READY FOR CLASS?

RE-VISITING THE LAW & ECONOMICS OF CLASS ACTIONS AND IDENTIFYING THE NEED FOR REFORM IN LIGHT OF RECENT JUDICIAL DEVELOPMENTS

by

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1. Introduction

The class action legal representation mechanism serves an important role for both society and the civil justice system. One scholar recently noted that the class action "is an affordable though controversial solution [to coordination costs] as it provides a powerful means for gathering dispersed interests and transforming them into a venture in which the different parties concur to promote individual and social interest" (Backhaus, Cassone, & Ramello, 2011). This quote appeared in a recent issue of the *European Journal of Law and Economics* which was themed entirely around class actions. The quote illustrates how the class mechanism is doubly beneficial as there are both private and public gains to its use. However, as the old adage goes, nothing is perfect. Alas it is true that the class action also has its flaws, as does the current legal systems which employ the mechanism. These flaws have become apparently recently, as the legal system has shown that reforms of the class action framework are needed for it to serve its purpose.

Recent decisions of the Supreme Courts of Canada and the United States warrant re-evaluating the role of the class action proceeding within a modern civil justice system. The judicial decisions to be analyzed reignite debate surrounding reform of class action legislation. Lessons from these recent decisions are to be critically evaluated and analyzed through insights provided in academic literature. The analysis and insights are, for the most part, globally applicable to any modern civil justice system. Through this analysis, the overarching goal of the paper is to build off of scholarship, identify problematic areas through recent judicial opinions, and provide suggestions for reform that increase the net social benefit generated by class action representation.

It is widely recognized that frequent high-stakes litigation is a more prevalent phenomenon in the United States than many other developed economies (Bone & Evans, 2002; Ulen, 2011). The usage of the class action by litigants and plaintiff attorneys is no exception to the general observation. This raises the question of whether the class action is abused in the civil justice system, a concern that has been expressed more than once (Bone & Evans, 2002). However, it must be recognized that the class action plays an important role and must continue to do so. Further, analysis of class actions is now broadly applicable today since the mechanism is no longer an idiosyncrasy of the United Sates legal system (Calbresi & Schwartz, 2011).

A critical examination of scholarly work surrounding the law and economics of class action reveals important insights into the economic fundamentals of class actions. The primary economic argument is for economies of scale for both the plaintiffs and defendants, as well as substantial savings of social resources in the justice system. This argument continues to hold and supports the importance of the class action. But the literature reveals important other aspects of class proceedings. For instance, the vast literature on class actions draws concrete conclusions surrounding social costs associated with class actions proceedings.

The recent judicial decisions suggest the time may be right for legislative bodies to consider reform. These decisions reveal that class certification is becoming increasingly difficult for plaintiffs. New difficulties are emerging on two fronts. The first difficulty is meeting the legislative requirements of certification that have been further developed through jurisprudence. The second challenge is the rise of prevalence of class-action waivers in contracts. Finally, a controversial area of antitrust class action litigation dating to the 1970's has also re-entered the

debate through a recent Canadian case. Since the role of the class action is compromised by these decisions, reconsideration of procedural class action legislation, substantive legislation (e.g. antitrust), as well as arbitration legislation may all be required.

The remainder of the paper is organized as follows. Section undertakes a literature review considering the law and economics of class actions. The literature review reveals complexities and nuances that must be considered in any attempt at reform. Section 3 discusses recent decisions from high level Canadian and American appellate courts. The section identifies how these decisions frustrate the purpose of the economics beneath the class action. Section 4 suggests a possible theoretical decision-making criterion for class certification. The criterion provides direction for legislative reform and is informed by the issues explored in the literature review. This portion of the paper also includes a discussion of an important consideration in a specific type of anti-trust proceeding. Finally, Section 5 then suggests potential legislative reforms to class action and arbitration legislation in light of the preceding discussion. Section 6 concludes.

2. The Economics of a Class Action – a Literature Review

The literature review begins with a recent survey of class actions by Professor Ulen published in the European Journal of Economics. The review here follows a similar path, since Professor Ulen's structure lays out the logical separations in exploring the law and economics of class actions. I also introduce additional sections from individual research.

Professor Ulen is well known in the law and Economics community for his co-authorship of *Law & Economics* – a comprehensive introduction into the field used for undergraduate and graduate courses in economics and law. The book is currently in its sixth edition. Professor Ulen's review is titled "An Introduction to the Law and Economics of Class Action Litigation" (Ulen, 2011). For a leading scholar in the field to write a survey paper as recent as 2011 demonstrates the relevance of this topic at the present time. Several recent decisions from the supreme courts of the United States and Canada within the last two years serve further to illustrate that the law of class actions is evolving. Outside of Canada and the United States, the European Union Consumer Commission is considering introducing a "collective redress mechanism" for violations of European Union law.[1] Where the law is evolving, there is a certainly an opportunity for economics to contribute to the debate.

2.1 The Economic Fundamentals of Class Actions

This first section of the literature review aims to set out functions of the class action within the justice system. Class actions have both social benefits and social costs to the actors involved: plaintiffs, defendants, and the courts . To the extent that class actions remove iterative proceedings of identical claims, social benefits are generated. At the same time, coordinating amongst a potentially large group of individuals creates social costs. First and foremost, a class action introduces transaction costs as counsel become coordinators of the various litigants. The court, as a supervisor of the litigation, in turn bears some of these social costs; public resources

[1] See *Commission Recommendation on common principles for injunctive and compensatory collective redress mechanisms in the Member States concerning violations of rights granted under Union Law*, C(2013) 3539/3 (European Commission, 2013). The recommendation of the European Commission grew out of public consultation paper: see *Public Consultation: Towards a Coherent European Approach to Collective Redress*, SEC(2011) 173 (European Commission, 2011).

are being used to absorb the transaction costs created by class action litigation. From a rational perspective, the legal system, operating on public resources, should seek to maximize the net social benefit of a class action proceeding.

2.1.1 The Economies of Scale and Social Benefits of a Class Action

It is helpful to begin a review with a definition of a "class action." The class action, at its most fundamental level, is the consolidation of similar legal claims into one large group of claimants/plaintiffs (Ulen, 2011). As will be explained in more detail in Section 3, not any group of claimants can be consolidated in this manner. In order for plaintiffs to seek the consolidation of their claims, they must first demonstrate there is a commonality or interrelatedness between the facts and law forming the basis their individual requests for relief.

From an economics perspective, this claim-relatedness is an intuitive requirement. For the consolidation of claims is likely only to be cost-saving if the claims are substantially related. As Professor Ulen notes, "…in economic parlance, there are likely to be economies of scale for both the plaintiffs and defendant or defendants in having one large trial than in having a series of individual trials" (Ulen, 2011). The economies of scale reflect the intuition that it is likely more efficient to litigate the same general claim once.

The degree to which this efficiencies become significant is likely to increase as the class increases in size. Each combined claim in turn means one less individual legal proceeding in the system. Thus the economies of scale associated with a class action are not realized only by the plaintiffs – the consolidation of claims means substantial savings for the justice system as a whole (Ulen, 2011; Spier, 2007).

Defendants against whom the proceedings are brought also realize economies of scale. Without a certified class, defendants may face individual claims from each and every member of the class, assuming all were to litigate (more on this shortly). By facing a pool of claims with similar substantive legal foundations, defendants may only face issues of liability and quantum of damages once. If defendants are found liable to the class, savings have been realized from not having to litigate each claim individually. Other factors can serve to increase savings.

The magnitude of savings will increase if plaintiffs are spread out over a geographic area. If plaintiffs are geographically dispersed, costs to the defendant will multiply. In the a federal state such as the United States or Canada, each state/province will likely have similar but different procedural and substantive laws relating to the legal issues in question. The defendant will have to obtain legal representation in each of the different jurisdictions. Not to mention a defendant may not be familiar with the courts of any given jurisdiction if business is not regularly conducted there. Since the defendant would be facing several related claims adopting a common strategy may be desirable. Coordination of dispersed lawyers will introduce transaction costs at the least, and is likely to also introduce travel costs for counsel and other relevant persons involved in the litigation.

Consolidation of the claims into one group and one jurisdiction eliminates the costs to the defendant associated with litigating claims individually or through several different classes. Thus a defendant may rationally be agreeable with litigation of the claims through the class action mechanism. The defendant can also lobby to have the class certified in a favourable jurisdiction. Or, through contractual terms, a defendant could stipulate that any class actions be litigated in a

specific jurisdiction. Such a contractual clause would have the effect of moving the proceeding into a jurisdiction with reliable and predictable courts, or the home jurisdiction of the defendant so as to minimize travel costs associated with the lawsuit.

While the principal efficiency argument has strength, it is worth asking if a class action is necessary within the legal system. Why would plaintiffs want to seek compensation for their legal claims through a class action? If the plaintiffs all seek to be compensated for losses (i.e. benefit from the litigation), each plaintiff could recover individually. Moreover, since the true value of any given plaintiff's claim (i.e. their losses) is independent of the litigation mechanism chosen. Further analysis of different possible types of classes shows why the class action rule can be beneficial to both society and the plaintiffs, depending on the composition of the class.

2.1.2 Class Action Taxonomy

The literature has followed a path of separating different classes into three broad groups. The groups are separated according to the monetary value of class members' legal claims, and further by the potential secondary effects within the legal system.

The first broad distinction drawn by scholars is between two fundamentally different groups of litigants (Bone & Evans, 2002; Ulen, 2011; Hay & Rosenberg, 1999-2000). The difference is important because it has decision-making ramifications for the individual litigants within the class, such as choosing to litigate a claim or not. The first is a group of litigants for whom litigation has a positive expected value for every member of the class. The second group is those for whom individual litigation is a negative expected value proposition. The expected

value of litigation can be understood as what an individual stands to gain after considering the costs associated. The latter group described will be worse off from pursuing litigation. This group is vulnerable and will be a focus throughout this paper. Let us look closer at each of these groups in turn.

2.1.2.1 Classes with positive expected value litigants

The first group is that for which litigation is a rational decision for each individual in the proposed class. Following the law and economics literature, this can be expressed as $x - c > 0$. The variable x represents the expected judgement at the end of the legal process, and c represents the plaintiff's expected litigation costs (Spier, 2007). Litigation costs would certainly include attorney fees, but could also include additional realistic costs such as effort, time and other opportunity costs associated with the lawsuit (Spier, 2007).

