Comments of the U.S. Chamber Institute for Legal Reform
on the
Consumer Affairs Agency's Proposal
entitled
Litigation System Relating to Recovering Damages for a Consumer Class

Introduction:

The U.S. Chamber Institute for Legal Reform ("ILR") is pleased to offer comments on the Consumer Affairs Agency's ("CAA") proposal called *Litigation System Relating to Recovering Damages for a Consumer Class* (the "Class Action Scheme"). ILR is a not-for-profit public advocacy organization affiliated with the U.S. Chamber of Commerce, the world's largest business federation, which represents the interests of more than three million businesses of all sizes and sectors, as well as state and local chambers and industry associations. ILR's mission is to ensure a simple, efficient and fair legal system. Since ILR's founding in 1998, it has worked diligently to limit the incidence of litigation abuse in U.S. courts, and has participated actively in legal reform efforts in the United States and abroad. Many of ILR's members have business interests in Japan, and ILR is deeply committed to the orderly administration of justice in the country.

For more than a decade, ILR has studied the effects of class action litigation and the ramifications of class action schemes for civil justice systems. ILR has published numerous articles on class actions and has participated in public symposia about them. ILR has also engaged in substantial advocacy efforts in the United States and in a number of countries around the world regarding legislation governing class actions. ILR has been recognized as an expert and constructive partner in reform efforts relating to class actions. A number of European governments have consulted or are consulting ILR when legislating in this area.

Regarding: General

Comment: Reconsider cost-benefit of introducing Class Action Scheme at this time.

Reason:

ILR recognizes that the CAA likely had only the best intentions in preparing the Class Action Scheme and likely thought it was acting to protect consumers. Nevertheless, we believe that the Class Action Scheme will have a number of negative unintended consequences for consumers and for the administration of civil justice in Japan.

Class action litigation – even when not modeled on the United States' class action scheme – is inherently more vulnerable to abuse than individual lawsuits because it aggregates the claims of numerous litigants in a single proceeding. When numerous claims are aggregated in this way, the overall amount in dispute increases – as does the cost of the dispute itself. As a result, a defendant in a class action frequently faces both litigation exposure and costs far exceeding the exposure and costs it faces in an individual lawsuit. This often compels defendants to settle class actions rather than seek adjudication on the merits, regardless of the validity of the claims and defenses at issue. Indeed, many defendants often agree to settle class actions on sub-optimal terms rather than take their chances at trial. This is true even when the defendant has meritorious defenses, or when the claims of the class members lack validity. At the same time, because class actions aggregate numerous individual claims – without individualized proof – they include weak or non-meritorious individual claims along with any valid claims, without any effective mechanism to litigate them individually.

For these reasons, class actions can portend economic ruin for business. Indeed, such aggregate litigation is *inherently* coercive: because the mere act of filing a class claim can threaten a defendant – even an innocent defendant – with serious economic harm, the availability of a mechanism to aggregate claims into a class action can lead to a flood of abusive litigation that can destroy a business.

If the class action experience in the United States is any indication, introducing the class-action device in Japan will have dire economic implications for the country. The debilitating impact of class action litigation on business has been well documented in the United States. In 2010, for example, American businesses were burdened with $265 billion in costs from tort litigation, including class actions, representing 1.8% of U.S. GDP.[1] These figures were even higher before ILR waged a

[1] Towers Watson, *2011 Update on U.S. Tort Cost Trends*, Jan. 2012, www.towerswatson.com/research/6282.

successful multi-year campaign to enact meaningful class action reform in the United States, which culminated in the Class Action Fairness Act of 2005.[2] Nonetheless, tort costs in the United States remain three times as high as those in other countries belonging to the Organization for Economic Co-operation and Development (OECD).[3] In addition, the ubiquity of class actions in the United States has stymied economic growth, with some companies spending more to prevent and litigate class actions than they spend on innovation. The brunt of these economic consequences is borne by small businesses.

In sum, the Japanese government should analyze the costs and benefits of class actions as a means of consumer redress, and compare it to other options to achieve the ends of consumer protection, including enhanced public enforcement of consumer-protection laws and mechanisms for collective alternative dispute resolution.

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[2] 28 U.S.C. §§ 1332(d), 1453, 1711-1715.

[3] *See U.S. Tort Costs and Cross-Border Perspectives: 2005 Update* (New York: Tillinghast-Towers Perrin, 2006).

