Facilitating Shareholder Class Actions: Proposals for reform

Clive Wolman, October 2004.

Introduction

Shareholder class actions aim to tackle a fundamental weakness of modern market-based economies - the “rational apathy” of the owners of large, quoted companies and their unwillingness to exercise their supervisory powers over what the British Labour party used to call “the commanding heights of the economy.” In effect, class actions are a device to supply the otherwise lacking “logic of collective action”[1].

Over the last 30 years, the shareholder class action against directors’ malpractice has come to play a central role in the legal, financial and corporate governance systems of the US. Last year, investors received $2.0bn. compensation in settlements of these actions (in 2002 - $2.5bn.)[2]. Boosted by the Enron and similar scandals, total pay-outs over the next five years are forecast at around $20bn.

Such class actions have also become an important part of the legal landscape in Canada (with the adoption by most provinces of a harmonised Class Proceedings Act) and Australia (since the legislature introduced an “opt-out” procedure in 1992[3]) as well as, recently, in China and Korea.

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[1] The title of a seminal book on the theory of group behaviour by economist Mancur Olson (1971 Harvard University Press).
[2] See Stanford Law School Securities Class Action Clearinghouse Website.
[3] And the key judgment in *Carnie v Esanda Finance Corporation Limited [1995] 182 CLR 398.*

In the UK, several companies whose securities are secondarily listed in the US have also been drawn into such actions in the US as defendants alongside their directors, for example Vodafone and Cable & Wireless. At the same time, streams of envoys from US class action law firms have been crossing the Atlantic to sign up as lead plaintiffs UK institutional investors with portfolio holdings in US companies.

Yet in the UK, shareholder class actions have, with one partial exception, never been initiated notwithstanding the many high-profile corporate collapses, executive frauds and allegations of excessive pay and abuses of power in the board room over the last 20 years. Instead to control and discipline errant directors, UK shareholders have relied on a variety of other legal, regulatory and informal devices.

The vast majority of shareholder class actions in North America and Australia allege misrepresentation, a common cause of action in the English legal system. Yet in England, claims alleging misrepresentation by the directors of a company's value, assets or prospects are rare. It is even rarer for such claims to be brought by quoted company shareholders. Generally the claimants are disappointed takeover bidders[4]; financial institutions like investment banks or market-makers[5]; small private company shareholders[6]; or subscribers to shares issued under a false prospectus[7]. The primary defendants are rarely the directors but deep-pocketed third parties such as the company's auditor[8], investment bank[9] or commercial bank/lender.[10]

None of these cases required the mobilisation of a large or dispersed group of shareholders - collective action, if needed at all, was easy to organise.

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[4] E.g. *Morgan Crucible v Hill Samuel Bank and Others CA [1991] Ch. 295*
[5] E.g. *Chase Manhattan Equities v Goodman and others Ch.D. [1991] BCLC 897, [1991] BCC 308*; and *Smith New Court Securities v Citibank [1997] AC 254, HL.*
[6] E.g. *Re Chez Nico (Restaurants) Ltd [1992] BCLC 192* and *Platt v Platt [1999] 2 B.C.L.C. 745 (Ch D).*
[7] Dating back to *Peek v Gurney [1873] LR 6 HL 377, Edgington v Fitzmaurice [1885] 29 Ch D 459* and *Derry v Peek [1889] 14 App Cas 337.* A more recent case was *Abbott v Strong Ch. D. [1998] 2 BCLC 420.*
[8] E.g. *Caparo Industries v Dickman [1990] 2 AC 605*, where the directors were also sued.
[9] E.g. *British & Commonwealth Holdings v Samuel Montagu and Others CA [1995].*
[10] E.g. Citibank in *Smith New Court.*

There are few other areas of legal practice where the UK differs so much from the other major common law countries.

The rationale for class actions

US judges and legal theorists have developed a rationale for class actions in general and shareholder actions in particular which falls into six categories.

First, class actions, it is said, redress the imbalance of information and power between the directors and officers of large corporations and individual consumers or investors. In a securities fraud, thousands of shareholders may be unaware of their rights or of the deception to which they have fallen victim - or each loss alone is too small to justify the costs of litigation. Class actions aggregate personal rights, which would otherwise remain unvindicated, and achieve economies of scale.

Second, class actions are an efficient way of administering justice to avoid the duplication of trials and risk of inconsistent judgments.