For the purposes of analyzing class actions, it will become relevant to decompose the gross return x to reflect the probability that a plaintiff is successful in receiving compensation for their claims. The probability of successfully obtaining a court judgement for compensation will inextricably be linked to the merit behind a plaintiff's claim. This is relevant because the probability is likely to affect of the decision to litigate. My motivation for explicitly representing the probability will become clearer in the section of this paper which proposes an economic criterion for class certification. For now, it suffices to say that a plaintiff's positive value proposition is, for the later purposes of the paper, represented as $p_i(a_i X_i - C_i) > 0$ where p represents the probability a plaintiff will choose to litigate, and X represents the legally claimable loss. Since we will be dealing with class litigation, i serves as a counter. The variable

a_i represents the probability a plaintiff successfully obtains a damages award from the court. If the plaintiff chooses not to litigate, C_i is not incurred.

A plaintiff with a positive expected value claim will rationally make the decision to litigate based on individual circumstances. The fact that each litigant can rationally decide whether to litigate and seek compensation for their losses necessitates questioning why a class may be a socially beneficial device. Some interesting insights have been made on this point.

In positive expected value classes, there are still economic reasons for plaintiffs to pool their claims and resources. Two such reasons have been expressed in the academic literature. The first reason, as has been mentioned previously, is that claim consolidation saves litigation costs through economies of scale. Secondly, consolidation avoids some external costs associated with multiple individual claims based on similar, if not identical, underlying legal foundations (Ulen, 2011).

To the first benefit, there will be substantial savings in litigation costs for the plaintiffs. Litigation savings arise primarily through the procedural realities of a legal proceeding. Through pooling claims, plaintiff counsel is only required to conduct discovery once to obtain the facts necessary to litigate the claim. Recall that C_i represents an individual's legal costs. Then under class litigation it will likely be the case that

$$C_{class} < \sum_{i=1}^{n} C_i$$

where C_{class} represents the litigation costs to the class as a whole. The summation represents the costs to plaintiffs if each member of the class were to litigate their claim individually. This

proposition is likely to be true based on the economies of scale reasoning underlying class actions. Although class actions introduce new complexities, the savings from conducting discovery once as opposed to for each individual plaintiff is likely to render the above proposition valid. It is also worth noting that the above proposition is why class actions are desirable from a social-planning perspective, since less resources are expended when an alternative, more efficient means to achieve the same outcome is available.

Through these savings, the class is able to expend collective resources on higher quality (or more) expert witness testimony. Likewise, the class counsel can spend more time building the legal argument, which may result in a more persuasive or effective case to present to the court. As Professor Ulen remarks, "[t]o the extent that [savings in litigation costs] leads to a heightened chance of recovery of meritorious claims, this is a social benefit" (Ulen, 2011). One can only assume that the reference to "meritorious claims" is to claims which, from a policy and legal perspective deserve to be compensated, but for practical reasons such as extensive factual records or complex requirements of expert witnesses may be face obstacles.

In addition, class consolidation may "level the playing field" between plaintiffs and defendants (Ulen, 2011). However, this may not be in the sense that one may intuitively consider. There is widespread recognition that class consolidation is likely to lead to more bargaining power to the class members and thereby increase the likelihood of settlement (Hay & Rosenberg, 1999-2000; Heaton, 2005; Ulen, 2011). It is not in this sense that the playing field is to be considered "levelled" between adversaries. The levelling mechanism is realized through the situation the defendant faces.

Assume for a moment that a class is not created. Since the defendant faces potentially n similar lawsuits, from plaintiff's claiming similar injuries, the defendant is exposed to more than one plaintiff's lawsuit in isolation. Consequently there is an incentive for the defendant, since – borrowing game theoretic terminology – the defendant is a repeat player, to expend extra resources on initial suits in order to win early cases. Through winning early cases, the defendant may establish favourable precedent, or the defendant may even entirely discourage other individuals from litigating (Ulen, 2011). Consolidation removes the possibility of this strategic maneuver. In this sense, levelling the playing field eliminates an externality that early decisions may have on subsequent proceedings. Thus class action litigation can produced greater judicial consistency and thereby decrease the likelihood of negative externality like effects.

There is an additional externality effect that can be created in a class actions in a very specific situation, and this effect has social benefits. This situation is known as the "limited fund" situation, and occurs when the aggregate claim of all plaintiffs exceeds the amount a defendant is able to satisfy if judgement is found against them (Bone & Evans, 2002; Ulen, 2011). Such an example may occur where the defendant has limited assets and a fixed amount of liability insurance. The elimination of the externality does not remedy the fact that part of the injury will go uncompensated. The class action serves a distributive purpose in the "limited fund situation."

Consider an example to illustrate the limited fund situation. Suppose an environmental disaster occurs that is attributable to a firm responsible for the accident. The recent example of the tragic train derailment in Lac-Mégantic, Quebec in July of 2013 suffices here. In fact, this is

a perfect example since the railway responsible has since filed for bankruptcy.[2] Suppose there are 10,000 claimants to be compensated for lost business, property damage, lost income, etc. Each claimant, with an equal $2 million of losses has a 60 percent chance of being successful at trial. Assume the corporation has $500 in disaster insurance and $1 billion in corporate assets. The expected value of the claimants is $12 billion, but the corporation has only $1.5 billion available to satisfy any judgement.

Where the plaintiffs do not bring claims through a class action, the expected number of claims required to exhaust the defendant's available resources is 1250. If every plaintiff were certain to recover the full amount, the first 750 claimants would deplete the fund. Without proceeding through a class action there will be a race to file first. Several plaintiffs will have uncompensated losses. Using an expected value figure, $10.5 billion of the totally expected liability of the defendant will not be honoured. The usage of a class action enables a court to address questions of liability and then apportion the funds amongst class members.

One further observation should be made about the class action as a means for litigating claims. Most of the economies of scale, time and expense that make class actions valuable to society could be realized through coordination amongst litigants. However, there would be significant transaction costs to proceeding this way. The transaction costs of coordination will increase with a number of factors: geographical dispersion of the class; complexity of liability and damages issues; the size of the class; and number of sub-classes within a primary class. Due to high transaction costs, plaintiffs are unlikely to choose this route and more likely to either

[2] News began to surface in early August that Montreal, Maine & Atlantic Railway filed for bankruptcy in both the United States and Canada. For one news story, see the *Financial Times*, August 7, 2013. (Online: http://www.ft.com/intl/cms/s/0/5a15b74a-ffa0-11e2-b990-00144feab7de.html#axzz2d04PsoqI)

consolidate claims into a class action, or avoid consolidation entirely (Ulen, 2011). Let's now consider the second group.

2.1.2.2 Negative Expected Value Classes

The second primary group litigants can be split into is that for which litigation is a negative expected value proposition for each individual. In a negative-expected-value class, the net returns to litigation for each individual are negative after taking into consideration the costs associated with litigation. The class action is most beneficial for those individual private litigants for which individual action is not economically feasible. That is, class actions make compensation possible.

Negative expected value classes are arguably also the most beneficial to society. Small transfers of wealth from individuals can sum up to massive windfall gains for the injurer. For example, let's assume a customer loses $50 due to a violation of a statute by the counter party, say a telecommunications company. That individual will not pay more than $49.99 to recover their loss. If the activity is repeated over 100,000 customers, the company has illegally gained $5,000,000. This windfall gain to the injurer can be avoided provided the 100,000 customers could collectively recover some or all of their losses for less than $5 million. This is precisely the purpose of the class action.

On this point, it is also relevant to note that in some contexts, such as consumer protection or antitrust legislation, alternative methods are available to ensure the law is enforced and violations are deterred (Ulen, 2011). For example, in the United States, Attorney General has

parens patriae jurisdiction and can bring antitrust claims on behalf of those injured if private litigation is not initiated. The same is true of fines in the setting of consumer protection for violations of consumer legislation.

However, not all jurisdictions are likely to have this type of alternative scheme. So it is the case in those jurisdictions that deterrence and compensation must be achieved through collective action amongst individual litigants. Further, when consumers mobilize, they may also bring about change. Negative-expected-value litigants will not rationally choose to pursue a claim. In this sense, the class action is a legal technology that remedies judicial market failure and promotes fair social welfare through avoiding illegal transfers of wealth (Backhaus, Cassone, & Ramello, 2011).

The negative expected value for each individual can be expressed as $x - c_p < 0$. Where, as before, x is the expected return to the plaintiff and c_p are the costs of litigation. Following the methodology above, this can also be expressed as $p_i(a_i X_i - C_i) < 0$ or $a_i X_i - c_i < 0$ since the bracketed term is material. The critical element for individuals in a negative expected value class is that class action transforms the negative expected value proposition into one where benefits outweigh the costs. This is analogous to bargaining models that have shown a time factor can transform a negative expected value claim to an economic decision. Since the costs are now spread over the class, individuals will chose to become part of the class provided

$$a_{class} k_i X - \frac{C_{class}}{n} > 0 \text{ where } 0 < k_i < 1 \ \ \forall \ k$$

where a_{class} again represents successful probability of judgement and C_{class} represent the litigation costs of the class. The individual receives k_i fraction of the total judgement X to the

class. For the class as a whole, the condition is $a_{class}X - C_{class} > 0$. Individuals have been differentiated because, as will be discussed later, damages do not have to be apportioned equally to every member of the class. Members may not have all suffered the same losses. If this were the case (i.e. $k_1 = k_2 = \cdots = k_n$), the condition for each individual would be

$$\frac{a_{class}X - C_{class}}{n} > 0$$

Litigation is an economic option for each member in the class provided that the expected portion of the award is greater than the individual's share of the class' costs. I have not found a mathematical expression for the individual's class-action condition in the surveyed literature. While an individual may not be considering this when choosing to enter a class, the fees paid to the lawyer are spread over the individual members of the class. This is the case since each individual's award is equally reduced as the lawyer fees are in practice taken from the total monetary award to the class. Thus it is economically beneficial for an individual to participate through the class action if their proportionate share of the award to the class exceeds their portion of costs.

2.1.2.3 The Nature of Negative-Expected Value Classes

Beyond recognizing that negative-expected-value classes exist, scholars have also turned their attention to *why* individuals have a negative expected value claim. This is worth devoting some attention to, because, class actions have the propensity to produce large awards and settlements for plaintiffs. Class actions are criticized because of the large awards created through punitive damages; awards may be large enough to bankrupt the defendant (Bone & Evans, 2002;

Calbresi & Schwartz, 2011; Heaton, 2005; Ulen, 2011). If the case has legal merit, this should not be a problem. And it is often likely the case that these are meritorious in a legal sense. As we will later see when considering settlements it has been observed that in several cases concerning securities fraud claims defendants quickly settle without giving much thought to the legal basis of claims (Calbresi & Schwartz, 2011; Porrini & Ramello, 2011).