Regarding: Criteria for Special Qualified Consumer Organizations

Comment: Strengthen Protections Against Improper Financial Incentives for SQCO's and Ensuring that Financial Benefits of Class Litigation Go to Consumers

Reasons:

Class action systems in other jurisdictions consistently fail to deliver fair and adequate compensation to class members in particular cases, and the availability of a class action mechanism does not deter misconduct by potential bad actors.[4] Indeed, the consumer benefit of class actions is tenuous at best. The parties that benefit the most from such actions are the lawyers who prosecute them and the finance companies that fund them, while the class members share only what is left after those entities take their cut. As a result, consumers typically receive just a few dollars of recovery, or a coupon to buy the defendants' products or services, while the litigation funders and attorneys receive substantial cash recoveries.[5] In U.S. securities litigation, for example, as much as 47 cents of every settlement dollar is lost in transaction costs (primarily attorneys' fees), substantially reducing the amount that eventually trickles down to injured investors.[6]

Should the Japanese government, after performing this thorough analysis, still determine that it wishes to implement a class action regime, it should take steps to mitigate as much as possible the risk that class actions will be abused. Ultimately, the abuse of class action procedures is driven largely by financial incentives. Legal culture and social conventions may mitigate the risk of abuse to some degree, but ultimately, those considerations will not deter parties from bringing dubious claims if

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4 *See* Lester Brickman, *Lawyer Barons: What Their Contingency Fees Really Cost America* (Cambridge Univ. Press 2011), at 292.

5 U.S. class actions had a long and tortured history with such "coupon settlements" until the enactment of the Class Action Fairness Act in 2005, which limited the practice. Before that reform, one of the most infamous coupon-settlement cases was *Kamilewicz v. Bank of Boston Corp*, 100 F.3d 1348 (7th Cir. 1996). In that case, the plaintiffs were mortgagor-borrowers from the defendant mortgage bank. They alleged that the defendant held too much money in escrow with respect to their mortgage loans. As a result of a sweetheart settlement in the case, each borrower had a miniscule sum of up to $8.76 added to his or her escrow account, while class counsel received between $8.5 and $14 million in fees. Even more shockingly, under the sweetheart settlement, the bank withdrew up to $90 from each plaintiff's escrow account to pay class counsel's fees. The end result was a net *loss* for the plaintiffs and a windfall for the lawyers who purportedly represented them

6 *See* Institute for Legal Reform, *Securities Class Action Litigation: The problem, its impact, and the path to reform* (July 24, 2008), at 19, available at http://www.instituteforlegalreform.com/sites/default/files/SecuritiesBooklet.pdf.

there is a prospect of financial reward. The principal factor in determining a class action mechanism's vulnerability to misuse and subversion is the extent to which it is profitable for parties to pursue frivolous litigation. Concrete measures that alter the risk-reward calculus of commencing litigation are thus the most important protections against such activity; a party who will be forced to bear significant costs if his or her claim is unsuccessful and who will receive only modest return if he or she wins is unlikely to bring claims or lawsuits that lack merit.

For these reasons, the key to preventing litigation abuse is establishing and maintaining structural "safeguards" – i.e., procedures that discourage litigation abuse by raising the cost of, or reducing the potential return from, such behavior. In this regard, it is of concern that nothing in the Class Action Scheme appears to constrain any relationships between QROs and law firms, including law firms having ownership interests in QROs and *vice versa*. Given that lawyers are the persons who ultimately decide whether to file and how to prosecute class actions, and given that they stand to reap the monetary rewards of doing so through attorneys' fees, any class action scheme providing for representative cases to be brought by QROs should strictly limit the types of relationships law firms and QROs may have with each other.

Moreover, as a conceptual matter, placing the decision to initiate class actions in the hands of consumer organizations – even those "qualified" by the government – may lead to abuse. Unlike individual claimants, consumer organizations have no personal stake in seeking redress for injuries and do not seek to vindicate any individual rights. Rather, representative organizations would use litigation to advance their core mission: advocating for the interests of particular groups, interests or causes, and in some cases seeking money from public and private sources to do so. Empowering such organizations to threaten businesses with substantial liabilities that could force them to change their business practices or to offer a substantial settlement, as in phase one of the Class Action Scheme, would pose a serious risk of litigation abuse. This risk is heightened, moreover, where QROs are allowed to fund their own operations from the proceeds of class actions brought by them – including settlement proceeds. In such circumstances, QROs would have a direct financial incentive to file phase-one lawsuits – even based on legally invalid claims – seeking to coerce a large settlement from a defendant, and thereby fund their own operations.

