11 March 2021

Review of Class Actions and Litigation Funding
Te Aka Matua o te Ture I Law Commission
Wellington
New Zealand

Email: ca@lawcom.govt.nz

Submission on the Law Commission's Issues Paper on Class Actions and Litigation Funding

The Institute of Directors (IoD) appreciates the opportunity to submit on the Issues Paper on Class Actions and Litigation Funding in New Zealand (December 2020). This is a first principles review and the Law Commission is seeking feedback on whether the potential benefits of class actions and litigation funding can be realised in a way that outweighs any risks and concerns.

Our submission mainly focuses on governance and director-related matters. Notwithstanding our comments here, the IoD may make further comments as the review progresses.

Summary

We welcome the review of class actions and litigation funding in New Zealand. This is a key opportunity to put in place a regime that is fit for purpose and for the long-term. There are benefits of class actions and litigation funding including providing access to justice and accountability.

In principle, the IoD supports a new statutory class actions regime and the regulation of litigation funding. However, there are significant risks and concerns that will need to be addressed and managed (eg dealing with unmeritorious proceedings). We are particularly concerned about the future of shareholder class actions. There are lessons that can be learnt from Australia's experience and its review of class actions and litigation funding. We urge the Law Commission to also consider the recommendations of the Capital Markets Steering Committee from 2019 including the need to review the continuous disclosure liability settings in New Zealand. It is essential that New Zealand gets the settings right.

We also highlight other significant concerns such as the deteriorating D&O insurance market and the importance of attracting and retaining skilled, experienced and responsible directors for New Zealand's prosperity and wellbeing.

About the Institute of Directors

The IoD is New Zealand's pre-eminent organisation for directors and is at the heart of the governance community. We believe in the power of governance to create a strong, fair and sustainable future powered by best practice governance.

Our role is to drive excellence and high standards in governance. We support and equip our members who lead a range of organisations from listed companies, large private organisations, state and public sector entities, small and medium enterprises, not-for-profit organisations and charities.

Our Chartered Membership pathway aims to raise the bar for director professionalism in New Zealand, including through continuing professional development requirements.

The IoD's Code of Practice for Directors provides guidance to directors to assist them in carrying out their duties and responsibilities with high professional standards. All IoD members sign up to the Code.

Overview of the Issues Paper

The Issues Paper summarises class actions: "A class action is characterised by the act of grouping claimants with a common factual or legal issue into a single legal proceeding so that their claims can be resolved together. This is normally achieved through the selection of one class member to act as a representative plaintiff on behalf of the class, although all class members will be bound by the outcome." New Zealand does not have a detailed class actions regime (like some overseas jurisdictions). However, proceedings that might be taken as a class action overseas can be taken as a representative action under the High Court Rules.

Litigation funding is summarised in the Issues Paper as involving "a person who is not a party to and has no interest in the litigation agreeing to fund some or all of a plaintiff's costs in exchange for a share of any sum recovered (the funder's commission). It is usually non-recourse, meaning that if the case is unsuccessful, the funder will be paid nothing. If the case is successful, the funder will be reimbursed for the costs of the litigation and will be compensated for bearing the financial risk of the case through payment of the commission." Litigation funding is not expressly regulated in New Zealand. However, there are some limits under the torts of maintenance and champerty and other principles developed by the courts. The Law Commission notes in the Issues Paper that "there has been a noticeable increase in the number of representative actions being brought in recent years. Reasons for this increase include the arrival of litigation funding."

The Law Commission highlights problems with the current regime in the Issues Paper and sets out advantages and disadvantages of class actions and litigation funding. It has formed the preliminary view that:

- it would be desirable to have a statutory class actions regime and
- litigation funding is desirable in principle and should be expressly permitted, provided that certain concerns can be adequately managed.

Various matters would need to be addressed in the creation of any class actions regime in New Zealand including broad principles which would underpin it and key features.

Concerns with litigation funding would also need to be addressed such as funder control of litigation, conflicts of interest, funder profits and capital adequacy of funders.

IoD commentary

Getting the settings right

Accountability is critical to corporate governance and class actions and litigation funding can help facilitate access to justice and ensure organisations and individuals are held to account. For example, shareholders need to be able to take action against organisations and directors where there have been failures and governance may have gone awry. However, there are issues with the current representative action regime in New Zealand and with litigation funding as identified in the Issues Paper.

