Civil Remedies for Breach of Continuous Disclosure Obligations under Ontario's Securities Act

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This paper considers the issue of whether a civil cause of action should be available to individual investors under Ontario's *Securities Act* to sue for investment losses suffered due to inaccurate continuous disclosure. The Allen Committee's recent proposals for statutory reform are considered. Managers (directors and officers) control the disclosure process. Any liability rule should therefore be aimed at providing managers with an incentive to take reasonable care when making disclosure. It is argned here that disclosure provides a benefit to shareholders as a group. Accordingly, an appropriate entity to bring an action against the managers in the event that they fail to take reasonable care when making disclosure is the corporation itself. Such a liability rule is called a managerial liability rule. A managerial liability rule already exists in that the corporation has the right to sue managers where they breach their general duty of care owed to corporations under corporate legislation. The Allen Committee's proposed statutory civil cause of action would result in the issuer being liable for the wrongs of managers and as such is a vicarious liability rule. The question is whether the vicarious liability rule adds anything to the managerial liability rule. It may in that by holding the issuer liable, the support of existing shareholders in monitoring management in its disclosure may be enlisted. However, the free-rider problem will limit the scope of how carefully shareholders will monitor management's disclosure. Further, there is a risk of multiple actions under the vicarious liability rule that does not exist under the managerial liability rule. Accordingly, it is an empirical issue as to which rule is superior.

Cet article vise à déterminer si des investisseurs devraient disposer d'une cause d'action civile individuelle en vertu de la *Loi sur les valeurs mobilières* d'Ontario pour les dommages subis à la suite d'inexactitudes dans la divulgation continue de renseignements corporatifs. À cette fin, il examine les propositions récentes de réforme législative émises par le comité Allen. Étant donné que les administrateurs et les dirigeants contrôlent le processus de divulgation, la règle relative à la responsabilité devrait avoir pour objectif de les inciter à faire preuve de diligence raisonnable lorsqu'ils remplissent ces fonctions. L'auteur avance que, la divulgation se faisant à l'avantage de l'ensemble des actionnaires, l'entité la plus appropriée pour intenter une action contre les administrateurs et les dirigeants en cas de manquement à l'obligation de diligence raisonnable est la compagnie elle-même. Une telle règle de responsabilité des administrateurs et des dirigeants existe déjà en ce que les lois corporatives permettent aux compagnies de poursuivre leurs administrateurs et dirigeants pour manquement à leur obligation générale de diligence. Toutefois, la cause d'action d'origine législative proposée par le comité Allen constituerait une règle de responsabilité du fait d'autrui, en ce qu'elle rendrait l'émetteur responsable pour la faute de l'administrateur ou du dirigeant. Cette règle ajouterait-elle quelque chose à celle de responsabilité des administrateurs et des dirigeants? Il se pourrait que le fait de tenir l'émetteur responsable incite les actionnaires à contribuer à la supervision de la divulgation continue, ce qui améliorerait son efficacité. Toutefois, cet incitatif pourrait être mitigé dans la mesure où même les actionnaires ne participant pas de près à ce processus de supervision bénéficieraient des efforts qui y seraient consacrés par les autres actionnaires. De plus, la règle de responsabilité pour autrui soulève la possibilité d'actions multiples, ce qui n'est pas le cas de la règle de responsabilité des administrateurs et des dirigeants. L'auteur conclut qu'en l'abscnce d'expérience concrète, on ne peut avancer que la solution proposée par le comité Allen est préférable à la règle actuelle.