Third, the regulators who have primary responsibility for preserving the integrity of financial markets are typically under-funded, under-paid, process-oriented and bureaucratic. Class actions are necessary to complement their work by harnessing private grievances and initiative to expose and deter malpractice.

Fourth, notwithstanding the occasional well-publicised mega-payouts to contingency fee lawyers[11], class actions have been subject to 40 years of refinement to cope with what economists call "the agency problem". In other words, their structure compels those who bring

[11] Caricatured in John Grisham's *King of Torts* (Century, 2003).

together and represent a large, inchoate group of litigants to act in the best interests of that group, rather than in their own interests or those of a sub-group[12].

Fifth, far from being a symptom of US litigiousness and an excrescence of Anglo-American jurisprudence, as critics suggest, class actions have been a natural part of its development over seven centuries. This argument draws on the research of Professor Stephen Yeazell,[13] demonstrating that, since the Middle Ages, the group representative lawsuit based on the English manor, parish or guild was the most common way of enforcing communal rights. The procedural rules to assist such groups were in the 18th century applied to urban and industrial associations and, by the late 19th and early 20th centuries, in the US, they formed the nucleus of the modern class action.

By contrast, in England, a parallel development was stalled in the 19th century by the internal problems of the Chancery courts, the growth of individualism and new legislation creating specific group rights in companies, friendly societies and trade unions. The stagnation was confirmed by a Court of Appeal judgment in 1910 that rejected an attempt by one owner of cargo on a sunken ship to sue on behalf of 44 others[14]. The ruling blighted the development of representative actions in England for 70 years until it was distinguished by Vinelott J in *Prudential Assurance v Newman Industries*[15], the leading case on public company shareholder litigation.

Finally, shareholder litigants are particularly well suited to class proceedings compared with, say, the less homogenous personal injury claimants in other mass torts who, as well as differing greatly in circumstances and injuries, will have different views towards the risks of litigation.

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[12] See for example John C. Coffee: *Understanding the plaintiff's attorney: the implications of economic theory for private enforcement of law through class and derivative actions*. Columbia Law Review, May 1986.

[13] in *From Medieval Group Litigation to the Modern Class Action* (Yale University Press, 1987).

[14] *Markt and Co. v Knight Steamship [1910] 2 KB 1021* at 1040.

[15] *Ch.D. [1979] 3 All ER 507.*

By contrast, the losses suffered by shareholders are purely financial, easy to calculate when assessing damages and proportionate to the size of their holdings. Similarly proportionate is the impact of other established remedies, for example corporate governance improvements. Furthermore, most shareholders own diversified portfolios of shares and so are unlikely to differ greatly in how much risk to take when holding out for a better settlement.

Nor do shareholder claimants need to prove that each relied on false statements, thanks to the "fraud on the market" doctrine entrenched in US jurisprudence[16]. The doctrine presumes that all shareholders, even if they rarely read prospectuses or annual reports, rely on the efficiency of the stock market, i.e. its ability to capture all publicly available information in the prices at which shares are traded.

Explanations for the absence of shareholder class actions in the UK

Alongside Yeazell's historical account, the disparity in practice between the UK and other leading common law jurisdictions can be explained by six specific factors, of which four have been subject to far-reaching change in recent years in what appears to be a process of international convergence.

The first factor - the shortage in the UK of deep-pocketed directors - has been tempered by the new share option-derived wealth of many executives. New targets for litigation have also been created by the surging sales of directors' and officers' insurance. More litigation of course means higher premiums – but only, provided proper underwriting standards are applied, for directors with chequered histories and companies with inadequate governance.

Second, the UK has traditionally relied more on regulation than litigation to deter corporate misconduct. However, the Financial Services and Markets Act 2000 facilitates in two ways private

[16] See *Basic v. Levinson 485 U.S. 224 (1988)* at 242

litigation backed by the Financial Services Authority. First, a quoted company's breach of its "Continuing Obligations" under the Listing Rules furnishes a cause of action, under section 90, that is bolstered by the FSA's status as listing authority. S.90 with its phrase "as a result of any untrue or misleading statement" opens the door to "fraud on the market" - even if the Law Lords have so far failed to grasp the doctrine.[17] Second, victims of the new offence of "market abuse" can now sue under an investor-friendly code drawn up by the FSA.

Third, UK institutional shareholders have traditionally preferred voluntary corporate governance codes and informal pressure to litigation. But that dichotomy has been undermined by the engagement of UK institutions in US class actions – and by the growing emphasis on corporate governance reforms in the settlement of US claims as, for example, in the cases against Cendant and Samsonite. Moreover, institutions have increasingly shed their inhibitions on going public in opposition to company directors, as in last year's veto of Michael Green as chairman of the merged Carlton and Granada.