The literature identifies two primary ways in which individuals will have negative-expected-value claims (Ulen, 2011). The first arises from the fact that a plaintiff has suffered no injury at all, or an injury not compensable at law. A typical example of this is damages for mental or emotional distress. While the law has begun to change in this regard in some Canadian jurisdictions, this type of claim still remains hard to prove. Individuals falling into this first group of injury have meritless legal claims, even if costs of litigation were trivial. Mathematically, these are cases for which either $X_i = 0$ or $a_i \approx 0$. An injury which is not recognized at law has $X_i = 0$. A claim may have a low probability of successful award, a_i if the individual has a farfetched legal argument, for example. Either of these can contribute to the total recovery for an individual being lower than the expected costs of litigation. It is perhaps worth noting that even if an individual believes to have suffered a significant loss (i.e. large X_i), a low probability of recovery a_i can make the claim an uneconomical pursuit.

Professor Ulen specifically identifies these claims as having the potential to be "frivolous". Frivolous claims are the very claims a well-functioning legal system should be able to filter out. However, when settlement considerations are brought into the fold, a class with a "frivolous" claim that manages to be certified becomes extremely likely to extract a settlement from the defendant for fear of high exposure to liability (Bone & Evans, 2002; Hay &

Rosenberg, 1999-2000). So it is critical that judges have the ability at the certification stage to look at underlying legal merits. This will be discussed more later when considering areas for reform. For now, remember that looking at the underlying merits of a claim may be beneficial.

The second reason identified in the literature is that where each member of the group has suffered a relatively small compensable wrong. It does not matter how small the compensable wrong is. The only relevant consideration is that the expected award at litigation $a_i X_i$ is lower than the costs. This situation can arise even if a_i approaches unity, where an award to a plaintiff is certain. This class has been referred to as a "small claim" class (Ulen, 2011). The class discussed later in one of the cases from the United States is exactly this type of class. This type of class may also occur in securities litigation, in addition to antitrust and consumer protection actions which have already been mentioned. Class actions arising in the securities industry of this type are particularly important for the financial markets. The importance of class actions in financial markets will be considered more in the next section.

2.1.2 Social Costs and Benefits of Class Actions

Like most problems in economics, there are associated costs and benefits with the class action mechanism to be weighed. The primary social benefit is the savings to the judicial system associated with the consolidation of claims (Backhaus, Cassone, & Ramello, 2011; Ulen, 2011). There are also savings to the individuals involved which reduce the deadweight loss of litigation. The corresponding cost is the introduction of transaction costs required to coordinate the litigants. Transaction costs are incurred both by the justice system as a whole, since judges are required to monitor the progress of the cases and manage the litigation from the court.

Transaction costs are also incurred by the plaintiffs, as the team of lawyers needs to coordinate sharing of information among the interested parties and have large client meetings (Calbresi & Schwartz, 2011; Ulen, 2011).

One non-obvious benefit of class actions has been explored within the context of financial markets. One scholar criticizes the law and economics approach which, he argues, relies on a view of static efficiency. Where an investor is defrauded by a securities seller, the investor suffers a private economic loss which takes the form of a distribution of wealth. There is a wealth transfer from the defrauded investor to the securities manager. This pure economic loss is a private loss that is not socially relevant because it involves a redistribution of wealth but has not resulted in a social loss (Backhaus J. G., 2003; Porrini & Ramello, 2011).

Porrini and Ramello argue, however, that the view to static efficiency is an incomplete analysis. The concern of these authors is with a view to dynamic efficiency of financial markets. If an investor is defrauded and unable to protect their interests, the investor may then think twice about making another investment, thereby reducing the total amount of capital available in an economy. Therefore, from a dynamic point of view, lack of protection for private economic interests may have effects on the behaviour of agents (Porrini & Ramello, 2011). A change in the behaviour of agents could in turn affect dynamic efficiency and lead to suboptimal outcomes. The class action serves as an *ex post* mechanism for the protection of private economic interests. If investors are not able to seek protection of their economic interests through a class action, assuming they have a negative expected value claim, then the legal market under-produces deterrence for securities fraud (Porrini & Ramello, 2011).

This type of under-deterrence where class actions are unavailable as a means of private enforcement of economic interests could be extended from financial markets to other areas of economic activity. Examples would include transactions covered by a sale of goods act or contracts governed by consumer protection legislation. As I will explore later, the legislation itself can be a mechanism for ensuring the class action mechanism remains available to agents seeking to privately enforce their economic interests.

An indirect cost associated with the class action is the externality-like effect a judicial decision has on members within and outside the class. The current U.S. *Federal Rules of Civil Procedure* surrounding class actions have increased the stakes of class action litigation. Under the 1966 changes to the initial rules in the United States, legislators formally made judicial decisions on common issues binding on each and every member of a class, including absent class members (Bone & Evans, 2002, p. 1263). Thus a decision made by a court based on a set of facts for a proposed or certified class had full and binding effect on all individuals that fit within the definition of the class. Decisions of the court could have effects on members of society that were not yet members of the class, because the purpose of class proceedings under the 1966 law was to adjudicate all claims in one proceeding (Bone & Evans, 2002), which is consistent with the underlying economics.

Similar to a judicial decision having an effect on individuals outside the class, which members become part of the class also has consequences. The nature of the effect is a result of adverse selection, and provides an example of how the incentives of lawyers do not always align

with those of their clients (Ulen, 2011). The lawyer has an incentive to maximize the size of the class, because this generally increases the total potential recovery and complexity of the case. Increased potential recovery results in a greater possible payoff to the lawyer. Increased complexity means more billable hours. The incentive to increase the size of the class may attract individuals with weak and/or small claims. If these weak-claim members dominate the class, or constitute a larger portion of the class, the defendant may offer a lower settlement as a result. Selection of weak-claim members in an effort to increase the size of the class could lead to a lower settlement, the result of which is a transfer of wealth from strong-claim to weak-claim members (Ulen, 2011).

2.2 Settlement Aspects of Collective Litigation

Settlements have become a widely-used and generally well known feature of modern legal systems. As the costs of litigation escalate, it is rational for the parties involved to attempt to privately settle the dispute between themselves, relying on courts only to the extent necessary. This practice saves costs of trials, shortens the legal process, and reduces the deadweight loss of litigation. Section 2.1 largely explored the positive aspects of class actions. Settlement related issues in class actions have been explored by many academics, and are a large area of concern in the literature.

The primary concern in class action literature is the extraction of unmeritorious settlements (Bone & Evans, 2002; Heaton, 2005; Hay & Rosenberg, 1999-2000). Since settlements have become such a pervasive feature of the modern legal system, and defendants seek to avoid bankruptcy-inducing judgements, there is a concern that plaintiffs with a weak

legal case can extract settlements. Hay and Rosenberg have formalized this idea and termed it a "blackmail settlement" (Hay & Rosenberg, 1999-2000). Associated with the idea of the "blackmail settlement" is the "sweetheart settlement", also examined by Hay & Rosenberg. Another scholar, Heaton has created a formal mathematical notion of "settlement pressure" (Heaton, 2005). Let's explore these in turn.

Before exploring these existing academic opinions, keep in mind that "blackmail settlements" work against the fundamental benefits of the class action. The social benefit of the class action is increasing in the size of a class. Each consolidation of claims furthers the economies of scale and generates savings for the justice system. At the same time, consolidation of claims increases the potential total liability exposure for a defendant. And as the total liability a defendant faces increases, the more likely the defendant is to pursue a settlement and avoid an unfavourable trial decision. There is a type of inverse relationship at work between the size of the class and probability of a "blackmail settlement", a transfer of wealth would be unlikely to occur at trial.

Hay and Rosenberg observe that class actions settle "most of the time" (Hay & Rosenberg, 1999-2000), which is consistent with the theory predicting behaviour of defendants just mentioned. Because class actions lawsuits typically involve a significant amount of money, critics have argued that the class action settlement process will inevitably result in abuse (Hay & Rosenberg, 1999-2000). Multiple different forms of abuse could occur. Hay and Rosenberg identify two specific dangers, both emanating from the plaintiffs' side of a class action. Though the effect of one abuse is positive for plaintiffs and the second is negative.

The first harm has been termed a "sweetheart" settlement. In the "sweetheart" settlement, the interests of the class are compromised by their legal representative (Hay & Rosenberg, 1999-2000). In this first type of abuse, class counsel "sells out" clients in order to guarantee a fee. Under this complaint, the lawyer settles claims for less than they are worth, as a result of the lawyer's private economic interests. Critics have argued it is possible the lawyer faces cash flow constraints, for example, which create an incentive for getting a quick settlement in order to guarantee a payoff. The effect on the class in this situation is negative, of course.

"Blackmail settlements" are the flipside of "sweetheart settlements". In this situation, the criticism of the class action is that lawyers are able to extract a settlement worth more than the claim would merit if litigated through to a court verdict. The criticism of the class action in this instance is that plaintiff lawyers have sufficient leverage to extract a settlement worth more than a defendant should objectively pay (Hay & Rosenberg, 1999-2000). The "blackmail settlement" is a positive result from the perspective of the class.

Related to the idea of a "blackmail" settlement criticism is the idea of "settlement pressure". The concept of "settlement pressure" refers to the defendants in large-scale litigation being forced to settle unmeritorious lawsuits to avoid catastrophic outcomes at trial (Heaton, 2005). In the "settlement pressure" model, Heaton concludes that academic concern with "settlement pressure" fits poorly with traditional economic analysis of litigation. The reason for this mismatch is because risk aversion is a necessary though not sufficient condition for the existence of settlement pressure (Heaton, 2005, p. 265). Heaton argues that traditional

dependence of litigation models on risk aversion does not square with reality, because large corporate entities cannot reasonably be described as risk averse.

Using expected utility analysis and the certainty equivalent, Heaton constructs a model that describes when a risk averse defendant would go to trail with an individual but settle with a class. Heaton then represents settlement pressure graphically, noting that there is a specific range of probabilities of plaintiff victory where risk aversion is solely responsible for settlement. The graphical representation is reproduced in figure 1 below. Settlement pressure cases are those that settle *only* because of risk aversion. In the settlement pressure cases, a risk neutral defendant would proceed to trial, but a risk averse defendant will settle. As the graphic depicts, beyond a certain probability threshold, risk neutral defendants would also settle with a class. And, Heaton argues, risk neutrality better represents large corporate entities than risk aversion.

