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# Investor Losses: A Fruitful Ground for Class Actions?

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*Senior Associate **Helen Macfarlane** compares the US and NZ situations for class actions and highlights some of the issues with this contentious area of legal practice. Helen worked on substantial litigations for many years in a large New York practice*

In tough economic times when share prices fall, corporate profits drop and companies edge towards insolvency, investors can face the depressing reality of dwindling retirement portfolios. Whether they have invested in residential properties, the debt of now struggling financial institutions or the shares of a failing company, many investors are questioning the advice and information they were given and whether they can recover some of their losses from any of the advisers, directors or executives involved.

Enter the class action, or as we call it here, the representative action. In the US the class action is a well established proceeding where a representative of a group of people who have been harmed by the same course of conduct can sue the persons allegedly responsible on behalf of the group. Class actions have, with varying degrees of success, been brought to remedy civil wrongs and financial improprieties.

In other jurisdictions including New Zealand, representative actions have been used with much less enthusiasm. However, recent corporate and institutional failures have led to a renewed focus on the class action as a means of redressing investor losses.

**Spreading the Cost of Lawyers**

No one likes paying lawyers. Plaintiffs like class actions because they spread the cost of legal fees across a broad group of people. This can be important to individual investors whose financial resources may be limited. The New Zealand representative action is much less attractive then its US class cousin from that perspective.

US rules provide for awarding counsel reasonable fees, and courts in successful monetary damages cases establish common funds out of which these can be paid. In New Zealand the successful plaintiff typically recovers a portion of legal fees, but this seldom covers the amount actually spent. As yet our legal system has not developed the concept of a court ordered common fund out of which fees can be paid. In limited cases (and where all class members consent) a fund representing common damages can be paid to the representative plaintiffs. Even here, however, shared legal fees must typically be negotiated among class members.

Funding the class action as it progresses and the costs of losing are other areas in which the US adopts more plaintiff-friendly rules. Many US plaintiffs' law firms undertake class actions on a no-

win, no-fee basis meaning that plaintiffs do not have to front up with legal fees and the law firm takes the risk of the lawsuit's failure. This makes financial sense from the firm's perspective because high US damages awards provide strong incentives to defendants to settle (which will include paying class counsel's fees) and the possibility that a single successful trial may be hugely profitable.

In New Zealand, restrictions on the litigation funding arrangements and generally lower damages awards means that they almost always need to enter into funding agreements among themselves regarding upfront legal fees. While this will result in cost and risk sharing, the extent will depend on the number of class members who enter into the agreement and may well not be class-wide.

In one significant respect the downside risk is greater here than in the US. In both countries, unsuccessful class plaintiffs cannot recover their legal fees from other class members who have not expressly agreed. However, unlike the US where each side bears its own legal fees, unsuccessful New Zealand class plaintiffs must pay a portion of the defendants' legal bill as well.

The higher up front costs and downside risks facing New Zealand plaintiffs helps to explain the generally more restrained use of the class action here. It requires a significant number of class members to agree to share upfront costs and downside exposure in order to attain any real cost-spreading benefit.

**The Individual Reliance Problem**

Potential downsides must be balanced against possible pay-offs. Pay-off potential is, however, problematic for New Zealand investors seeking class-wide damages for misleading disclosure.

On both sides of the Pacific a critical issue is whether the questions to be tried are common to the class as opposed to requiring proof on a person by person basis. If person by person proof is needed, it is unlikely a class claim will succeed. In misleading disclosure cases one key matter to be proven is reliance by investors on the relevant advice or statements. The question then arises whether this reliance must be proven investor by individual investor. The US says (frequently) no, but New Zealand says (almost always) yes.

US courts apply the “fraud on the market” theory which assumes that information by a company will be reflected in the share price and that misstatements by the company or its advisers will affect that price. Unfortunately (for investors) the “fraud on the market” theory has been rejected by New Zealand courts in favor of the need to prove reliance on an individualized basis. Unless our courts reconsider the individual reliance issue, however, investors will face uphill hurdles in recovering class-wide damages.

Investors could still use the representative proceeding to obtain a declaration of the defendants' wrongdoing – such as that statements in a prospectus were false or misleading. However, the lack of a class-wide damages fund from which lawyers fees could be paid means that unless there is a settlement, class plaintiffs will end up carrying the costs of fees if successful. Unless there are a sufficient number of class members willing to share in funding the action up front, the incentives to bring a more complex representative claim instead of an individual one are limited.

**Where to from Here?**

It seems unlikely that New Zealand will see a spate of class actions exploding across the horizons of financial advisors and corporate directors. They are just not that attractive or easy to bring here. The question is, should we change that? Class actions certainly further worthwhile objectives – they promote efficient use of the courts by avoiding the need to try multiple individual actions and reduce the likelihood of inconsistent findings in different individual cases. They can also serve to level the playing field by allowing a group of less affluent individuals to call more wealthy institutions to account, something that the difference in means between the parties might otherwise preclude.

US law and practice furthers this last objective by mostly eliminating the costs and risks to class action plaintiffs. Many say the US goes too far and encourages a proliferation of meritless lawsuits. It is more likely that high damages awards are the real culprit driving prolific US class action practice. These stem from juries deciding civil matters and frequently awarding punitive damages, which are calculated to impact the defendant and so can be high indeed. Reign in the damages and you will reign in the gamblers bringing weak class action claims. In New Zealand, where civil matters are heard before judges and punitive damages are typically modest, the incentive to gamble on a weak case is low.

Without adopting higher damages awards or abandoning its loser pays rules, New Zealand could ease some of the technical restrictions on class action funding and consider developing the common fund concept out of which successful class counsel's reasonable fees could be paid.

Given the modest upside potential and the significant downside risk of class actions here, this would be unlikely to produce a flood of meritless lawsuits. What it would do is render class actions a more readily accessible tool for the genuinely aggrieved.

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