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Introduction

This paper contributes to the debate on a current policy issue in the area of securities law. This issue is whether there should be an amendment to securities legislation[1] to provide for a statutory civil cause of action in the event that issuers make continuous disclosure that is inaccurate. Under current securities legislation, there is a statutory civil cause of action for a misrepresentation in a prospectus document.[2] However, for most provinces, there is no statutory equivalent when there is a misrepresentation made by an issuer in a continuous disclosure document.[3] It is a statutory offense to make a misrepresentation in a continuous disclosure document.[4] However, there is a concern that due to budgetary constraints, securities regulators are unable to effectively enforce the statutory obligation.[5] Further, recourse is available in a common law action for negligent misrepresentation. However, this remedy is considered to be virtually ineffective against misleading continuous disclosure.[6]

The Allen Committee[7] recently considered the matter. It concluded that there is cause for concern about the growing incidence of misleading continuous disclosure.[8] It therefore proposed amendments to the *OSA*[9] to provide a similar remedy to that found under American securities legislation. In particular, the Allen Committee's proposal (which is stated at this point in somewhat general terms and outlined in more detail below) is that where an issuer discloses information that is not accurate to a certain degree, both the issuer and its managers (directors and officers) should be liable to pay damages to investors who disposed of or who acquired shares of the issuer

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[1] Ontario's *Securities Act*, R.S.O. 1990, c. S.5 [hereinafter *OSA*] is used as the model Securities Act. Other provinces and the territories, however, have enacted similar legislation: *Securities Act*, S.A. 1981, c. S-6.1 (Alberta); *Securities Act*, R.S.B.C. 1996, c. 418 (British Columbia); *The Securities Act*, R.S.M. 1988, c. S50 (Manitoba); *Security Frauds Prevention Act*, R.S.N.B. 1973, c. S-6 (New Brunswick); *The Securities Act*, R.S.N. 1990, c. S-13 (Newfoundland); *Securities Act*, R.S.N.S. 1989, c. 418 (Nova Scotia); *Securities Act*, R.S.N.W.T. 1988, c. S-5 (Northwest Territories); *Securities Act*, R.S.P.E.I. 1988, c.S-3 (Prince Edward Island); *Securities Act*, R.S.Q. 1990, c. V-1.1 (Quebec); *The Securities Act*, S.S. 1988, S-42.2 (Saskatchewan); and *Securities Act*, R.S.Y. 1986, c. 158 (Yukon).

[2] See *OSA*, *ibid.*, s. 130.

[3] M. Gillen, *Securities Regulation in Canada*, 2d ed. (Scarborough: Carswell, 1998) at 209. See also Toronto Stock Exchange, Committee on Corporate Disclosure, *Toward Improved Disclosure: A Search for Balance in Corporate Disclosure* (Toronto: TSE, 1995) at 34 [hereinafter *Allen Committee Interim Report*]. The Allen Committee prepared this interim report. The Allen Committee issued its final report in March, 1997: Toronto Stock Exchange, Committee on Corporate Disclosure, *Responsible Corporate Disclosure: A Search for Balance* (Toronto: TSE, 1997) [hereinafter *Allen Committee Final Report*].

[4] *OSA*, *supra* note 1, s. 129.

[5] *Allen Committee Interim Report*, *supra* note 3 at 53.

[6] *Ibid.* at 51.

[7] See *supra* note 3 and accompanying text.

[8] *Allen Committee Interim Report*, *supra* note 3 at 22.

[9] See *OSA*, *supra* note 1.

between the dates when the inaccurate disclosure was made and when it was corrected. However, it is further proposed that neither the issuer nor its managers would be liable if due diligence were exercised, or alternatively, if reasonable care were taken, to ensure that the disclosed information was accurate. If damages are awarded, a plaintiff would be entitled to recover investment losses but there would be a limit on the total amount that could be recovered.

One of the shortcomings of the Allen Committee's Report is that it does not have an adequate theory of the function of disclosure or why we have securities legislation. The notion that is built upon here is that securities are simply specialized contracts.[10] Private bargaining between issuers, managers, and investors, the principal parties to the securities contract, will determine what information is to be disclosed. Disclosure provisions in the securities contract will promote the production of information that is productive in nature and discourage the production of information that is purely redistributive in nature.[11] Information is productive if it improves the allocation of resources. Information is purely redistributive if all it does is enable a party to a transaction who possesses the information to make trading gains at the expense of the other party. Indeed, arguments such as these explain contract doctrines relating to the allocation of information such as the doctrines of unilateral mistake and frustration.[12]

Disclosure is productive in that it reduces the costs to shareholders *as a group* of monitoring management (also called agency costs) and the costs to *all* shareholders of disposing of or acquiring the firm's shares in the capital market (also called liquidity costs). As such it is in the mutual interests of shareholders *as a group* to reach an agreement with managers, who control the process of producing and disclosing information, whereby managers provide disclosure of information that reduces agency and liquidity costs.