It may be true that larger corporate entities *tend* to be risk neutral, because the financial strength of the entity permits not acting in a risk averse manner. I would argue, however, that an interesting question to be explored is how large a corporate entity must be in order for it to act in a risk neutral manner rather than risk averse. Small and medium size enterprises may be risk averse because they do not have the same degree of financial flexibility. Size of the corporation may trigger its behaviour in litigation, rather than the nature of the entity.

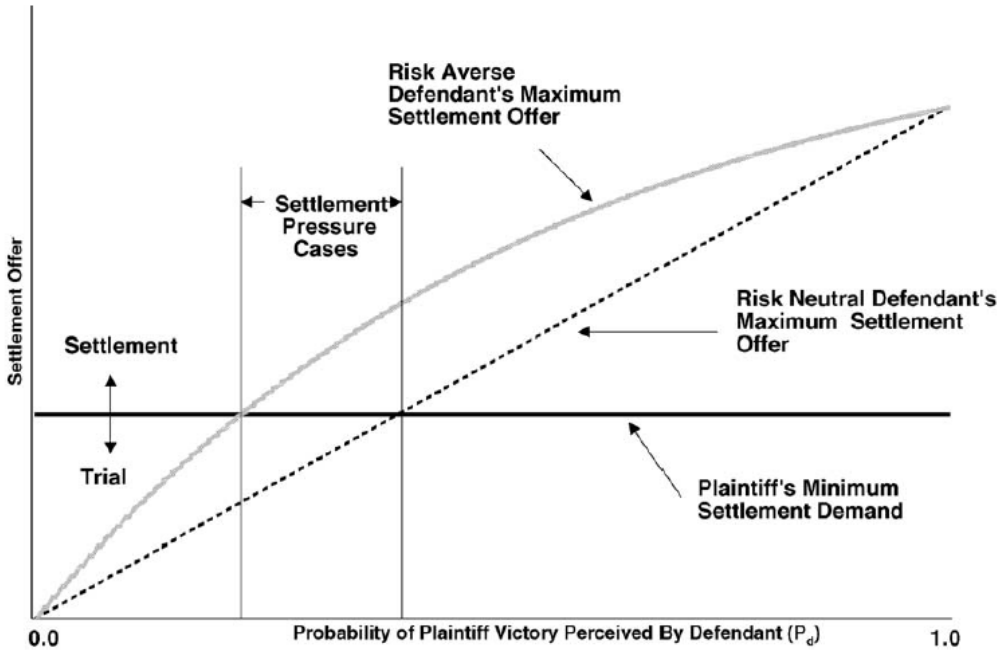

Figure 1: Graphical representation of settlement pressure (Heaton, 2005)

Heaton presents two alternative motives for the pervasiveness of settlement in large-scale class action litigation. Instead of relying on the concept of risk aversion, Heaton argues that it may be more accurate to consider settlement as a corporate hedging motive. Settlement is a guarantee that the firm will continue to exist, instead of facing potentially overwhelming judgement at trial. The behaviour is attributable, then, to hedging and not risk aversion. To some extent this seems to be avoiding calling a spade a spade. Another potential explanation for settlement behaviour in litigation is already built in to the legal system and does not require risk aversion. Differing from the traditional economic models of litigation, if damages a defendant is exposed to rise greater than linearly to the plaintiffs' claim, then risk neutral corporations would also settle. Risk aversion, then, is not the cause of settlement.

2.3 Class Actions in the Courts

After exploring the most salient and fundamental aspects of class actions – composition of classes, social costs and benefits, and settlement considerations – and how collective litigation affects the judicial process, I turn now to endeavor to explore how courts have recently reacted to class actions. In these recent developments, the trend seems to be that the class action faces challenges on several fronts. What begins to become clear is that the class action is necessary for negative expected value claims, but this does not gather sympathy from the judiciary. While judges are aware of the importance of class actions, there are competing constraints from bodies of law such as evidence and arbitration that, it will be seen, frustrate the effective functioning of collective litigation.

3. Recent Judicial Developments

Courts have had to wrestle with legal and economic structure surrounding class actions in several recent judicial decisions. Some of the jurisprudence to be considered in this section have involved cases where, perhaps not surprisingly, trial and appellate courts made different certification decisions. The general trend, emanating from the higher courts, has been unfavourable for class action plaintiffs. For various reasons, usually with legislative and precedential legal force, the supreme courts and high appellate courts of the United States and Canada have rejected several certification attempts.

This section considers these factual situations and legal decisions in light of the review of the law and economics of class actions presented above. I argue that these cases provide evidence reform of the legal regime surrounding class actions is necessary, especially within areas of law prone to class action situations such as antitrust and consumer protection.

It is no surprise, then, that these recent cases have taken place against the backdrop of primarily three areas of law: antitrust, arbitration, and consumer protection. Not surprisingly, the economic analyses involved in the recent antitrust decisions are complex. However, in one case where anti-competitive activity was proven, a class was not certified for evidentiary legal reasons. In another decision, certification was disallowed due to a contractual provision stipulating class-waiver in a standard form consumer contract. In a case awaiting decision from the Supreme Court of Canada, the old issue of direct and indirect purchaser class certification has again been raised. Specific cases are introduced below and discussed in more detail in subsequent sections.

The three main cases to be considered are *Comcast*[3], *American Express*[4], and *Sun-Rype*[5]. In *Comcast* the Supreme Court of the United States rejected certification of a class where anti-competitive activity was established by expert economic testimony. Certification of the *Comcast* class was disallowed for what amounts to evidentiary reasons. In *American Express*, the U.S. Supreme Court rejected class certification of merchants alleging a tying strategy against

[3] See *Comcast Corp et al. v. Behrend et al.*, 569 U.S. __ (2013).
[4] See *American Express Co. et al. v. Italian Colors Restaurant et al.*, 570 U.S. __ (2013)
[5] See *Sun-Rype Products Ltd. v. Archer Daniels Midland Co.*, 2011 BCCA 187. Certification was initially allowed by the British Columbia Supreme Court in *Sun-Rype Products Ltd. v. Archer Daniels Midland Co.*, 2010 BCSC 922. The Supreme Court of Canada heard arguments in this case during December, 2012. Judgement of the Supreme Court was reserved and has not yet been released.

American Express. Certification was denied in *America Express* due to a class-action waiver provision in the standard contract of American Express with its merchants. Finally, the British Columbia Court of Appeal in *Sun-Rype* disallowed certification of a group of indirect purchasers alleging a price-fixing conspiracy against a possible upstream cartel.

3.1 Anti-Trust Class Certification – *Comcast* and *Sun-Rype*

The recent decisions of *Comcast* from the United States Supreme Court and *Sun-Rype* from the British Columbia Court of Appeal demonstrate unsettled areas of class action certification law. Competition theory is the underpinning to these cases that unites the plaintiffs in each case. The law and economics of these cases should be closely examined.

3.1.1 *Comcast* and establishing economic harm to a class

Following the Comcast-NBC merger which gave rise to vertical integration concerns during regulatory approval by the Federal Trade Commission, Comcast was in the news again concerning aggressive behaviour. Plaintiffs brought a lawsuit against Comcast and its subsidiaries claiming that the cable distributor's activity in the Philadelphia area led to supra-competitive prices. The activity which allegedly led to supra-competitive prices was a "clustering" strategy to consolidate market power in a single region by swapping out incumbents. Expert evidence employing econometric methods demonstrated prices were above competitive levels, yet class certification was overturned by the Supreme Court of the United States. The Supreme Court held that certification was inappropriate in this case because the exact anti-competitive theory resulting in price increases may have differed between counties.

This is a case which, I argue, should have been decided based on the dissenting opinion. The dissenting judges, four of the nine-justice bench, would have upheld certification. Dissenting judges, perhaps motivated by the efficiency collective litigation in a case such as this, would have certified the class not withstanding the fact that different competitive harms may have been at work for different Comcast customers in the class. In short, the dissenting judges would have not overturned certification regardless of possible sub-classes within.

Here are the facts: Comcast and its subsidiaries engaged in a series of transactions from 1998-2007 which concentrated operations within a particular region. To borrow methodology from Nielsen Media Research, the courts adopted a Designated Market Area (DMA) for the purposes of the analysis. The DMA in question was comprised of 16 counties in Pennsylvania, New Jersey, and Delaware (Comcast v. Behrend et al., 2013, pp. 1-2). Over the span of nine years, Comcast was able to increase market share in the DMA from 23.9 percent to 69.5 percent. Concentration was accomplished by Comcast "swapping" its systems in Palm Beach, Florida and Los Angeles, California with those of Adelphia Communications in the DMA.

The plaintiffs advanced four theories of anti-competitive impact. One was accepted by the District Court, which sufficiently satisfied the court for the purposes of class certification. The four antitrust impact theories were: first, clustering made profitable by withholding certain sports programming in order to decrease market penetration by direct-broadcast satellite providers; second, Comcast's clustering activities reduced competition from "overbuilders", companies that build competing cable networks in areas where an incumbent (i.e. Comcast)

already operates; third, "benchmark competition" was reduced, thereby limiting the ability of customers to compare prices; and finally, Comcast's bargaining power was increased through market concentration relative to other content providers. The court hearing the certification motion accepted *only* the "overbuilder" theory of anti-competitive impact and initially allowed certification . This is an appropriate point to quickly review the requisite legal criteria for certification under the *Federal Rules of Civil Procedure* before discussing reform.

The plaintiffs in *Comcast* sought to certify a what was most likely a negative expected value class under Rule 23(b)(3) of the US *Federal Rules of Civil Procedure.* Under rule 23(b)(3) class certification is permitted only if a specific prerequisite is satisfied. Under that federal statute, a court must find "that questions of law or fact common to class members predominate over any questions affecting only individual members" (Comcast v. Behrend et al., 2013, p. 2). This requirement is consistent with the economics underpinning class actions. Economies of scale will not be generated – certainly not to the same degree – if class action still requires adjudicating individual claims within a class that are not sufficiently common to the all class members.

In order to satisfy the predominance requirement, the plaintiffs had to demonstrate two further items: "1) existence of individual injury resulting from the anti-competitive impact was 'capable of proof at trial through evidence that was common to the class rather than its individual members'; and 2) that damages resulting from the injury were measurable 'on a classwide basis' through the use of a 'common methodology' " (Comcast v. Behrend et al., 2013, p. 3).