The IoD supports the Law Commission's preliminary view that a statutory class actions regime should be created and that litigation funding should be regulated. However, there are significant risks and concerns that will need to be addressed and managed in developing a new regime. For example:

- there should be a form of certification process early on in proceedings to deal with unmeritorious claims and
- there needs to be assurance that claimants have the ability to pay an adverse costs order.

We are particularly concerned about the future of shareholder class actions, as reported in a recent Australian review (discussed below).

The Law Commission's review is a key opportunity to put in place a regime that is fit for purpose and for the long-term. Ultimately, the regime needs to be reasonable and balanced for all parties involved in the proceedings – with appropriate procedural safeguards for claimants and defendants. It is essential that New Zealand gets this right for various stakeholders and also for governance, capital markets and the country as a whole.

Adverse outcomes of getting this wrong may lead to greater risk aversion in board decision-making and further add to the compliance burden. A danger with undue risk aversion is that boards can miss strategic and innovative opportunities failing to realise the potential for their organisations. Nearly half of directors (47%) in our 2020 Director Sentiment Survey (with ASB) agreed that increased personal liability has made them more cautious in business decision-making. Our survey also found that time spent on compliance activities continued to increase for the majority (70%) of directors. This was significantly higher for directors of listed companies (88%). A growing regulatory burden can mean directors spend disproportionally more time on compliance rather than performance and strategy. This was highlighted in the New Zealand Productivity Commission's report New Zealand boards and frontier firms (2020):

> "most of the directors who noted concern about the compliance burden hold (or have held) roles in firms that are subject to financial markets legislation. The major concern these directors expressed is that compliance is occupying a considerable amount of board time,

meaning that “forward looking conversations around strategy and what’s happening in the business is sometimes fighting for space on the agenda.”

Lessons from Australia

There are lessons that can be learnt from Australia’s experience and its review of class actions and litigation funding.

The Australian Parliamentary Joint Committee on Corporations and Financial Services published a report Litigation funding and the regulation of the class action industry in December 2020. The Committee found: “Having considered the evidence put to it, the committee considers the concerns about the class action and litigation funding industries to be well-founded. In the Committee's view, the class action system needs to be reformed to reflect the underlying tenets of its original intent: that is, to deliver reasonable, proportionate and fair access to justice in the best interests of class members.”[1]

The Committee also found that “participants in class actions are the biggest losers in this deal. When they finally get their day in court, it is the genuinely wronged class action members who are getting the raw deal of significantly diminished compensation for their loss, as bigger and bigger cuts are awarded to generously paid lawyers and funders.”[2]

In relation to shareholder class actions, the Committee stated that these “are generally economically inefficient and not in the public interest. Even successful actions amount to shareholders effectively suing themselves and in net terms being no better off. Evidence to the committee focused on the ease with which shareholder class actions may be triggered by an alleged breach of Australia's continuous disclosure provisions. Reform is required to continuous disclosure laws given the increasing prevalence of this type of shareholder class action.”[3]

Since the Committee’s report was published, the Australian government announced permanent changes to Australia’s continuous disclosure laws in the Treasury Laws Amendment (2021 Measures No. 1) Bill which amends Australia’s Corporations Act 2001. The change means companies and their directors/officers will be liable for civil penalty proceedings in respect of continuous disclosure obligations where they have acted with “knowledge, recklessness or negligence.” The Australian Treasurer’s media release notes that “the introduction of the fault element for private actions also more closely aligns Australia’s continuous disclosure regime with the approach taken in both the United States and the United Kingdom.”

In addition, the Committee stated “the increasing prevalence of shareholder class actions has broader undesirable outcomes on the availability and cost of D&O insurance, with consequential challenges for attracting and retaining experienced and high quality directors and officers. A culture

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[1] The Australian Parliamentary Joint Committee on Corporations and Financial Services report on *Litigation funding and the regulation of the class action industry*, December 2020, p xvi.
[2] Ibid. p xiii.
[3] Ibid. p xx.

of risk-averse decision-making across Australian boards is a further adverse outcome of shareholder class actions, with harmful long-term impacts on economic growth, job creation and investors' returns on equity."[4]

These undesirable and adverse outcomes are also relevant to New Zealand and we discuss them further below.