Fourth, although the cautious development of UK company law in the first four post-war decades limited the causes of action available to shareholders, the courts have been catching up. For example, under the influence of US and Australian case law[18] and of the 1986 Insolvency Act (s. 214)[19], they have overcome their traditional reluctance to hold directors liable for falling below an objective standard of skill, competence and diligence.[20] Similarly the *Foss v Harbottle*[21] restrictions on minority shareholders bringing derivative actions against directors have been

[17] See in particular Lord Bridge's misunderstanding of the symmetry in buying and selling shares in *Caparo* at 627.
[18] *Smith v van Gorkom 488 A 2d 858 (Del 1985) and Daniels v Anderson [1995] 16 ACSR 607*.
[19] See Hoffman J in *Norman v Theodore Goddard [1991] BCLC 1027* and *Re D'Jan of London Ltd [1994] 1 BCLC 561* and the Court of Appeal in *Cohen v Selby [2001] 1 BCLC 176* (at 201) and *Re Barings plc (No. 5) [2000] 1 BCLC 523*.
[20] Dating back to *Re Cardiff Savings Bank: The Marquis of Bute's case [1892] 2 Ch.100*. and *Re City Equitable Fire Insurance Co. Ltd. [1925] Ch 407*.
[21] *[1843] 2 Hare 461*. The influence of *Foss* reached a zenith in *Pavlides v. Jensen [1956] Ch. 565*.

outflanked by "unfair prejudice" petitions under s. 459 of the 1985 Companies Act,[22] just as they have by legislative reforms in Canada, Australia and New Zealand.

The remaining obstacles requiring reform

However, to facilitate shareholder class actions in the UK, reforms are still required in the two most important areas, viz. the rules of procedure and costs.

The boom in US shareholder class actions can be traced to the introduction in 1966 of an "opt-out" procedure by which a lead plaintiff and his law firm can be certified as representing an entire class of victims. If successful, they can claim damages sufficient to compensate the entire class without the individual members taking action. Only when the case is won do the lawyers typically track down all the members of the class and notify them of their entitlement to damages. The individual shareholder then merely has to fill in, sign and return a form. The administrative costs of this exercise are met from the damages fund. The only individuals excluded from such damages are those who have opted out. Very few do.

In the UK, the closest equivalent is the Civil Procedure Rules ("CPR"), Part 19, where section II deals with representative actions, and section III covers group litigation orders ("GLOs").

In a section II action, the representative need not sign up all or any of the class of claimants he purports to represent. Until he secures a settlement or a judgment, the rest of the class need take no action at all - except to contest his right to represent them. Thus the representative operates more like a US "lead plaintiff".

But in contrast to the US, the other members of the class cannot sit back and await a damages pay-out. In *Prudential v Newman*, Vinelott J endorsed a two-stage procedure to allow class members to secure damages. Firstly, the claimant must win a declaration that the class he

[22] E.g. *Anderson v Hogg [2002] SLT 254, Inner House*

represents (in that case, the shareholders) are entitled to damages, perhaps assessed according to a specified formula. Then the class members, after proving their personal loss, can invoke that declaration to secure damages.

In a few cases, where no distinctions need to be made between the class members, the courts have awarded sufficient damages to compensate them all at a single trial. The representative is charged with distributing the compensation[23] or, in one breach of copyright case, all the victims agreed to pay the damages to their industry watchdog.[24]

However, neither of these nor the *Prudential* case has been used as a springboard to develop representative suits on US class action lines. The initiators of the leading recent representative action[25] were not the claimants but the defendant insurance company which financed a test case itself to achieve finality in a controversy. Generally, CPR 19 II has remained a procedural backwater.

In February 2001, the Government published a consultation paper, "Representative claims: proposed new procedures", which would have strengthened CPR 19 by allowing:

- representative organisations, such as consumer or environmental groups or trade unions, to bring an action on behalf of all its members;
- ad hoc groups to proceed without notifying or even identifying all the members of the class they represent, where it would be impracticable to do so. This provision might well have covered one or more large institutional shareholders willing to represent all shareholders in a company;
- sufficiently high damages to be awarded in some cases to cover the entire class, with such damages either:

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[23] *The S.S. Greystoke Castle HL [1947] 1 All ER 647*.
[24] *EMI Records Ltd. v Riley [1981] 1 WLR 923*.
[25] *Equitable Life Assurance Society v Hyman HL [2000] 3 WLR 529*.

a) being applied for the benefit of the class as a whole e.g. to finance health and safety measures or research or a price reduction - this is already the effect of a successful derivative action against a company's directors; or

b) being held in a trust fund and distributed to those who applied – this would be the appropriate mechanism where directors have misled the market. It would follow closely the US model.