The critical difference between the majority and the dissent, which led to blocking certification, was on the interpretation of exactly what is "common to the class" and whether damages resulting from injury were "measurable on a classwide basis." The point of divergence was the question of whether the anti-competitive impact theory accepted by the District Court was "common to the class". Since the economic model, which I will discuss further momentarily, did not isolate one form of anti-competitive harm, the evidentiary burden of satisfying the classwide basis criterion was not met.

Since the "overbuilder" theory was the only of the four accepted by the District Court, the basis for appeal was whether the expert evidence available demonstrated damages measurable on a classwide basis. The majority of the Supreme Court held this opinion: "If respondents prevail on their claims, they would be entitled only to damages resulting from reduced overbuilder competition, since that is the only theory of antitrust impact accepted for class-action treatment by the District Court." The majority then opined, "[i]t follows that a model purporting to serve as evidence of damages in this class action must measure only those damages attributable to that theory. If the model does not even attempt to do that, it cannot possibly establish that damages are susceptible of measurement across the entire class for the purposes of Rule 23(b)(3)" (Comcast v. Behrend et al., 2013, p. 7).

The court's disapproval of the experts witness' evidence stems from the fact that the expert's damages calculation model was a hypothetical baseline of what prices would have been without *any* antitrust violations. In other words, the damages model was constructed against the baseline of a market that contained none of the four potential distortions introduced by

Comcast's "clustering" strategy. The regression model of comparing actual cable prices to hypothetical prices that would have prevailed but for "clustering" calculated damages of US$875,576,662 for the class as a whole. Comcast attacked this model on the basis that it did not isolate anti-competitive effects only to the "overbuilder" deterrence of entry theory. The expert witness acknowledged that the model did not isolate damages resulting only from any one theory of antitrust impact (Comcast v. Behrend et al., 2013, p. 4). Rather, he admitted that the model calculated damages resulting from anticompetitive conduct as a whole.

Notwithstanding the model's lack of isolation to a single anticompetitive theory, the District Court found that damages resulting from the overbuilder-deterrence impact *could* be calculated on a classwide basis. The Court of Appeals affirmed certification of the class. The Court of Appeals refused to consider Comcast's attack against the statistical methodology because, under principles of US law this type of attack on the merits of a case was inappropriate at the stage of certification (Comcast v. Behrend et al., 2013, p. 4). The Court of Appeals emphasized that at the certification stage the plaintiffs do not bear the onus of establishing the damages directly caused by each individual theory of antitrust impact. The dissenting opinion of the Supreme Court also endorsed the expert testimony.

The dissent accepted that the model provides evidence of Comcast's anti-competitive conduct. The anticompetitive conduct led to a greater than 60% market share and cause the class to suffer injuriously higher prices. So much was accepted by the dissent. The dissent also criticized the majority of the Supreme Court for meddling with factual findings of the District Court. Appellate courts are legally permitted only to overturn findings of fact from trial courts

only in exceptional circumstances. The legal thresholds of "exceptional circumstances" are not relevant for our purposes. The dissent was acutely aware of this. However, justices Ginsburg and Breyer, writing for the four dissenting judges, criticized the majority of the Supreme Court for considering fact-based matters. With a bit of a humorous twist, the dissent observed that to reach their decision the majority of the Supreme Court "must consider fact-based matters, namely what this econometric multiple-regression model is about, what it proves, and how it does so." Aware of the appellate nature of the court, the dissenting judges were aware that while considering fact-based matters, the majority "must overturn two lower courts related factual findings to the contrary" (Comcast v. Behrend et al., 2013, p. 22)

Not mentioned by the majority, the dissenting judges noted that the District Court found the econometric model *was* capable of measuring damages on a classwide basis even after striking three of the four antitrust theories (Comcast v. Behrend et al., 2013, p. 23). In short, with a sound model, where two courts accepted an econometric model as capable of demonstrating damages on a classwide basis, a majority of the Supreme Court still rejected certification. The majority was also critical of the use of class actions as an exception to the norm of individual litigation.

The dissent was much more aware of the role of efficiency of class actions to litigate certain legal issues. "In particular, when questions of liability common to the class will achieve economies of time and expense, the predominance standard is generally satisfied even if damages are not provable in the aggregate" (Comcast v. Behrend et al., 2013, p. 17). A footnote of the dissenting opinion further illustrates legislative intent to permit class certification when it

is the expeditious method of adjudication. The note of the dissenting opinion observes that rules 24(c)(4)-(5) of the US *Federal Rules of Civil Procedure* allow classes to be divided into subclasses to the adjudication of damages.

The practical result of this provision means the econometric model's classwide basis acceptance could be left in place, allowing the class to be certified. Questions of damages and liability specific to the overbuilder theory could have been adjudicated at trial. Even more importantly, the dissent also noted that, a class can be certified for liability purposes only. Where this is the case, liability questions are answered and then individual (i.e. sub-class) damages calculations can be determined in subsequent proceedings. Flexibility is built in to the *Federal Rules of Civil Procedure* by congress to enable judicious use of the class representation mechanism. Further, as litigation proceeds, judges are able to amend or alter initial class certification orders under authority of Rule 23(c)(1)(C).

These two specific legislative provisions identify examples of statutory flexibility for the use of class actions. Nonetheless, as *Comcast* illustrates, legislative reform is necessary because the legislative framework for effective use of class actions is not being appropriately applied by courts. Specifically, there is no clear legislative direction guiding judges as to what extent the merits of a case, including to what extent evidence is to be considered at the certification stage.

The purpose of turning individual negative expected value claims into economically feasible means of recovery is thwarted by such decisions such as *Comcast*. The result is individual claimants being unlikely to pursue small amounts of compensation for overpaying on

their cable bill. If the expert evidence in *Comcast* is correct, individual consumers suffered nearly $0.9 billion in uncompensated losses due to anticompetitive behaviour likely in violation of the US antitrust statutes. The transfer of wealth was avoidable if, or would have been mitigated, through a class action proceeding.

3.1.2 Fruits and Bricks: *Sun-Rype* and re-visiting the *Illinois Brick* doctrine

A case currently progressing through the Canadian courts raises again the issue of direct and indirect purchasers in antitrust class action litigation. The case, *Sun-Rype* was heard by the Supreme Court of Canada last year. As I noted earlier, the decision of the court has yet to be released. Regardless of which way the Court decides it will simultaneously please and displease certain groups in society (which perhaps is the case with every judgement). This question was recently part of a comprehensive set of recommendations for reform by the special Antitrust Modernization Committee (AMC or "the Commission") in the US Congress. The AMC was special committee tasked with exactly what its name invokes.

Direct and indirect purchaser litigation is a specific and unique instance of class action litigation within the antitrust context. In addition to being a specific type of litigation, this type of litigation also provides a unique insight into the importance a class action can serve in specific contexts. Direct vs. indirect purchaser litigation takes place along a multi-level supply chain with several suppliers and purchasers. Disputes are generally characterized by a price-fixing cartel at some level, possibly the top of the supply chain, which increases prices. Increased prices are then passed down the supply chain to the ultimate end-users which are frequently consumers.

The price fixing cartel colludes to raise prices in violation of antitrust and competition statutes. Higher prices are then passed through the supply chain. Complexity enters the fold because high prices for direct purchasers do not necessarily mean 100 percent of the price increase will be passed through to the next purchaser; so on down the supply chain.

Typically, it is easiest to think of direct purchasers as intermediate entities in a supply chain. Consumers are then the indirect purchasers at the end of the supply chain. The simplest type of example applying these characterizations is a two-stage/three-level supply chain. This structure is demonstrated in figure 2 below. Firms at the top of the supply chain supply an input to an intermediate upstream firm. The intermediate upstream firm uses the input to produce a good that is then sold downstream to consumers. If there is a cartel on the supply side of the first-stage market, this increases the price of the input for the intermediate firm's product. The intermediate firm is likely to suffer injury in the form of lost consumer surplus from the increased prices. On the other hand, it may not suffer injury because it can pass on 100 percent of a price increase to consumers. Consumers (i.e. the indirect purchasers) are one stage removed from the cartel and are likely to suffer injury as the intermediate firm passes through some of the increase in price.

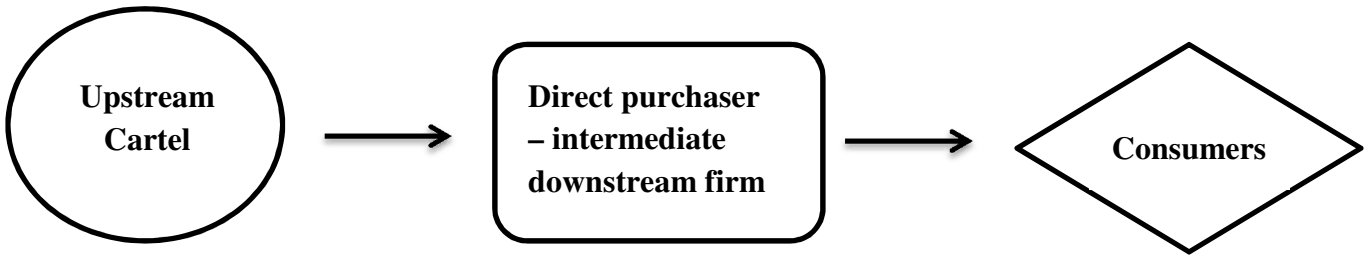

Figure 2: Two level supply chain with upstream cartel

The very type of two-level supply chain detailed here is identical to the market structure in the current *Sun-Rype* litigation and *Illinois Brick*[6] decided in 1977 by the Supreme Court of the United States. In both cases, price-fixing cartels allegedly existed at the first stage of the supply chain. *Illinois Brick* involved price fixing of bricks which were sold to home builders in the construction of new homes. Consumers – the home purchasers and thus indirect purchasers – were then harmed by this illegal activity when the rise in input costs increased the price of their homes. *Sun-Rype* involves price fixing by an upstream cartel which supplies High Fructose Corn Syrup (HFCS), an input for various consumer goods. The plaintiffs in *Sun-Rype* sought certification of a class containing both direct and indirect purchasers in order to efficiently and effectively adjudicate their claims.

Illinois Brick established a principle which blocks indirect purchasers from recovering against the colluding firms for violation of the U.S. federal *Sherman Act*[7] which prohibits collusion and price fixing. The primary motivation for this doctrine, radiating from the *Illinois Brick* decision, is avoidance of double recovery. Under the doctrine of *Illinois Brick*, only direct purchasers are able to recover for the harm suffered due to the price increase attributable to the cartel. The legal ruling has force only for claims brought under the *Sherman Act* and *Clayton Act*[8] because these are federal antitrust statutes. The ruling would not apply to state claims for jurisdictional reasons.