Recommendations of the Capital Markets Steering Committee

In 2019, the Capital Markets Steering Committee called for a review of New Zealand's continuous disclosure liability settings in the report Growing New Zealand's Capital Markets 2029:

> "Market participants have noted that the current continuous disclosure settings are giving rise to various negative consequences, or will certainly do so if left unabated. These include (1) an increase in class actions driven by litigation funders (as seen in Australia), (2) limiting the interest of companies in listing, (3) dissuading quality individuals from taking up directorship roles for public companies, (4) significant increases in directors' and officers' insurance costs … and (5) an undue focus by the board and management on continuous disclosure issues rather than strategy.
>
> We recommend that MBIE review the liability settings for continuous disclosure to assess whether or not the current 'no fault' regime remains appropriate, given the negative consequences noted above. MBIE should seek FMA and NZX feedback and, as part of that review, we also recommend that NZX Regulation and FMA more clearly delineate their responsibilities for investigating and prosecuting potential continuous disclosure breaches. Market participants have observed that the current system, where they receive inquiries from both FMA and NZX Regulation, results in higher compliance costs and duplication of effort in responding to the same, or overlapping, inquiries. …
>
> The Australian experience of class actions and litigation funding in relation to alleged continuous disclosure breaches highlights the importance of having both fit-for-purpose continuous disclosure laws and an appropriate class action regime under which investors may seek redress for a breach."

The Capital Markets Steering Committee also recommended that the New Zealand Law Commission "not to go down the same track as the Australian regime in relation to shareholder actions. In our view, a more appropriate balance would be served by an 'opt in' regime for class actions, rather than the current 'opt out' approach taken by Australia."

We note that in New Zealand the Supreme Court has ruled on this matter since the Capital Markets Steering Committee report was published. The Law Commission will need to address this and take into account Australia's experience especially in relation to shareholder class actions as part of ensuring a balance between preventing unmeritorious proceedings and ensuring investor redress.

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[4] Ibid. p 349.

In light of the Australian developments, the review and recommendations proposed by the Capital Markets Steering Committee are even more critical.

We urge the Law Commission or other appropriate agency to consider the continuous disclosure liability settings in New Zealand to align/contribute to the development an appropriate class actions regime. This should also take into account issues for dual-listed companies on the ASX and NZX.

Continuous disclosure is a fundamental obligation of listed companies and boards and it is essential to market integrity and investor protection. On the whole directors of listed companies are diligent and they take their continuous disclosure obligations very seriously.

Settlement pressure

We also highlight that a key related issue in Australia is where defendants are compelled to settle claims that they consider unmeritorious and defensible. We understand that the percentage of shareholder class actions that settle in Australia is very high. This is similar to the position in the highly litigious United States. The reality is that insurers in these cases have significant control in the proceedings given they are funding the defence and can end up driving settlements on financial grounds. There are many undesirable incentives and outcomes in this type of regime including settlement proceeds going mainly to lawyers, experts and funders – rather than the class action members. It is important to note that organisations and directors that settle in these circumstances cannot clear themselves of wrongdoing and are still seen to have erred in the public's eyes, notwithstanding the reasons for settling. It is critical that the Law Commission develops appropriate procedural mechanisms to deter this type of environment emerging. As part of this, the Law Commission should give serious consideration to the role and responsibilities of regulators in class actions, for example whether they should play a special role as lead claimants.

Impact on D&O insurance

D&O insurance is a critical protection mechanism for any strong corporate governance regime that ensures the sustainability of boards and ultimately the organisations they represent.[5]

The Law Commission states in the Issues Paper that it has "not yet seen robust evidence that the increase in funded litigation across Australasia has caused a hardening of the D&O insurance market." The IoD has a strong view about this correlation. Directors have been telling us about their concerns about the rise of litigation funded actions having a flow on negative impact in terms of obtaining and renewing D&O insurance. We have also heard from Marsh that they have seen significant cost increases and reduced coverage in D&O in Australia and New Zealand.

In response to director concerns about D&O insurance, the IoD with Marsh and MinterEllisonRuddWatts assessed and reported on current trends and issues in Under pressure: D&O insurance in a hard market published in September 2020. It highlights that Australia and New

[5] IoD, Marsh and MinterEllisonRuddWatts, *Under pressure: D&O insurance in a hard market*, September 2020, p 2.

Zealand are in the midst of the most volatile and restrictive D&O insurance market in its history. This is not only impacting listed companies, but is flowing through to private companies and not-for-profit organisations. And there are no signs of things getting better anytime soon.

A number of factors have contributed to this market including:

- the board's role and responsibilities have expanded in recent years
- policy-makers continue to target directors for personal liability in reforming regimes
- regulators are more active and well resourced
- class actions are on the rise and litigation funding is prevalent
- there have been notable legal developments in class actions and litigation funding such as the Supreme Court's ruling on 'opt out' claims and
- there have been substantial court awards against directors and organisations.

