CLASS ACTION INJUSTICE

PETER S. SPIRO

Letting shareholders harmed by misrepresentations sue as a class seems like a good idea. But the devil is in the details.

Autoriser des actionnaires lésés par suite de présentations inexactes à exercer un recours collectif semble une excellente idée. Mais le diable est dans les détails.

Securities markets are seeing a growing number of class action lawsuits in which plaintiffs allege that a company misrepresented its financial information, thus inflating the price of the stocks they bought. These lawsuits may appear to be the ultimate revenge of the little guy against the big bad corporation, since they allow for a large number of people with small claims to get together and seek justice they could not obtain alone. But a closer look suggests that the winners and losers in these suits may not be the right ones.

These are what are called "secondary market" class actions, because the investors who are suing bought the stocks from other investors, rather than newly issued stocks from the company itself. Historically, the lack of a direct business relationship would have precluded a legal claim by such an investor against the company. The major event that opened the floodgates of secondary market securities class actions was the United States Supreme Court's 1988 decision in *Basic Inc. v. Levinson*. That decision created what has come to be known as fraud-on-the-market. It accepted the economic theory of the "efficient markets hypothesis," that all public information affects the price of a stock. As a result, a court can take it as given that the misrepresentation was relied on by investors, so investors can sue without having to show they acted on the misrepresentation.

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Since 1988, securities market class actions have grown to represent about 50 percent of all class actions launched in the United States, and in recent years well over 200 securities class actions have been initiated annually — producing total settlement costs of $50 billion per year. There are fewer than 5,000 companies listed on stock exchanges in the United States; if these lawsuits were distributed evenly among them, one in 20 companies would face a lawsuit in any given year.

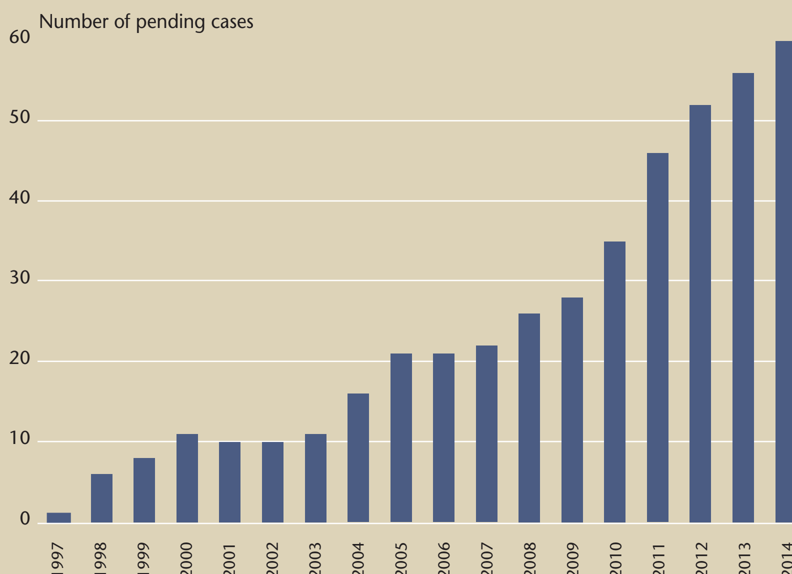
The number of publicly traded companies listed in the United States has dropped considerably, from over 9,000 in the late 1990s, a rate of decline much steeper than the global rate. Critics suggest that the compliance burden of being a public company — including the cost of securities class actions — has encouraged more companies to go private.

The US precedent was not accepted into the common law by Canadian courts, but was ushered into this country by government. Ontario was first to introduce legislation empowering secondary market class actions — Bill 198 — with an amendment that came into force at the beginning of 2006. Other provinces followed Ontario's lead.

One significant factor that makes the Ontario statute different than the US common law regime is a cap on liability, which is set at 5 percent of the market capitalization of the defendant company. That makes it unattractive to sue small companies, and has reduced the number of claims. But with a large company, there is still a lot of money involved. In 2014, the average market capitalization of a company that was a member of the Toronto Stock Exchange 60 index was $23 billion. According to the consulting firm NERA, as of December 2014, "there were a total of 60 unresolved securities class actions representing more than $35 billion in total claims." That works out to

FIGURE 1
NUMBER OF CANADIAN SECURITIES CLASS ACTIONS, 1997-2014

Source: *Trends in Canadian Securities Class Actions: 2014 Update*, NERA Economic Consulting.



an impressive average of $580 million per claim, in spite of the statutory cap.

Relative to the number of listed companies, the number of securities class actions in Canada remains much lower than in the United States (figure 1). There are now about 10 new cases per year, compared with only 2 or 3 per year prior to the amendment. A few have led to large settlements of the type that garner headlines for class actions. For example, investors in Sino-Forest recently received a $117-million settlement from the company's auditor. (The largest securities class action in Canadian history was against Nortel Networks Corp. It was based on events that occurred several years before Bill 198, but it was a cross-border class action, as Nortel's shares were also listed in the United States, and thus determined by US law. The resulting settlements resulted in payouts of more than US$800 million in cash — plus even more in stock, for a total of over $2 billion — probably hastening Nortel's bankruptcy.)

