be a repeat user of litigation funding.

However, a stronger form of regulation could be considered for active funding of reliant plaintiffs, such as court supervision.

Court supervision of litigation funding arrangements is in real-time, avoiding one of the main drawbacks that typically arises with court regulation

Another regulator option is to rely entirely on court supervision, which is essentially the status quo in New Zealand. For example, the courts can enquire about funding arrangements⁵⁷ and if they have any concerns they could enquire about the steps the lawyer took to ascertain the plaintiff's status and suitability for passive versus active funding, the advice provided about those issues and the processes undertaken to facilitate competitive tendering of funding.

Similarly, disclosure of funding arrangements to the court would allow it to ascertain whether the funding arrangement is passive or active. Along with the above disclosures about the plaintiff's status, the courts would be in a sound position to decide whether (a) the selection processes should be re-done before

⁵⁵ The latest version of the code is <https://associationoflitigationfunders.com/wp-content/uploads/2018/03/Code-Of-Conduct-for-Litigation-Funders-at-Jan-2018-FINAL.pdf>

⁵⁶ As discussed earlier, there are significant principal-agent concerns with class actions but those arise irrespective of how they are funded.

⁵⁷ CSA's understanding is that the High Court requires disclosure of any third-party funding to plaintiffs and the terms of the funding agreement.

allowing the case to proceed and (b) how actively to monitor case management decisions during the litigation. If the plaintiff is clearly a sophisticated party, such as a large corporate or someone with legal expertise, then the courts may inform the parties it will not be supervising their case management decisions.

Table 6: Summary of potential regulatory approach to case management

	Reliant plaintiff	Independent plaintiff
Passive funder	Self-regulation	Self-regulation
Active funder	Court supervision	Self-regulation

For both selection and case management issues the under-regulation risks are minimal as courts have the power to cease proceedings, which in practice means they have the power to order funding agreements to be rewritten to meet the courts requirements.

The main drawback with court supervision is the higher costs to the court of supervising case management decisions and the additional costs if supervision decisions are appealed. The courts could reduce this risk by charging the plaintiff the full cost of court supervision of the case and interlocutory appeals on matters relating to case management (regardless of whether the plaintiff wins or loses the case). The courts could also adopt a rule of not charging for supervision if the plaintiff obtains independent supervision. This would incentivise reliant plaintiffs to choose passive funders and discourage active funders from wanting to fund reliant plaintiffs.

When the Australian Productivity Commission reviewed litigation funding in 2014, it expressed concern that effective court oversight was predicated on disclosure of funding agreements and the court having jurisdiction to impose sanctions over the funder for abuse of process or contempt of court (APC, 2014b, p. 630). In CSA’s view, if there are similar jurisdictional concerns for New Zealand courts, they should be addressed through amendments to the High Court Rules.

Further statutory regulation – beyond co-regulation with the Law Society – is unlikely to be efficient or more effective

The third regulator option is statutory regulation, administered either by the Executive, or an existing independent regulator or by establishing a bespoke independent regulator. Clearly, an independent regulator would be a better option than the Executive, to minimise any risks of compromising judicial independence regarding case management issues.

However, as a co-regulatory arrangement for lawyer conduct is already in place with independent standards committees and an independent Disciplinary Tribunal, there is no obvious reason to establish a separate independent regulator to address concerns about lawyer conduct arising from litigation funding. Given the limited prevalence of improper conduct, it is unlikely to be cost-effective to establish a new independent regulator to deal with those issues.

Overall, passive litigation funding could be left to industry self-regulation, and the courts could be left to supervise active litigation funding

With the proviso mentioned earlier about the RCCC, there is a good case for relying on industry self-regulation for funding of litigation, with court supervision where a judge thinks this is necessary, for example for active funding to reliant plaintiffs.

5.3.3 The pros and cons of the regulatory options for addressing capital management and trade credit concerns

The capital management concerns are primarily about the risks of litigation funders becoming insolvent, leaving plaintiffs unable to meet their financial commitments to their lawyer and to the courts for adverse costs. In essence, these are 'trade credit' issues and they arise regardless of whether the funder is a passive or active participant in litigation.

As in the previous section, this section considers the three options of self-regulation, statutory regulation and supervision and regulation by the courts. It is easiest to begin with the statutory option.

The existing statutory regime (option 4) likely reduces insolvency risks but it does not specifically cover the risks faced by plaintiffs and their lawyers

Litigation funders in Australia will soon be required to hold an Australian Financial Services Licence and comply with the managed investment scheme regime. The comparable approach in New Zealand would be to require litigation funders to comply with the Financial Markets Conduct (FMC) Act 2013, including the Act's licensing requirements (as providers of financial products or financial services).⁵⁸

The FMC Act governs how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. The Act defines four broad categories of financial products (debt, equity, managed investment products, and derivatives), and it empowers the Financial Markets Authority (FMA) to designate products into an appropriate category so that they are covered by the Act. Hence, the regime contains considerable flexibility for the FMA to bring novel investment vehicles and products within its purview.