However, following a lukewarm response, the Government in April 2002 decided not to proceed with a general provision but only provisions to cover specific issues. Several respondents thought that CPR 19, in the words of Professor J. A. Jolowicz, "can achieve the greater part of what could be achieved by the procedures adumbrated in this Paper."

GLOs could also be adopted to facilitate opt-out class actions. The final report of Lord Woolf's committee, on which the CPR is based, recommended that opting-out be permitted by the court in some cases. The only hint of that recommendation in the CPR however is in 19.11(3)(a)(iii) which says: "A GLO may, in relation to claims which raise one or more of the GLO issues, direct their entry on the group register."

If "claims" here is interpreted to include <u>any</u> assertion of a right to seek a judicial remedy and not just claims backed by the issue of a claim form, then a judge would be able to place latent claims on the register. For example, all those who bought shares in Marconi in the months before its price collapse in 2000-1, even if they had taken no action themselves, might be registered – unless they expressly opted out. If the claimants were successful at trial, damages would be awarded to the entire group and the lawyers would notify the shareholders, as in the US and as (in principle) with UK representative actions. So far however, although about 45 GLOs have been issued since May 2000, no judge has been asked to interpret CPR 19.11(3) so boldly.

Thus, to remove the procedural obstacles to class actions, legislative reform is less important than the willingness of judges and lawyers to interpret and exploit existing provisions in a bolder way.

A question of costs

However, the crucial dampener on lawyers' willingness is the rules on costs. Under English law, the representative himself – or lead claimant under a GLO - has to pay all his legal costs upfront. If he loses, he, unlike his US counterparts, also pays the defendant's costs while being unable to recoup anything from those he represents. Thus there is little incentive for the other class members to join the action or pay their fair share of the costs; they can remain free riders on the representative or lead claimant – and do nothing until he wins. Then they piggyback on his success.

The Prudential in its case against Newman Industries pointed out that it was acting in such a public-spirited way by bringing and financing the action on behalf of all Newman's shareholders, although owning only 3% of the shares. But the argument was given short shrift by the Court of Appeal.[26]

In the US, the plaintiff's law firm is incentivised to take big litigation risks by the lure of contingency fees set as a percentage of the damages awarded (which in shareholder claims can be huge). In the UK, the no-win-no-fee rules allow a success-related uplift but only up to 100%. As a claimants' law firm has to incur large up-front costs in evaluating a claim and tracking down and organising a group of claimants and then faces the risk of paying the other side's costs (or the price of insuring against it), the limitations on the uplift make the activity uncommercial.

One solution would be, by means of a statutory instrument, to give the court the power, in a representative or GLO action, to require all piggybackers to pay a small percentage of the

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[26] *Prudential v Newman [1982] Ch. 204 at 224*

damages they receive as a bonus or "franchise" fee to the lead claimant law firm. How high that percentage should be could in principle be fixed by the court in an early case management conference. If more than one (sufficiently well-resourced) law firm wished to become the lead claimant firm, as has sometimes happened in GLOs, a tender or reverse auction could be used to award "lead" status to the firm demanding the lowest percentage bonus. Such reverse auctions have been used in the US since 1990.[27]

Conclusion

Although modest statutory reform would be required of the rules on costs, most of the reforms needed to bring to life shareholder class actions in the UK fall within the province of the judiciary, in particular its interpretation of CPR 19 and its stance towards the "fraud on the market" doctrine.

The underlying judicial principle to be applied was indicated by Vinelott J in *Prudential v Newman*. He said that the court should "have regard" to the inhibitions on shareholders controlling errant or incompetent directors: "today it would be uncommon for any large number of shareholders to attend and vote in person at a general meeting of a large public company and….directors alleged to be liable to the company might be able to determine the outcome of a resolution …. by the use of proxy votes".

2,977 words.

[27] See *re Oracle Sec. Litig., 131 F.R.D. 688, 689-90 (N.D. Cal. 1990)* and, for example, *re Cendant Corp. Sec. Litig., 2001 U.S. App. LEXIS 19214 (3d Cir. 2001).*