ILR believes that funding mechanisms for class actions should be tailored to mitigate the risks of lawsuit abuse while still providing access to justice. We therefore respectfully urge the government to assess carefully how class actions in Japan will be financed. Class actions are as a rule complex, time-intensive and costly. Accordingly, any class action scheme in Japan should rule out funding mechanisms that involve "investors" seeking to profit from lawsuits.

Two examples of such problematic investments in lawsuits, which we believe should not be permitted – or, at the very least, should be regulated strictly – in any class action scheme are attorney contingency fees and funding by third-party litigation finance ("TPLF") companies.

With respect to contingency fees, ILR believes that such fees should not be permitted in the context of class actions. Contingency fees incentivize attorneys to bring potentially lucrative claims, regardless of merit, and then to prosecute the litigation and structure any settlement in a way that maximizes their own return, rather than the compensation to the claimants. Moreover, particularly in a phase-one representative case, because the claimants' lawyer is the only person on the claimants' side with a significant interest in the case, the lawyer is typically willing to agree to any terms offered by the defendant that will reimburse the attorney's investment and provide him or her a profit. For this reason, the "sweetheart settlement" problem – where the claimants' attorney negotiates with defendants for large fees and very little in the way of claimant recovery – is heightened in class action cases where attorneys are paid on contingency. All of these problems are prevalent in United States class actions – where claimants' attorneys typically work on contingency.

With respect to TPLF, experience has shown that such funding encourages the filing of frivolous litigation and exerts undue settlement pressure on defendants by providing claimants – here, QROs – with the resources to continue litigating claims regardless of merit. These dangers are exacerbated in class action proceedings, which already exact substantial leverage against defendants based on their sheer size and the potential for enormous exposure (regardless of merit).

TPLF also exacerbates another fundamental problem with representative litigation – that it is generally controlled by the QRO and its attorneys rather than by class members. When a third-party funder is involved in class action proceedings, the consumers (who generally have only a small stake in the outcome) are squeezed out of the picture, and the lawsuit essentially becomes a collaboration among the lawyer, the QRO and the funder. Thus, the funding company will have the power to steer the direction of the litigation – and it will have every incentive to do so in a way that serves its pecuniary interests, rather than the claimants'.

In Australia, where third-party funding of class actions is so common that class actions are considered investment vehicles, many judges, scholars, defense lawyers and other critics have expressed serious reservations about the practice. In fact, Federal Court Chief Justice Patrick Keane gave an interview to *The Australian*

Financial Review in which he expressed his concerns, especially those about excessive fees charged by TPLF companies and their support for non-meritorious claims.[7]

One illustrative case is the putative class action by residents of Brisbane, Australia, relating to recent flooding. The funder in that case, IMF Australia is expected to take 30 percent of any damages awarded to the class. Some are estimating that a settlement in this case – which might become Australia's largest class action – could top $500 million and could yield IMF over $100 million, more than double its gross revenue for 2010-11.[8] TPLF has also dominated the protracted shareholder class action litigation involving the shopping center company Centro and its former auditor, PwC. The shareholder suit, which is also being funded by IMF, has yielded a record $200 million settlement.[9] The litigation has adversely impacted the companies' economic vitality, further underscoring the potential for TPLF abuses.

Funded class actions are not only a problem in Australia. Class action competition litigation has been pending for years against a group of air-cargo carriers. As part of this litigation, in September 2010, one Ireland-based funding company (which is owned by an Australian plaintiffs' firm) spearheaded the filing of a EUR 500 million against airline Air France-KLM in Dutch court. Reportedly, more than 300 plaintiffs from across Europe are pursuing air-cargo companies in class actions in various jurisdictions.[10]

For these reasons, we respectfully urge the Japanese government to study the problems inherent in financing class actions and to consider prohibiting investments – through contingency fees or TPLF – in such cases. If a blanket prohibition is not possible, such funding mechanisms should at the very least be regulated to prevent abuses.