The function of disclosure is not to enable *individual* investors to make speculative profits. Disclosure may be of a private benefit to individual investors if an investor is able to obtain information about the underlying value of an issuer before other investors uncover it. An informed investor is thereby able to use such information to make trading gains or speculative profits at the expense of uninformed investors. This creates a private incentive on the part of individual investors to incur expenditures to obtain an informational advantage over other investors. However, it is argued here that

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[10] There has been a growing literature that analyzes securities law from the perspective that securities are specialized contracts. See generally F. Easterbrook & D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991) at 1–39 [hereinafter *Economic Structure*]; and F. Easterbrook & D. Fischel, "Optimal Damages in Securities Cases" (1985) 52 U. Chi. L. Rev. 611 at 614 [hereinafter "Optimal Damages"]. Even the Allen Committee implicitly takes a "contractarian" approach to analyzing securities law (see *Allen Committee Interim Report*, *supra* note 3 at 3-5).

[11] This is a goal of contracts law in general. See *e.g.* R. Cooter & T. Ulen, *Law and Economics*, 2d ed. (Reading, Mass.: Addison-Wesley, 1997) at 245-48.

[12] *Ibid.* See generally A. Kronman, "Mistake, Disclosure, Information and the Law of Contracts" (1978) 7 J. Leg. Stud. 1.

disclosure for such a purpose is redistributive in nature. Investors, *as a group*, therefore have an incentive to reach an agreement with managers whereby managers disclose some information, but not detailed information, that may be used for the purposes of making speculative profits. Such minimal disclosure will reduce the private incentive for individual investors to incur wasteful expenditures to uncover the information.

Thus, private bargaining will result in disclosure of information that reduces agency and liquidity costs, and the private incentive to incur expenditures uncovering information about the issuer. Indeed, private bargaining in the absence of transaction costs will provide for much the same disclosure that is also provided for under securities legislation. The function of securities legislation is to "enable" the formation of securities contracts by providing a model contract that most issuers, managers, and investors would make in the absence of transactions costs. By adopting the model contract, the parties to the securities contract are thereby saved the expense and inconvenience of negotiating disclosure terms.

The model contract set out in securities legislation, in addition to providing for what information will be disclosed, will also provide a mechanism to ensure that the disclosure is accurate. Such a mechanism is called a liability rule. The liability rule provides an incentive to managers, who control the disclosure process, to take reasonable care in the production and disclosure of information. Since the parties to the disclosure agreement are, on the one hand, shareholders as a group, and on the other, the managers, it is appropriate for the corporation itself to enforce the agreement on behalf of the shareholders. The term given here to a liability rule that provides for the corporation, or its shareholders as a group, to sue the corporation's managers if they fail to take reasonable care in the production and disclosure of information is the "managerial liability rule". Corporate legislation arguably already provides a managerial liability rule in that managers owe a duty to exercise reasonable care in the performance of their duties as managers.[13] This remedy could, in theory, be invoked if managers failed to exercise reasonable care to eusure that disclosure was accurate.

It would seem at first glance, therefore, that there is little necd to provide individual investors with a statutory civil remedy against the issuer in the event that managers make inaccurate disclosure. Such a liability rule is termed a "vicarious liability rule" in that the issuer is liable for the conduct of its managers. Essentially, the liability rule proposed by the Allen Committee is a vicarious liability rule. A number of questions about the Allen Committee's proposals arise. If managers control the process of disclosure, why should the issuer, or alternatively, the shareholders as a group, be vicariously liable? Further, why is the class of plaintiffs limited to those shareholders that traded in the firm's shares between the dates when inaccurate disclosure was made and when it was corrected? Why are these plaintiffs entitled to recover their individual *investment losses*?