[6] See *Illinois Brick Co. v. Illinois*, 431 U.S. 720, 728-29 (1977), the original United States Supreme Court decision which has created the controversy that continues to interest lawyers, scholars and jurists today.
[7] See *Sherman Act*, 15 U.S.C. §§ 1 – 7.
[8] See *Clayton Act*, 15 U.S.C. §§12 – 27, 29 U.S.C. §§ 52 – 53.

The Antitrust Modernization Commission observed in their 2007 Report to the President and Congress ("the 2007 Report") that *Illinois Brick* has led to fierce debate. Debate has moved beyond courts and peer-reviewed journals, as 36 states have passed legislation directly nullifying the effect of *Illinois Brick* under state antitrust and competition statutes (Antitrust Modernization Commission, 2007). Potentially influenced by negative-expected-value classes and efficiencies, the 2007 Report from the Commission called for legislatively overruling the *Illinois Brick* doctrine to allow for indirect purchaser claims. The doctrine, its economics and related controversies are at the heart of the current *Sun-Rype* litigation.

The *Sun-Rype* case is important for Canadian jurisprudence because it will likely determine whether the *Illinois Brick* doctrine will become Canadian law, or if Canadian competition law will permit indirect purchasers to have a cause of action. If indirect purchasers have a valid claim in law, then it will be most efficient to allow adjudication of these reforms in one forum, simultaneously with the direct purchaser claim. The one-forum idea was precisely the suggestion adopted by the AMC.

In the *Sun-Rype* decision from the British Columbia Court of Appeal (BCCA), debate on this issue was immediately apparent. There was a strong dissenting opinion against the majority which overturned the British Columbia Supreme Court's certification. The dissenting judge held the opinion that the question of barring indirect purchaser claims is "wide open in Canada" (*Sun-Rype*, BCCA 2013, p. 12). The defendants in *Sun-Rype*, the firms at stage one of the two-stage supply chain, assert the position that indirect purchasers do not have a cause of action in Canada.

Lack of the cause of action for indirect purchasers is argued to be a corollary to the law not recognizing pass-through of increased prices as a valid defence available to cartel participants.

Following a 2007 Supreme Court of Canada decision *Kingstreet Investments*[9], Canadian law does not recognize pass-through as a valid defence to an alleged violation of the *Competition Act*[10], Canada's federal competition statute (*Sun-Rype*, BCCA 2013, p. 12). The result of this legal principle is that cartel members cannot sidestep a violation simply because a direct purchaser passed on the price to an indirect purchaser. For example, if a cartel successfully increased the price of a good by $1 per unit for the direct purchaser, and the direct purchaser passed on $0.50 in the form of higher prices, the colluding firm cannot use the pass-through to shield themselves from the full $1 of liability.

Even if the direct purchaser passes on some of its injury in the form of a higher downstream price, there is still a loss to be compensated. In fact, there are two such losses. The direct purchaser suffers an immediate loss from purchasing the good at a higher price than would competitively prevail. This is a type of rent extracted by the cartel in the upstream market. Direct purchasers also suffer harm from lost revenues in the downstream market in the form of lost revenue through decreased sales to consumers, as the market adjusts to higher prices (i.e. lost

[9] See *Kingstreet Investments Ltd v. New Brunswick (Finance)*, 2007 SCC 1. The British Columbia Court of Appeal also cited *British Columbia v. Canadian Forest Products Ltd.*, 2004 SCC 38 in support of this legal principle.
[10] See *Competition Act*, R.S.C. 1985, c. C-34. It is worth noting that under Canadian federal law, by virtue of principles of federalism in the Canadian Constitution, competition law is entirely a federal jurisdiction in Canada. That is not the case in the United States, as we have seen, where there is overlap which allows states to pass legislation specific to antitrust lawsuits which take place in State courts. Even if a proceeding is launched in a provincial court in Canada, the area remains one of federal jurisdiction. In fact, provincial superior courts such as the British Columbia Supreme Court are federal courts under section 96 of *Constitution Act,* 1867. The consequence of the Canadian system is that final say in the direct vs. indirect purchaser debate ultimately lies within the federal government for legislative purposes. As a digression it would be an interesting matter of constitutional law to analyze whether provincial governments could legislatively allow direct and indirect purchasers to form a class through civil procedure legislation, which is a matter of provincial competency.

producer surplus). These theoretical foundations of indirect purchaser litigation will be discussed further in section 4 of the paper.

For the purposes of the law and economics of class actions, let us consider what type of classes would bring proceedings against a cartel. If it is assumed that indirect purchasers have a cause of action, then there are three possible permutations of classes that could bring claims against the cartel. First and foremost, there are the direct purchasers. Second, there is the group of indirect purchases. Third, the groups of direct and indirect purchasers could seek certification together to litigate their claims against an alleged cartel. What will be the most efficient?

The Antitrust Modernization Commission recommended option 3 in the 2007 Report. That is, direct and indirect purchasers should litigate as a single class through the certification and trial stages. The word-for-word recommendation of the Commission is to "allow consolidation of all direct and indirect purchaser actions in a single forum for both pre-trial and trial proceedings" (Antitrust Modernization Commission, 2007, p. 271). In making this recommendation, the Commission was undoubtedly motivated by the savings to litigants and the justice system that would be created. Economies of scale would be created through coordinated litigation of both purchaser groups. The most important consequence of this recommendation is the economies of scope resulting from consolidating claims of both direct and indirect purchasers in a single forum. The evidentiary crossovers of factual matters associated with adjudicating these claims favours consolidation.

The British Columbia *Class Proceedings Act*[11] seems to show awareness of the provincial legislature of these economic efficiencies produced through class action litigation. The British Columbia statute is more accommodating and flexible towards class actions than the U.S. *Federal Rules of Civil Procedure*. Under s. 4(1)(c) the BC statute allows for certification when "the claims of the class members raise common issues, whether or not those common issues predominate over issues affecting only individual class members". The result is the social benefit of minimizing social costs of litigation through removing unnecessary duplicative litigation from the justice system.

In stark contrast to the federal US statute, the BC *Class Proceedings Act* necessarily requires under s. 4(1)(d) that "a class proceeding would be the preferable procedure for fair and efficient resolution of the common issues". Section 4(2)(d) of the BC statute requires the court to consider "whether other means of resolving the claims are less practical or less efficient". Pursuant to s. 4(2)(e), a court must consider "whether the administration of the class proceeding would create greater difficulties than those likely to be experienced if relief were sought by other means". All of these clauses demonstrate an overarching concern with the efficiencies generated through class action litigation.

Specific to the direct vs. indirect purchaser situation in *Sun-Rype,* or the different competitive impact theories in *Comcast*, there is an enabling clause for such a class with separate subclasses. Section 7 of the BC statute expressly directs that a court must not refuse to certify a class because either: 1) "different remedies are sought for different class members"[12] or 2) "the class

[11] See *Class Proceedings Act*, R.S.B.C. 1996, c. 50.
[12] See *Class Proceedings Act*, s. 7(c).

includes a subclass whose members have claims that arise common issues not shared by *all* class members"[13]. Overall, the Canadian statute seems much more concerned with ensuring the most economically efficient route to compensating meritorious claims.

The recent case of *Sun-Rype* is evidence that debate originating with *Illinois Brick* continues to be unsettled. As a result, potential changes are on the horizon for class action and competition law in Canada. The Supreme Court of Canada may adopt recommendations from the 2007 Report of the Antitrust Modernization Commission, notwithstanding the fact that the report was written for the President and Congress of the United States. The economics underlying the debate does not have a national affiliation. Or the Court may go down the route of casting *Illinois Brick* in stone. This ongoing litigation demonstrates that certain areas of class action are still being moulded. The law and economics favours transplanting the recommendations of the Antitrust Modernization Commission into the Canadian context to maximize the social benefits of the economic efficiencies associated with class actions in this context.

The economic theory behind the recommendation for removing a bar to indirect purchaser litigation will be presented further in section 5. The next recent judicial opinion presents a different type of threat to class action litigation.

[13] See *Class Proceedings Act*, s. 7(d).

3.2 Arbitration Waivers – *American Express, Seidel and Amway*

Class action waivers, provisions which remove access to collective litigation, are likely to unambiguously result in negative-expected-value claims never reaching a litigation stage. These waivers are becoming more and more common in consumer contracts. An example is in standard form consumer agreements such as cellphone contracts, where the parties to the contract undertake to solve all disputes arising from the contract through final and binding arbitration. The usage of these clauses in contracts has extended from displacing single-party disputes from court to also waiving the right to class action court proceedings. Arbitration clauses remove disputes from the jurisdiction of courts. Class action waivers, which do not provide for class arbitration, remove the right of an individual to litigate through a class – regardless of whether or not there is a negative expected return of individual proceedings.

The validity of such a class action waiver as part of a standard contract was recently at issue before the United States Supreme Court in *American Express v. Italian Colors Restaurant*. Several merchants which accepted American Express credit cards as forms of payment argued that the credit card company was abusing its dominant market position to impose a tying arrangement in violation of the *Sherman Act*.

The standard merchant contract used by American Express went further than requiring arbitration. The contractual provisions in question in *American Express* required parties to arbitrate, and also expressly prohibited class arbitration. The contract also disallowed any type of joinder or consolidation of claims or parties (*American Express* dissenting opinion at p. 7, dissent). Lastly, there was also a confidentiality provision which prevented any claimant from

informally arranging with other merchants to produce common expert evidence for the purpose of any claim.

The standard agreement not only removed formal mechanisms of cost-sharing such as class proceedings, but also eliminated any possibility of generating economies of scale through voluntary coordination. In upholding the arbitration agreement, the Supreme Court arguably endorsed a contract which removed all possible mechanisms of generating economies of scale in litigation. The arbitration agreement also precluded any shifting of costs to American Express, even if an individual claimant was successful. The agreement left no way to transform a negative expected value claim into a rational economic decision to litigate.

From a law and economics perspective, this judgement is an important development because it identifies the need for legislative intervention if the injured parties are to have a realistic opportunity at seeking compensation. The effect of the class action waiver as part of an arbitration clause now means an injured party to a contract with such a clause cannot possibly generate economies of scale. The arbitration clause in *American Express* not only removed access to a court of law for class proceedings. The clause also removed the opportunity for a party to the contract to have access to a class action mechanism.