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[7] *See* Jennifer Ball, "Australia: Litigation funding in policy vacuum," *Australian Fin. Rev.* (Oct. 14, 2011).

[8] Chris Merritt, *IMF May Win Big in Damages Suit 2009 Sign up for Class Action Over Queensland Floods*, The Australian, Mar. 23, 2012.

[9] *See* Adam McLean, *Centro, PwC Take Record $200m Legal Hit*, Financial Review, May 9, 2012, *available at* http://afr.com/p/national/centro_pwc_take_record_legal_hit_6CaSTKu6K1w7nJFFIZOxWL.

[10] Jean-Michel Gradt, *Air France-KLM : des clients du fret portent plainte pour entente* (Sept. 29, 2010).

Regarding Judicial Exceptions

Comment Clearly Exclude Actions based on violation of regulatory statutes.

Reasons: These negative impacts are most pronounced when class action procedures are available in actions to enforce a regulatory scheme (competition law, securities law, financial institution regulation, for example), and thus begin to supplant public enforcement of those schemes. Regulatory enforcement should always remain the sole province of public authorities, which have the expertise and judgment to enforce regulatory schemes dispassionately and in the best interests of all consumers. Public authorities are also better positioned to make the policy judgments that surround every enforcement decision than private claimants who have a direct financial stake in a matter. Accordingly, public enforcement by a government authority is superior to private enforcement through class action litigation.

Regarding: Special Exceptions

Comment: The Class Action Scheme should explicitly provide it will have only prospective effect – that is, that it will apply only in cases based on conduct occurring after the effective date of the Class Action Scheme.

Reasons: We understand from the CAA's response to comments on the Class Action Scheme that it received in December 2011 that the CAA intends the Scheme to be "applicable to demands (actions) instituted after this law is put into effect in cases where subject claims exist on the basis of substantive law." We are concerned that such broad-reaching application – including to conduct pre-dating the Class Action Scheme – would unfairly penalize businesses for possible past conduct. As we described above, class actions are *inherently* coercive and prone to abuse; potential class liability is thus so much more damaging and costly than individual liability that making conduct subject to potential class liability constitutes a substantive legal change, and not a mere change in civil procedure. Applying the Class Action Scheme to past conduct would be tantamount to giving it retroactive effect. We are unaware of any other recently enacted class action scheme that has been given retroactive effect – and for good reason. Although the CAA views the Class Action Scheme as a modest procedural reform, in fact, if enacted, it would constitute a radical departure from existing law. If applied retroactively – as is currently contemplated – it would subject Japanese businesses to significant liability for conduct that occurred in the past – even years or decades in the past. Plaintiffs' lawyers and litigation funding companies would have every incentive to seek out old cases of alleged wrongdoing, which would no doubt increase the volume of lawsuits brought against Japanese businesses. Moreover, business would be hard-pressed to defend themselves against this expected onslaught of litigation, because relevant evidence about these old claims may no longer exist. Thus, business, the engine of Japan's economy, would have to endure the constant threat of frivolous class-action litigation concerning claims that should have been litigated long ago, if at all. Rather than hire new employees, innovate, and invest in their companies, these businesses would have to spend enormous sums of money to fend off stale, meritless class actions. The result would be that Japan would see its economy continue downward.

In short, retroactivity would be highly unusual and, for the reasons discussed in these comments, would invite serious abuses. Given the substantial changes the Class Action Scheme would effect in Japan – and the economic havoc it would wreak on Japanese businesses – it should have only prospective application, if enacted at all, as the CAA apparently has determined.

Regarding:

Comments: Provide More Precise Certification Standards, Focusing on the Requirements of Commonality, Adequacy, Typicality, and Numerosity.

Reasons:

Another effective safeguard against abuse of class actions is a "certification" standard that sets forth a detailed procedure by which a court can assess whether a proceeding is appropriate for aggregate adjudication or can serve as a test case for future common claims. In the United States, the Class Action Fairness Act made most class actions subject to the jurisdiction of the federal courts, which have relatively stringent certification standards, and thereby divested the state courts, which tend to have looser standards, of jurisdiction. Thus, by moving class actions from courts with looser standards to courts that have more stringent and precise standards, this law greatly diminished the incidence of class action abuse in the United States.