[13] See *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 122(1)(b) [hereinafter *CBCA*] and *Business Corporations Act*, R.S.O. 1990, c. B.16, s. 134(1)(b) [hereinafter *OBCA*].

Despite the questions about the Allen Committee's proposal, the vicarious liability rule nevertheless has *some* merit. A managerial liability rule may not result in managers taking reasonable care when making disclosure if they do not have the resources to pay any damages award in the event they are found to be liable. If managers are judgment proof, their incentive to take care is reduced. However, it is argued here that as long as recovery of investment losses is limited, a vicarious liability rule will provide an incentive for existing shareholders to monitor managers more carefully to ensure that they take reasonable care when producing and disclosing information. For this reason, managers may be more likely to take reasonable care when producing and disclosing information under a vicarious liability rule than under a managerial liability rule.

However, because liability is shared among so many shareholders, this creates a free-rider problem that reduces the incentive for any individual shareholder to monitor management's disclosure. Further, because there are so many more potential plaintiffs under the vicarious liability rule than under the managerial liability rule, there is a risk of a multiplicity of lawsuits that is not present under the managerial liability rule. Whether the benefits of the vicarious liability rule are outweighed by its costs is an empirical question. On balance, therefore, it is unclear whether the vicarious liability rule provides any additional gains that the managerial liability rule, which already exists under corporate law, cannot provide.

The rest of the paper will proceed as follows. In Part I, there is a brief discussion on the theory of disclosure and the function of disclosure legislation along the lines outlined above. Part II, which deals with liability and damage rules, is the heart of the paper. After reaching an agreement over what information will be disclosed, the parties will provide for mechanisms, namely liability and damages rules, to ensure that it is accurate. If it could be determined at the time of disclosure whether the information was accurate, there would be no need for such rules. The purchaser of information, who is the shareholder, simply would not pay for the information unless it were accurate. However, there is a timing problem in that it may be some period of time after disclosure is made before it can be determined whether disclosure is accurate. In this case, there would be scope for opportunistic behaviour on the part of those who provide the information, namely the managers of the issuer. Accordingly, liability and damages rules are required to deter such opportunistic behaviour.

In Part II.*A*, the managerial liability rule is discussed. Two possible managerial liability rules are considered. The first to be considered is a rule whereby managers guarantee the accuracy of the information they disclose so that if disclosure is not reasonably accurate or accurate to a certain degree, managers are liable to pay damages. This would give managers an incentive to take reasonable care or cost-justified precautions when producing and disclosing information. This is a sensible result since managers control the process of producing and disclosing information. However, such a rule would also effectively result in managers insuring investors against losses due to inaccuracies in disclosure that investors are better at insuring against themselves. Investors can insure against these losses through their ability to diversify their investment portfolios.

An alternative liability rule would be for managers to be liable only if disclosure were not reasonably accurate, and managers failed to take reasonable care in the production and disclosure of information. This would give managers an incentive to take reasonable care when making disclosure. It would also provide shareholders with an incentive to insure themselves against these losses due to inaccurate disclosure. Thus, a reasonable-care managerial liability rule would be more efficient than a rule where managers guarantee the level of accuracy of disclosure.

As for a damages rule, it is argued here that under a rule where managers are personally and solely liable if they fail to take reasonable care, there would be no agreement that managers would be liable for investment losses suffered by shareholders as a result of inaccurate disclosure. As mentioned above, the parties to the securities contract will agree that disclosure is to be made to reduce agency and liquidity costs, and the private incentive to incur expenditures in order to obtain an informational advantage over other investors. Information, however, also creates expectations by investors and the market about the future value of the issuer's shares. Accordingly, if disclosure is inaccurate, it may result in mistaken expectations by investors and the market. Those who traded in the firm's shares between the dates when disclosure was made and when the inaccuracy was discovered may suffer trading losses. If managers were liable for investment losses, they would in effect be insuring investors against investment risk. Again, this is something that investors can better insure themselves against than can managers. Thus, the damages rule would not result in managers being liable for investment losses.