Although the FMC Act and regulations could inhibit entry, reducing dynamism in an emergent part of the financial sector, there is also a strong case for having all financial service providers covered by the same regime, and indeed that was a key objective of the reforms leading to the creation of the FMC Act, which replaced five other Acts.⁵⁹ Not including litigation funders within the FMC Act would begin to re-establish a disparate regulatory regime for financial services.

Having said that, the FMC Act will not remove all insolvency risk, and in fact considerable insolvency risk could remain in particular instances. Moreover, the problem for plaintiffs and their lawyer is that litigation funders promise to pay for litigation costs, and so plaintiffs incur liability for those costs on the basis of that promise. These risks are not specifically addressed by the FMC Act and associated regulatory regime.

Court requirements for security (option 5) may make sense for only a limited range of circumstances, leaving plaintiffs with insolvency risks

In regard to capital management issues, the courts are able to require the plaintiff (and therefore the funder) to post the security necessary to ensure defendants are covered for adverse costs awarded against a plaintiff.

This protection for defendants makes sense for two reasons. First, defendants have no influence on whether plaintiffs take on funding risks to pursue litigation against them. Secondly, the requirement to post security shifts the risk-monitoring role from courts to other parties, such as banks, who specialise in financial risk monitoring and are willing to supply security on the strength of their monitoring activity.

⁵⁸ The FMA has published a useful guide at <https://www.fma.govt.nz/assets/Guidance/131101-a-guide-to-the-financial-markets-conduct-act-reforms.pdf>

⁵⁹ p. 6 *ibid.*

This still leaves plaintiffs exposed to the risk of a funder becoming insolvent, leaving the plaintiff liable for her own litigation costs and unable to carry on with litigation or unable to do so on similar terms and conditions. In some cases, insolvency may drive (or force) a plaintiff to pursue a settlement rather than pursue the case further. On this basis, courts could potentially require funders (via plaintiffs) to post security sufficient to pay all costs.

However, in general there is not a strong case for courts to intervene beyond requiring security to cover the risk of adverse costs. The allocation of risk between members of the plaintiff side of the case are for them to address. After all, the trade credit risk ultimately falls on lawyers if their clients are unable to pay their bill.

Self-regulation is unlikely to be effective (option 1)

The Code of Conduct for Litigation Funders, published by the Association of Litigation Funders of England and Wales, included requirements on funders to:⁶⁰

- meet capital adequacy requirements
- be audited annually by a recognised national or international audit firm and provide a copy of the audit opinion and other evidence of capital adequacy to the Association.

However, as for the statutory regime just discussed, capital adequacy requirements do not remove all insolvency risk, and considerable insolvency risk could remain in particular instances.

In reality, annual audits would be too infrequent for many cases and many plaintiffs are unlikely to be well-placed to monitor the capital adequacy of their provider during the course of the litigation, and even if they did do it well they would likely be left with considerable legal bills in the event of halting their legal proceedings.

Co-regulation by the Law Society (option 4) may be the best approach to address funding risks for plaintiffs

As lawyers are obligated (by The Lawyers and Conveyancers Act and the RCCC) to act in the best interests of their client, they should require funders to offer funding on a no-risk basis, by posting security in private trust accounts to protect their client and themselves from funder insolvency. As mentioned earlier, this shifts the risk monitoring job to parties that specialise in doing it.

At a minimum, the plaintiff's lawyer could at least request funders to price both a standard funding agreement and a 'no-risk' funding agreement. If the courts were minded in particular circumstances, they could also include these considerations in their enquiries about the selection of funders and the terms of funding arrangements.

⁶⁰ Refer <https://associationoflitigationfunders.com/wp-content/uploads/2018/03/Code-Of-Conduct-for-Litigation-Funders-at-Jan-2018-FINAL.pdf>

6 Concluding comments

The above analysis is more definitive about efficiency gains from litigation funding than from class actions, and vice versa for improving equitable access to justice. In both cases, the analysis is predicated on an assumption low-cost regulatory options exist for effectively mitigating problems that arise with both activities.

Further analysis, including a quantitative impact analysis and cost-benefit assessment, would likely assist with making final decisions on these issues. In doing this, it is important to gather evidence on the nature and magnitude of alleged problems, and to appreciate that problems need to be significant to justify statutory regulation. No market works perfectly, and young markets in particular can be expected to exhibit significant imperfections that may reduce over time.

This paper has outlined the pros and cons of alternative options for regulating class actions and litigation funding. The aim in this paper was to provide a high-level basis for readers to begin thinking about the alternatives, including the alternative of leaving matters to the courts to supervise and regulate, which in policy analysis is often called the 'no regulation' option. Decisions to introduce statutory regulation of one sort or another should be based on realistic and evidenced-based assessments of the costs and benefits of the options, including a 'no regulation' option.

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