Based on the U.S. experience, we believe that any class action regime should impose the following four requirements:

A. Predominance Of Common Issues/Cohesiveness

This requirement is intended to ensure that before a class action is permitted to proceed on its merits, a court must determine that all of the claims of the proposed class members can be adjudicated fairly in a single proceeding and established through common proof. More specifically, courts must decide whether the proposed class action comports with the principle that "trial for one can serve as trial for all" – i.e., the relevant facts and law as to each class member's claim are such that adjudicating the representative claimant's claim (or significant issues related to that claim) *necessarily* resolves the claims (or the same significant issues) for the class members.

Our review of the Class Action Scheme proposal, as released for public comment, suggests that its requirement that common questions of law and fact so predominate that a phase-two proceeding could efficiently adjudicate all class members' claims is not sufficiently strong. We suggest that, should the government determine to move forward with the Class Action Scheme, the bill be revised to include explicit statutory language directing courts to dismiss proceedings brought under the Class Action Scheme where common factual and legal issues do not predominate.

B. Adequacy

"Adequacy" means that a court evaluates any qualified representative organization that seeks to act as a representative claimant to assure that it is willing and able to represent the class adequately. This safeguard protects potential class members by ensuring that any qualified representative organization that purports to speak for them and compromise their rights shares the same interests they do and is motivated and informed about the suit. Among other things, an adequacy requirement will help ensure that a representative is not seeking to file a lawsuit in order to extort a fast "sweetheart" settlement for itself and its attorney, or to advance any particular agenda, while casting aside the interests of the potential class members.

C. Typicality

"Typicality" means that the claims asserted by or on behalf of the representative claimant must be typical of the claims of the class. This safeguard is intended to ensure that only those claimants who advance the same factual arguments may be grouped together in a class action. The typicality requirement protects class members by ensuring that the representative claimant's incentives align with those of the class members – and that it can fairly represent their interests.

D. Numerosity

"Numerosity" means that a class action should not proceed unless there are so many potential claimants that no other form of dispute resolution would be practical. This safeguard does not require establishment of a specific numerical threshold for classes; rather, it requires courts to assess whether any purported class action involves a sufficiently large number of potential claimants under the circumstances to make individual proceedings impractical.

We are concerned that the Class Action Scheme does not include an adequate certification requirement. Thus, we believe that phase-one representative suits brought under the Class Action Scheme will not adequately define the class of consumers who may be eligible for compensation in the second phase of a class action, the result of which is that the courts will not be able to establish the criteria for common proof to be applied to the class claims. We therefore respectfully suggest that, to the extent the Japanese government decides to move forward with class actions, it should amend the Class Action Scheme to include a certification procedure as outlined here.

Regarding:

Comment: Provide More Clear Rules for Case Closure.

Reasons: As we understand the Class Action Scheme, after a QRO is successful in a phase-one representative lawsuit, then, in the second phase of the class action, claimants meeting the class definition have the option of joining the class. Importantly, however, phase-two claimants are not bound by the phase-one result when the QRO loses. In such circumstances, if the QRO has not been successful in its phase-one case, nothing prevents another organization from bringing its own case, with a slightly different class definition.

Thus, the Class Action Scheme does not provide any mechanism for a defendant that is successful in phase-one litigation to achieve closure by preventing copycat litigation. When a phase-one QRO loses its representative case, nothing in the law would prohibit a second (or a third, or a fourth) QRO from also bringing a phase-one class action against the same defendant.[11] Once any QRO is successful in phase one, the defendant will be subjected to enormous liability in phase two, regardless of how many prior phase-one cases it had won. This feature of the Class Action Scheme thus poses additional risks of abuse – especially considering that the proposal does not limit the number of consumer organizations that can act as QROs or provide standards for their qualification; the members of a QRO that loses a phase-one case could form a new consumer group and petition the government for qualification in order to have a second chance suing the same defendant. For these additional reasons as well, we respectfully urge the Japanese government to consider mechanisms that would provide closure to defendants who are successful in phase-one representative litigation, should Japan decide to move forward with class actions.

[11] We understand that the CAA's response to similar comments received in December 2011 was that "it will be appropriate to stipulate that judgments with regard to phase-one proceedings instituted by a specified qualified consumer organization also apply to other specified qualified consumer organizations." It thus appears that the CAA correctly recognizes this potential for abuse, but it does not appear that the text of the Class Action Scheme itself contains any provision to address it.