Arbitration, like traditional litigation, defaults to a single party dispute. However, arbitration clauses arise as an instance of a legal entity's freedom of contract. In order for class arbitration to be possible, all parties involved must agree to the proceeding. Merchants such as American Express, then, must in effect *consent* to class actions being brought against them in

arbitral proceedings. In a court of law the defendant has no rational choice but to defend themselves when a court is seized with a claim. Without legislative mechanisms imposing class proceedings in certain contexts, such as consumer protection or negative expected value claims, the injured party is without redress. The injurer will not rationally consent to class arbitration, since the two alternatives in claims such as *American Express* are either class arbitration or no arbitration. The injuring party will trivially opt not to expose itself to any possible liability. The injured party is then left out to dry.

In situations such as consumer cellphone contracts or merchant payment systems, it is likely the case that the injured party faces a negative expected value proposition. The effect of the *American Express* ruling is to eliminate all economic means of recourse for the negative expected value litigant. Even if an individual chose to litigate, total costs in the legal system are increased.

If the usage of class action waivers are endorsed by the Supreme Court, usage is only likely to increase. Any rational actor that can shield themselves from liability almost entirely through the combination of an arbitration clause and class action waiver will chose to do so. The Supreme Court's endorsement of an economical path to compensation not necessarily needing to be provided in law sets a dangerous precedent.

While the *American Express* decision is the most recent judicial pronunciation of the interpretation of class action waivers, Canadian jurisprudence seemed to already be setting the

path. In two early cases, *Bisaillon v. Concordia University*[14] in 2006 and *Dell v. Union des Consommateurs*[15] in 2007, the Supreme Court of Canada ruled that arbitration provisions in collective agreements and online purchases could defeat class actions. This represented an early defeat for class action proceedings.

In a more recent case, *Seidel v. Telus Communications Inc.*[16], the Supreme Court of Canada seems to be taking a middle ground in response to legislation enacted by Canadian provinces. Following the *Bisaillon* and *Dell* decisions, Quebec and Ontario passed amendments to their respective consumer protection legislation which effectively invalidated arbitration and class action waiver clauses in consumer contracts (Kotrly & Valasek, 2011). In the amended statutes, provided that a plaintiff's claim arose from statutory provision, and the act did not allow for waiver from these provisions by contractual agreement, the statute would trump arbitration and class action waivers.

In *Seidel*, the Supreme Court of Canada followed this logic to override an arbitration clause for certain of Ms. Seidel's claims against Telus. Ms. Seidel had launched a proposed class against for breaches of British Columbia's *Consumer Protection Act* and other statutes (Kotrly & Valasek, 2011). The claims arising from the consumer protection legislation are those relevant for the purpose of this discussion. It appeared as though the class action may not proceed, as the cell phone contract from which the claims arose contained an arbitration agreement which also included a class action waiver. However, the Supreme Court of Canada held that the Ms. Seidel was able to continue to seek certification of the proposed class action arising from the *Consumer*

[14] See *Bisaillon v. Concordia University*, 2006 SCC 19.
[15] See *Dell Computer Corp. v. Union des Consommateurs*, 2007 SCC 34.
[16] See *Seidel v. Telus Communications Inc.*, 2011 SCC 15.

Protection Act. Claims arising form a statute providing for the right to bring an action in court could not be nullified through an arbitration agreement. This provides an illustration of legislation providing for effective use of the class action mechanism. The case is also an example of where legislation could protect the usage of a class proceeding for negative expected value litigants.

Finally, a more recent decision from Canada's Federal Court of Appeal confirms that legislative language will be necessary to override any arbitration agreement/class action waiver in Canada. *Murphy v. Amway*[17], decided in February of 2013, confirmed arbitration agreements and class action waivers cannot be overridden without explicit statutory language. The language must protect a contracting party's ability to enter a class action, notwithstanding the fact of any waiver of the mechanism. At question in *Amway* was an action brought under Canada's *Competition Act*[18]. The plaintiff, Murphy, was seeking to certify a class for a claim brought pursuant to a section of that statute. The Federal Court of Appeal relied on *Seidel* to uphold the effect of the class action waiver. The *Competition Act* did not contain explicit language protecting the collective mechanism such as the *British Columbia Consumer Protection Act* did in *Siedel.* The Federal Court of Appeal held that without such language, a class action waiver requiring individual arbitration will continue to have effect (Norton Rose Canada Fulbright LLP, 2013).

[17] See *Murphy v. Amway Canada Corp.*, 2013 FCA 38.
[18] See *Competition Act*, R.S.C., 1985, c. C-34.

Legislation regulating other areas where negative expected value claims are likely to arise, such as consumer protection and competition legislation, can serve to protect creating economies of scale through collective action.

4. Theoretical Considerations

Constructive and informed advances of a system are accomplished through considering previous scholarly work, experience, and theory. Section 2 of this paper canvassed the literature for fundamental underpinnings of class actions litigation. Section 3 considered the legal system's recent experience with class actions. The purpose of this section is to build on the first two by providing theoretical considerations. Two theoretical contributions are discussed.

The first contribution is to express mathematically when society stands to benefit from class litigation. This expression will inform the parameters that can then be used to introduce suggestions for legislative reform. The second theoretical discussion builds on the review of the *Sun-Rype* decision of the British Columbia Court of Appeal. Foundational public economics can contribute to the direct versus indirect purchaser debate in antitrust class action litigation.

4.1 An Economic Criterion for Class Certification

Bringing together the ideas from the literature review, a social-policy decision making criterion for class certification can be proposed. Such a theoretical decision making tool could be transformed into express decision making criteria for a judge facing a class certification motion.

The social benefits and costs can be reflected explicitly through integrating these aspects of class actions into the appropriate legislation. To some extent, as mentioned above, the *Class Proceedings Act* of British Columbia already appears to do this.

The decision should be as straightforward as possible for a judge considering whether or not to certify a proposed class. From a social planning standpoint, the optimal approach is to minimize the use of social resources. If the costs of class litigation are less than the costs of individual litigation, then the proposed class should be certified. At first this may seem trivial. If class certification always creates economies of scale, then this could lead one to think that social costs will *always* be minimized through consolidated litigation when more than one potential plaintiff exists. However, the situation is more nuanced than this.

As was explored in the literature review, there are many economic dimensions to class actions. For example, negative expected value claimants would rationally choose not to litigate if a class is not certified. Thus a failed certification decision will mean decreasing the amount of overall litigation in the justice system, at least from the standpoint of a claim considered in isolation. It could be possible, for example, that a proposed class is comprised of many positive expected value claims and only a few with negative expected value. A failed certification motion then results in only some of these claims being introduced to the justice system.

Social costs are similar for both class litigation and individual litigation so far as the nature of the costs is concerned. Plaintiffs and defendants incur litigation costs, which are a pure social deadweight loss. If the defendant did not violate the law and harm the plaintiff, society

would not incur these costs. Through either litigation pathway, the public justice system faces costs for occupying court time and resources, including time of the judge. Class action proceedings introduce two specific added social costs.

The social costs of class action litigation arise from transaction costs and the empirically verified settlement phenomenon. Where there are multiple plaintiffs in a class and potentially multiple defendants, coordination costs arise. Counsel for the various parties involved in the litigation must coordinate their efforts. The lawyers representing the class must specifically take time to communicate with the class through coordinating meetings of the whole group, or a significant portion of such. This requires more resources than serving only one client. If members of the class are geographically dispersed, then communication efforts become more onerous.

In addition to coordination costs, I have also discussed the potential for extracting settlements when the underlying legal claim is without merit. These have been termed "blackmail settlements" in the literature, as was mentioned in the literature review section of this paper. Where a corporate defendant fears event a small probability of judgement at trial being in favour of the class, defendants have chosen to settle and avoid this possibility. In turn, certification has itself become a weapon for the class. If a class is certified, their bargaining power is instantaneously elevated (Bone & Evans, 2002). This creates a probability of plaintiffs extracting an undeserved settlement, or perhaps more than would be awarded at trial.

It is worth mentioning when considering the settlement aspect of class actions that the effect of "blackmail settlement" may be very different in Canada and the United States. Canadian courts rarely use jury trials in civil litigation. By contrast, juries are commonly employed in American courts, including class action litigation. The result changes the dynamic of settlement. American defendants are much more fearful of the probability of a large judgement in favour of the plaintiffs at trial. Not only are juries more likely to be sympathetic to plaintiffs, but American law is allows for far more extensive punitive damages. Canadian law generally limits recovery to pecuniary damages plus a certain fixed amount of non-pecuniary or punitive damages. Thus, the probability of blackmail settlement is arguably lower in Canada.

Let's turn to the decision. A class should be certified when the total social costs of class action litigation – inclusive of litigation costs to plaintiffs, litigation costs to defendants, coordination costs, and a discounted probability of an unworthy settlement – are less than the social costs of no certification. Mathematically, a class should be certified when

$$L_p - s_p + J_{class} + D - s_d + bS + TC_{class} < \sum p_i l_i + J_{no\ class} + \sum p_i d_i$$

In this expression $L_p - s_p$ represents the total litigation costs to the plaintiffs of a class action, L_p less s_p, the savings generated through economies of scale. The analogous costs to the defendant are $D - s_d$. The costs to the justice system with and without a class are J_{class} and $J_{no\ class}$, respectively. The coordination costs of class proceedings are represented by TC_{class}. The effect of blackmail settlement is captured by bS, where b is the probability of a blackmail settlement and S is the amount of such a potential settlement. The right hand side of the

expression contains costs through individual litigation. The total litigation costs are the sum of litigation costs for each individual plaintiff and defendant. These are represented by $\sum p_i l_i$ and $\sum p_i d_i$, respectively and are discounted by p_i, which is the probability of a plaintiff choosing to individually litigate a claim. Note that the same probability applies to both the defendant and the plaintiff, since a defendant will only be required to incur d_i litigating a claim if the plaintiff chooses to launch proceedings. This was the reason for breaking down the probability in the literature review.

This expression can also be re-arranged to generated further insight. The above expression can also be represented as

$$bS + TC_c < \left(\sum p_i l_i - (L_p + s_p)\right) + \left(\sum p_i d_i - (D + s_d)\right) + J_{noclass} - J_{class}$$

This expression isolates the primary social costs added through class action litigation. Reading the expression this way, it is socially optimal to certify a class only if the cost of blackmail settlement and coordination costs are outweighed by differences in litigation costs for the justice system, plaintiffs and defendants. Put another way, when the economies of scale are sufficiently large, the added social costs of class action proceedings are immaterial.

I will explore more how this may be translated into a legislative framework in the later section which discusses potential means of implementing legislative reform in the areas identified throughout the paper.