Investment losses are, therefore, similar in nature to consequential losses that arise as a result of breach of contract for which, generally, contracts law is loath to permit recovery. In this respect, the theory developed here for a managerial liability rule is consistent with the law of contracts. Managers would, however, be liable to return wages that they were paid to produce information if they failed to take reasonable care in the production of information. Removing any reward for taking less than reasonable care in making disclosure will remove any incentive to take less than reasonable care.

The conclusion to Part II.*A* develops the argument that a managerial liability rule already exists under corporate law in that managers have a duty to exercise the same degree of skill and care that a reasonably prudent person would exercise in managing his own affairs.

In Part II.*B*, the vicarious liability rule proposed by the Allen Committee is discussed. After managers, existing shareholders are in the best position to control the accuracy of disclosure because they can monitor whether management is taking reasonable care and they have the legal power to dismiss management if it is not taking reasonable care. Accordingly, it would be useful to enlist their efforts to increase the likelihood that disclosure is accurate. Issuer vicarious liability is a mechanism to enlist that support.

The Allen Committee proposes that some investors should be able to recover their investment losses, which is inconsistent with the argument that under a managerial liability rule, investment losses would not be recoverable. How can the Allen Committee's recommendation be justified? It is argued here that if securities legislation is to promote economic efficiency, it should be more concerned with deterring inaccurate disclosure than with compensating investors for their investment losses as a result of inaccurate disclosure.[14] This is because investor compensation simply means that investors are insured against investment losses. However, as mentioned above, investors can efficiently insure themselves against losses by diversifying their portfolios.

If the goal of securities legislation is to deter inaccurate disclosure rather than to compensate investors, then the right to sue should be allocated to those persons who can prosecute an action against the issuer and managers most efficiently. It is argued that the best *prima facie* prosecutors are those persons who traded in the issuer's stock between the dates when inaccurate disclosure was made and when it was corrected. In order to give such persons the incentive to sue, they must be permitted to recover at least some of their investment losses, provided that the total investment losses recovered do not exceed the actual harm caused to all shareholders by inaccurate disclosure. If recovery of investment losses is not limited, managers will be deterred too much from making inaccurate disclosure and will take too much care when making disclosure. Further, shareholders will be induced to monitor their managers too much.

The paper concludes that, on balance, it is unclear whether the vicarious liability rule would add much more to what is already provided under the managerial liability rule.

I. Agreement on the Information to Be Continuously Disclosed

Private bargaining could, in the absence of transaction costs, determine what information issuers of securities would provide on a continuous basis. Generally, contracts may provide for the allocation of information by one party to another.[15] A distinction, however, is made between two types of information: productive information and redistributive information.[16] Information is productive if, when it is produced and disclosed, it improves the allocation of resources or increases the total wealth of the parties. Typically, the production and disclosure of such information is also costly. The parties to the contract may reach an agreement for one of the parties to produce and disclose the information up to the point where the marginal joint expected benefits of doing so are equal to the marginal joint costs.[17] The agreement will also provide for a sharing of the resulting joint net benefits between the parties.

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[14] Whether the goal of the liability rule should be compensation or deterrence was one of the questions considered by the Allen Committee (see *Allen Committee Interim Report*, *supra* note 3 at 58).

[15] Cooter & Ulen, *supra* note 11 at 245.

[16] *Ibid.* at 245-48.