There is an immense American literature on these lawsuits, and many observers argue that securities class actions have become such a burden on the economy that their benefits do not justify the costs. Of course nobody would deny that deliberate or negligent misrepresentation of financial information by corporate executives ought to be punished. Such behaviour is clearly harmful. However, there is considerable debate about whether the class action is an effective way to deal with it.

The key concern is that the money paid in securities settlements comes at the expense of the innocent shareholders of the company, who had no benefit from the misrepresentation. This is neatly summed up in the congressional testimony in 2009 of Professor Adam Pritchard of the University of Michigan, one of the leading authorities on securities law in the United States. "For every shareholder who *bought* at a fraudulently inflated price, another shareholder has *sold*: The buyer's individual loss is offset by the seller's gain; investors can expect to win as often as lose from fraudulently distorted prices," he testified. "They can protect themselves against fraud much more cheaply through diversification…Critically, there is no offset for the windfall gain on the other side of the trade. The investors lucky enough to have been selling during the period of the fraud do not have to disgorge their profits."

The average investor does not benefit from securities class actions. The announcement that a class action has been launched against a company results in about a 4 percent decline in the value of its shares.

It has been observed, in the United States and Canada, that defendant companies almost always settle these claims, rather than fighting them at trial. Critics suggest that this reflects a conflict of interest on the part of corporate management. If the matter went to trial, it might be found that specific executives were at fault, and they would have to pay damages out of their own pockets. Settlements are always structured so that all the money comes out of corporate funds, meaning that they are at the expense of current shareholders, robbing Peter to pay Paul. One of the putative societal benefits of class actions is to deter undesirable behaviour, but that may not be happening here. Pritchard has noted that the deterrent effect of these settlements is likely to be minimal, because it almost never comes out of the pockets of the corporate executives who actually committed the misdeeds.

The United States Supreme Court had another opportunity to rule on the matter in a 2014 decision. Critics of

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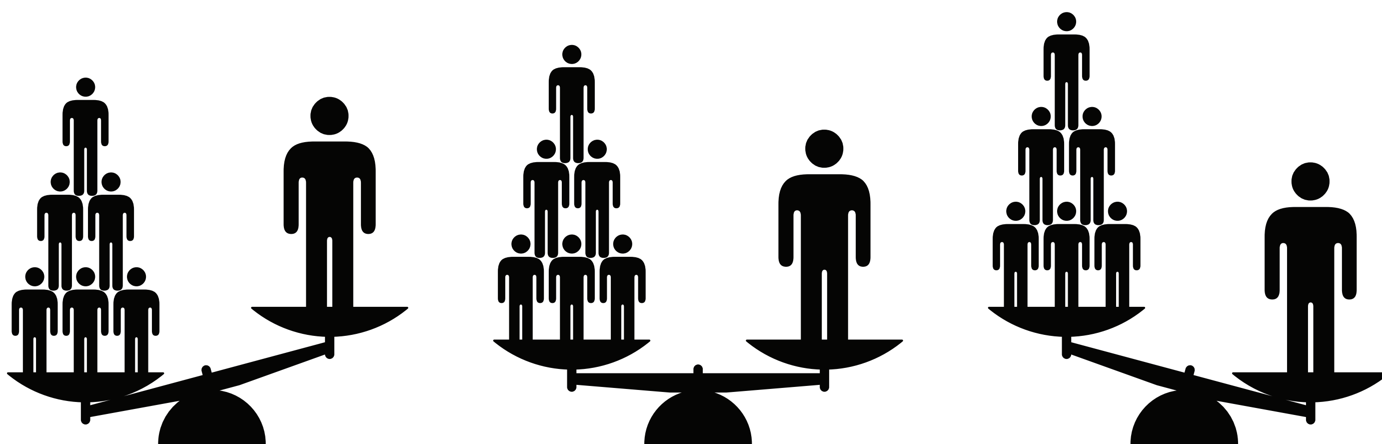

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securities class actions had been hopeful that the Supreme Court would overrule its own earlier *Basic v. Levinson* decision from 1988. Writing for the majority, Chief Justice Roberts declined to do so. "Halliburton and its amici contend that, by facilitating securities class actions, the Basic presumption produces a number of serious and harmful consequences," he wrote. "Such class actions, they say, allow plaintiffs to extort large settlements from defendants for meritless claims; punish innocent shareholders, who end up having to pay settlements and judgments; impose excessive costs on businesses; and consume a disproportionately large share of judicial resources…These concerns are more appropriately addressed to Congress."

The original legislative change that introduced these class actions to Canada was well intentioned as an investor protection measure, but it appears to need some fine tuning to achieve that aim. If too much of the settlements is found to be going to large traders and speculators, at the expense of small buy-and-hold investors, it might be desirable to put a cap on awards to individual class members. And fees to class counsel could be made contingent on successfully pursuing the executives who were actually responsible for the misrepresentation, to ensure that they personally pay part of the claim. At present, there is no incentive for the prosecuting lawyers to take a stronger role to actually deter misrepresentation by corporate executives.

The situation in Canada is certainly not as extreme as in the United States. The cap on liability, as well as the absence of juries in most civil trials, creates a different atmosphere. Therefore, the deep level of concern expressed by critics in the United States may not be fully applicable here. Nevertheless, many of the same issues are relevant, and this is an area that deserves careful scrutiny. ■