The market has also been impacted by a number of insurers (locally and overseas) who have ceased providing D&O insurance, particularly to dual-listed entities.[6] A significant number of insurers across Australasia have withdrawn from insuring this class of insurance for listed companies or effectively withdrawn (by quoting onerous terms).[7] As a result, some organisations may face the possibility of a reduced overall policy limit with increased retentions, reduced coverage (especially if Companies Securities cover is purchased), and a year-on-year premium uplift.[8] In addition, COVID-19 has also added further pressure to an already disrupted marketplace with some insurers limiting their appetite to take on new D&O business, especially for certain sectors.

One of the biggest issues with D&O insurance in Australasia is the exponential rise in premiums and the concern that it is becoming prohibitively expensive. Evidence from Marsh to support director feedback to the IoD about costs escalation shows that there has been an average premium rate increase of 157% for its listed company clients in New Zealand over a two year period between 2018 and 2020. There are also examples of D&O premiums increasing by more than 200% for the same period for dual-listed companies.

Given our concerns about escalating costs and access to D&O insurance we included specific questions on D&O insurance in our annual Director Sentiment Survey in 2020. We found that D&O insurance costs rose for 78% of directors of listed companies in the last year. A third of these directors (34%) reported increases of between 20% and 50% – and 8% had increases greater than 50%.

Against this background there is now a catch-22 situation with D&O insurance:

- the role and responsibilities of directors are expanding and D&O insurance is even more important and getting sufficient coverage at a reasonable price is becoming more difficult

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[6] Ibid. p 3.
[7] Ibid.
[8] Ibid.

- however having a high D&O policy limit also means that directors are more likely to be targeted where there is a litigation funder than if they didn't have a policy or one with a lower limit.

We are especially concerned about the impact of this on good governance and attracting and retaining quality directors.

The importance of good governance

Good governance has the power to transform organisations, communities and countries. The critical importance and need for strong governance and leadership has always been vital but has been further highlighted as a result of COVID-19. The role of the board and the need for skilled and capable directors are now more important than ever in leading our organisations.

Boards have to be across an array of complex and diverse issues. They also need to be responsive to increasing stakeholder demands and expectations. New laws targeting directors personally are adding to an already large legal onus and there is greater accountability with active regulators and liquidators and the growth in litigation funding.

It is fundamental to good governance and essential to New Zealand's future wellbeing and prosperity that highly skilled, experienced and responsible individuals are encouraged to serve as directors. This risk of such individuals being deterred from seeking board roles is particularly high in relation to financial institutions and listed companies, when compared with directors of other entities in other sectors. Directors have the choice to contribute to New Zealand in a range of ways, and we are already aware that many favour serving on boards of private companies that are not operating in the financial services industry or listed markets because of the lower risk profile. The deteriorating D&O market especially for listed companies may also impact this.

In 2019 and 2020, 40% of directors in our Director Sentiment Survey said that the scope of director responsibilities is more likely to deter them from taking on governance roles. This was higher for directors of listed companies (46%).

We also highlight that being a director can carry a high level of reputational risk along with responsibility. There are a number of examples in New Zealand and Australia in the last 12 months where directors have faced significant public scrutiny when things have gone wrong in their organisations. Personal reputation is front of mind for directors and a strong driver for them in ensuring organisations are well governed. Class actions are public and often lengthy proceedings and reputations can be unjustifiably tarnished, for example when proceedings are settled without admission and for reasons unconnected with the merits of the claim.

Conclusion

The IoD supports the Law Commission's preliminary view that a statutory class actions regime should be created and that litigation funding should be regulated. However, there are significant risks and concerns that will need to be addressed and managed in developing a new regime.

We are particularly concerned about the future of shareholder class actions. There are lessons that can be learnt from Australia's experience and its review of class actions and litigation funding.

We urge the Law Commission to also consider the recommendations of the Capital Markets Steering Committee including the need to review the continuous disclosure liability settings in New Zealand.

We have also highlighted potential adverse impacts and outcomes of getting the settings wrong including in relation to D&O insurance, and attracting and retaining skilled, experienced and responsible directors for good governance in New Zealand.

We appreciate the opportunity to comment on behalf of our members and we would be happy to discuss this with you.

Yours sincerely

Selwyn Eathorne
Manager, Governance Leadership Centre