[17] An efficient contract for the disclosure of information will maximize the parties' joint net expected benefits from information. The optimal amount of information is obtained where the marginal joint expected benefits are equal to the marginal joint costs of producing information. That is to say, the first step in bargaining is to maximize the size of the pie to be divided between the parties. The

Information is redistributive if, where one party to a transaction has information that another does not, the informed party is able to make gains from trade at the expense of the uninformed party. Redistributive information does not add to the joint wealth of the parties. Rather, it simply redistributes the wealth. If no party has an informational advantage over any other party but an informational advantage can be acquired by incurring expenses or making an investment in information, each party has a private incentive to make such an investment. However, if each party behaves in the same way, nobody is able to obtain an informational advantage. Each party ends up as equally well informed as the other, and no party is able to make a trading gain at the expense of the other. Indeed, the parties are jointly worse off because each has incurred expenses to acquire the information. It would therefore be in the interests of the parties to reach an agreement that neither will invest in redistributive information. However, such an agreement would be costly to enforce. An alternative to such an agreement would be to pay someone to make an investment in such information and publicly disclose it. The amount of information that would be disclosed would be just sufficient so as to remove the private incentive for all parties to make investments in such information.[18]

It should also be noted that information may be productive and redistributive.[19] For example, if there are several principals to a contract and they engage an agent to uncover information and disclose it to all of them, all the principals will enjoy an increase in wealth because the information is productive. However, if one principal is able to obtain the information from the agent before the other principals and then buy out the other principals' interest in the contract, he will be able to enjoy the entire increase in wealth for himself. Accordingly, there will still be a private incentive on the part of principals to the contract to incur expenditures to uncover the information. On balance, however, economic efficiency will be improved if the increase in wealth as a result of the production of the information exceeds the costs incurred by principals trying to uncover the information.

The *OSA* provides for the continuous disclosure by issuers of considerable amounts of information about themselves to the secondary market. Under sections 77, 78, and 79 of the *OSA*, issuers are required to file interim financial statements and audited annual financial statements with the Ontario Securities Commission, and to provide copies of these documents to their security holders.[20] There is also a provision

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next step to bargaining is to divide the maximized pie between the parties. How that pie is divided will depend upon the bargaining power of the parties.

[18] D. Diamond, "Optimal Release of Information by Firms" (1985) 40 J. Finance 1071 at 1073 [hereinafter "Optimal Release of Information"].

[19] Cooter & Ulen, *supra* note 11 at 247.

[20] Issuers are required to prepare and file quarterly financial statements and annual audited financial statements. Financial statements must be prepared in accordance with generally accepted accounting principles and regulations (see *OSA*, *supra* note 1, ss. 77-79; and R.R.O. 1990, Reg. 1015, s. 2 [hereinafter *OSA Regulations*]).

to promptly disclose material changes in the affairs of the corporation.[21] Coupled with this is a prohibition against insiders trading on material information that has not been made public.[22] Generally, issuers with revenues or assets above a certain level[23] are also required to disclose an Annual Information Form[24] and Management Discussion and Analysis ("MD&A")[25] providing detailed information about the firm beyond what is normally disclosed in financial statements.[26]

Included in MD&A is information that is intended to give the investor an analysis of the firm's future prospects.[27] Such information provides investors with information that enables them to make predictions about the future value of the firm's shares. Investors use such predictions to decide whether to trade in the firm's shares with the expectation of making trading profits. However, arguably the quantity of forecasting information which issuers are required to disclose in MD&A is quite minimal. Forecasts are a type of forward-looking information. Another type of forward-looking information is the business plan of the firm. The regulation of the disclosure of the

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[21] See *OSA, ibid.*, s. 75(1). A material change in the affairs of the company is one that is reasonably expected to have a significant effect on the market value of its shares: see "material change", *OSA*, s. 1(1).

[22] *Ibid.*, s. 76(1).

[23] See *OSC Policy Statement 5.10*, Part I, General Instructions, Exemptions (*OSC Policy Statement 5.10* was first published in (1989) O.S.C.B. 4275, as am. by (1990) 13 O.S.C.B. 943). Generally, *OSC Policy Statement 5.10* applies to all issuers except to mutual funds, to issuers with shareholders' equity or revenues of $10 million or less, to issuers that are registrants with the SEC of the United States and which file a Form 10K or 20F with the SEC pursuant to the *Securities Exchange Act of 1934*, and to foreign issuers.

[24] *Ibid.*, Part II, Annual Information Form, General Statement at para. 1.