4.2 Theoretical Aspects of Direct vs. Indirect Purchaser Litigation

This section aims to expand on the discussion arising from the *Sun-Rype* litigation introduced in section 3.1.2. The essential element in designing a model for allocating damages along a supply chain is to ensure the potential injurers (i.e., cartel participants) have incentives to take efficient levels of care. This is analogous to the transformational economic analysis of torts which established the foundation of efficient levels of precaution and the negligence rule established in 1970 (Calabresi, 1970).

Considering efficient incentives, the *Illinois Brick* rule of compensating direct purchasers with damages of $P_{cartel} - P_{competitive}$ per unit on Q_{cartel} with no pass-through is equivalent to a rule which allocates damage at two levels: (1) First harm to direct purchasers equal to the price increase associated with collusion, less any pass-through to the next level; and (2) harm to indirect purchasers due to the price increase associated with the cartel.

The equivalence is associated with the incentives created from the *Illinois Brick* rule. If the first level of the supply chain, with the direct purchasers, exposes cartel participants to a maximum recovery of $P_{cartel} - P_{competitive}$ then the cartel has equivalent incentives as if the damages were distributed among two levels of the supply chain. This is because the price increase from the cartel can be viewed as theoretically analogous to a tax. The increase in price from $P_{competitive}$ to P_{cartel} per unit introduces what is effectively a tax on the market commodity. The public economics theorem of tax incidence can then be invoked, which provides that incidence of a tax is independent of which side bears the burden of the tax.

The *Illinois Brick* rule exposes potential injurers to the full incidence of the harm created by the cartel. And this is also the gross amount of harm the cartel introduces into the market. The specific distribution of the harm will be determined in the second level of the supply chain as the price adjusts. *Illinois Brick* therefore holds the cartel fully accountable for the economic surplus removed from markets at the first level of the supply chain, without allowing for pass through. From an incentive perspective, *Illinois Brick* will produce the efficient outcome as the potential injurers take into account the full amount of harm that would be done through collusion. This rule internalizes the full extent of injury that would be caused provided no pass-through defence is accepted.

From a normative perspective, however, *Illinois Brick* is arguably inferior to a rule which distributes damages between direct purchasers and indirect purchasers. While *Illinois Brick* will produce efficient incentives for a potential injurer, indirect purchasers are left without compensation for higher prices they may bear in the downstream market. The sum of the harm to direct purchasers and indirect purchasers must necessarily equal the total incidence of the economic loss generated by the cartel's price increase. This removes concerns about duplicative recovery, which would expose the defendant to liability greater than the total harm done.

A rule which allows for direct and indirect purchasers to litigate against a cartel in order to recover distributed harm makes whole *all* economic agents which are affected by the cartel's anticompetitive behaviour. From a societal perspective, then, a distributive rule is arguably superior. The optimal litigation strategy under a distributive regime would be to consolidate

litigation against a cartel into one proceeding. This one proceeding would generate the greatest possible economies of scale and determine harm done to all market actors involved in different levels of the supply chain.

One caveat, however, would be that if the supply chain is sufficiently complex then a distributive approach may not be realistic. If determining harm at different levels would prove impracticable, then competition authorities can rest knowing an *Illinois Brick* regime sufficiently punishes illegal activity because it accounts for the complete welfare loss incidence created by members of the cartel. The difficult question would then be identifying when a supply chain reaches this level of sufficient complexity. Is a three stage supply chain, with indirect purchasers three degrees removed from the cartel, impracticable for an allocative approach? Drawing the line may seem arbitrary. This may militate in favour of maintaining *Illinois Brick* since it is a simple, practical rule which fully holds actors accountable for anticompetitive behaviour. Having considered theoretical aspects, I now turn to recommending reforms integrating all discussion.

5. Potential Legislative Reforms

Based on the analysis explored throughout the paper, this section proposes four distinct areas for legislative reform that can provide for the most effective use of class actions in the legal system. In some instances, the proposals build off prior recommendations. The four proposals directly relate to the economic analysis of class actions and recent judicial trends discussed in section 3. I will outline the recommendations and then proceed to discussing each in more detail.

The first recommendation is to create a framework for courts to make preliminary inquiries into the merits of a case underlying a proposed class action. Second, class action statutes should clearly outline what will suffice as evidence required to established classwide harm at the certification stage. Third, competition and/or class action statutes should be appropriately amended to provide for direct and indirect purchaser litigation. Finally, arbitration statutes and others should be amended to protect the economic mechanism for individuals to bring negative expected value claims.

5.1. The Preliminary Inquiry Question

Significant suggestions for reforming class certification criteria were made in a 2002 article published in the *Duke Law Journal*. Drs. Bone and Evans argued for either partial or complete elimination of the *Eisen*[19] rule in the United States. The *Eisen* rule, in its strict application, restricts courts from a preliminary inquiry into the merits of the case (Bone & Evans, 2002). This rule is introduces inefficiencies into the functioning of class actions in the legal system. I raised this issue when formulating the social decision making criterion in section 4.

By restricting courts from reviewing the merits of the case at the certification stage, a proper assessment of certification is compromised. Classes will be certified that will increase the probability of "blackmail settlements". Additionally, classes which do not satisfy the social cost decision making criterion may also be certified. Conversely, cases which should be certified to proceed as a class may not be. These are two possibilities of erroneous judicial decision making

[19] *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974).

that can be avoided by inquiring into the merits of a case, which decreases the probability of social costs exceeded the benefits from collective litigation. Reforms which assess merit to some extent would allow courts to consider the possibility of blackmail settlement and look at the likelihood that certification is the socially optimal decision.

5.2 Evidentiary Concerns

The *Comcast* decision highlighted that in some class action litigation there may be a high evidentiary threshold for certification. Recall that the US Supreme Court overturned a certification because the economic model used to measure harm was built on assumptions which *may* not have applied to certain of the class members. This case illustrates that the evidentiary basis required to demonstrate measurable harm on a classwide basis may be high, even at the initial stages. At the same time, one can certainly question how looking at evidentiary assumptions is not akin to a preliminary inquiry into the merits.

What is clear from *Comcast*, is that lawyers and experts require better defined rules which spell out the required evidence for class actions at the preliminary stages. While the economist in *Comcast* may have taken liberties with assumptions, at the same time he presented a working econometric model that measured damages to people in the Designated Market Area. Since US class action law allows for sub-classes, the econometric model could have likely been further refined and adopted based on differ assumptions relevant to members of sub-groups within the broad class.

5.3 Direct and Indirect Purchaser Classes

The recommendation with respect to direct and indirect purchaser antitrust litigation is to eliminate the *Illinois Brick* rule, as recommended by the United States Congress-established Antitrust Modernization Commission. Blocking potential recovery by indirect purchasers leaves the ultimate consumers, possible those with greatest price elasticity of demand, uncompensated. Preventing the direct and indirect consumers from litigating together as one class introduces unnecessary duplicative social and private costs into the legal system. As discussion in section 4, the allocative rule will also produce efficient incentives for potential injurers.

The specific recommendation is to amend legislation allowing to permit the consolidation of all claims into one forum. Discovery, other pre-trial proceedings and the production of evidence could be then monitored in one lawsuit not two. The class could be split into two separate proceedings – one for direct and the other indirect purchasers – at a later stage, if this would make the most efficient use of social resources.

5.4 Reconsidering the Waiver

Perhaps the greatest barrier to the benefits class actions can bring to litigants and the justice system is the usage of class action waivers in arbitration clauses. Through the combined class action waiver and agreement for private arbitration, it is very unlikely that negative expected value claims will be litigated at all. While a sense of injustice immediately arises, there is also the possibility of dynamic inefficiencies if litigants cannot hold law breakers accountable for actions in the market. Insights from the securities markets do not have to be isolated to that

context. Dynamic inefficiencies could occur in other areas of the economy where agent behaviour over time could be affected.

The Canadian scheme that has been established through *Murphy v. Amway* and *Seidel* provides for a reasonable middle ground. Legislators could either follow this route or compel that arbitration clauses do not contain class action waivers, or at least provide for class arbitration. Either option would increase access to justice and ensure negative expected value litigants have a mechanism to seek compensation and prevent unjust transfers of wealth. An option which creates a statutory block to waiving the right to collective litigation, especially in areas where violations of law are likely to generate small monetary loss, is the optimal structure.

This approach is in accord with economic fundamentals of the class action while protecting freedom of contract. The obvious example is consumer legislation, which encompasses a wide variety of contractual relationships. Other areas such as securities litigation and antitrust – as demonstrated though *American Express* – would also serve to introduce more balance into interactions in these legal spheres. Alternatively, legislators could amend arbitration legislation to disallow clauses which prevent sharing of information amongst private arbitration participants. This approach, at the very least, would allow for informal coordination of information and alignment of market incentives.

6. Conclusion

Recent jurisprudence discussed throughout the paper demonstrates a trend in courts that is making class action litigation increasingly difficult to successfully pursue in Canada and the United States. This emerging trend evident through recent judicial developments undermines the private and social economic functions served by class actions and collective litigation. This paper has shown that reform is required for class actions to continue to effectively serve the function they are meant to in the justice system.

Progressive and effective reform in society should be illuminated by a combination of theory and experience. In this spirit this paper has attempted to identify possible areas of improvement in the class action framework through exploring the law and economics literature and analyzing recent judicial decisions. The literature reveals that class action is a critical mechanism to litigating negative expected value claims. At the same time, this important function must be considered against possible abuses in settlement practices once a class is certified. One suggested way in which this balance could be achieved is having courts make a preliminary inquiry into the merits of a proposed class action. Courts would then have the ability to monitor the probability of blackmail settlements and ensure the social costs of a class action are less than the benefits.

The paper has made two suggestions for facilitating class action litigation. First, through avoiding class action waivers in arbitration clauses, and second, allowing for the economies of scale and scope created through direct and indirect purchaser antitrust litigation. Finally, the paper has also suggested reforming the degree of evidence necessary to establish that damages

are measurable on a classwide basis. Such reform would remove uncertainty in the system and provide better guidance to expert witnesses providing evidence, especially where complex models are required to demonstrate loss. Combined, these reforms may create increased certainty in the legal system and lead to more equitable outcomes.

Together, the suggested reforms in this paper have sought to closer align the legal system with the economic theory of class action litigation. Further empirical research could serve to identify the benefit class actions serve to the legal system. A potential research project may be to engage with lawyers and have them professionally estimate budgets for individual litigation and class action litigation. Since much of the theoretical benefit of class action is to produce economies of scale, such a collaborative project with legal professionals would provide a better sense of the private and social resources preserved through collective litigation.

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