[25] *Ibid.*, Part III, Management's Discussion and Analysis of Financial Condition and Results of Operations, General Statement.

[26] *Ibid.*, Introduction.

[27] MD&A requires management of the issuer to explain in narrative form the issuer's current financial situation and future prospects, and is intended to give the investor the ability to look at the issuer through the eyes of management by providing both an historical and a prospective analysis of the business of the issuer. Thus, MD&A may be characterized as forward-looking in part in that it provides information about the future prospects of the issuer (see *OSC Policy Statement 5.10, supra* note 23, Part III, Management's Discussion and Analysis of Financial Condition and Results of Operations). The AIF must also include some forward-looking information (see *ibid.*, Part I, General Instructions at para. 14). However, while the AIF and MD&A require disclosure of certain forward-looking information, what is required is qualitative in nature. The issuer is not required to disclose numerical projections or forecasts. But if issuers choose to disclose numerical projections or forecasts, such forward-looking information (also called future-oriented financial information) must comply with the requirements of *National Policy Statement 48*, which was first published in (1992) 15 O.S.C.B. 5978, as am. by (1993) 16 O.S.C.B. 194; App. A revised by (1993) 16 O.S.C.B. 716. *National Policy Statement 48* specifies the manner in which future-oriented forecasting information ("FOFI") is to be disclosed. FOFI is defined by the *Statement* as "information about prospective results of operations, financial position or changes in financial position, based on assamptions about future economic conditions and courses of action. Future-oriented financial information is presented as either a forecast or projection".

firm's business plans is governed so as to prevent the firm's competitive position from being harmed by premature disclosure.[28]

Further, under section 86 of the *OSA*, any person who solicits proxies from security holders to exercise on their behalf their right to vote at annual meetings must send an information circular to each security holder whose proxy is solicited. Management must solicit proxies where it gives or intends to give notice of a meeting to holders of voting securities of a reporting issuer.[29] The management form of information circular and any information circular voluntarily sent to holders of voting securities must be in prescribed form,[30] indicating, among other things, information concerning the interest of the person making the solicitation in the matters to be voted upon, details of executive compensation, indebtedness of directors, executive officers and senior officers to the issuer, and interests of insiders in material transactions.[31]

As already discussed, securities can be viewed as specialized contracts.[32] It is, therefore, arguable that the parties to the securities contract would reach an agreement providing for disclosure of many of the same things provided for in the statutory disclosure regime described above. In particular, the securities agreement would provide for:

(a) the disclosure of financial statements and of the information required to be disclosed in the information circular;

(b) the broad disclosure of information so that it is publicly available;

(c) the disclosure of more detailed information as the size of the firm increases;

(d) the minimal regulation of the firm's disclosure of business plans;

(e) the prompt disclosure of material changes; and

(f) the disclosure of minimal amounts of forecasting information.

There would be an agreement to items (a) through (c) because such information is productive. In particular, disclosure of such information makes it easier for shareholders to monitor the conduct of managers to ensure that they are not shirking their management responsibilities and it thereby reduces agency costs. Agency costs arise

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[28] See *OSA*, *supra* note 1, s. 75(3), where disclosure of a material change would be unduly detrimental to the interests of the issuer, the issuer can make disclosure on a confidential basis. New business plans are arguably "material changes" in the affairs of the issuer. Disclosure of such plans would be detrimental to the interests of the issuer. Accordingly, there would be confidential disclosure of business plans.

[29] *Ibid.*, s. 85.

[30] *OSA Regulations*, *supra* note 20, s. 176 and Form 30.

[31] *OSA Regulations*, *ibid.*, Form 30. See also Gillen, *supra* note 3 at 183.

[32] See *supra* note 10 and accompanying text.

whenever a principal entrusts his affairs to an agent.[33] Managers, however, bear the burden of agency costs in the form of lower salaries.[34] Therefore, managers will bear the burden of the costs incurred to produce information that is useful for monitoring managers.

With respect to item (d), the parties will agree to regulate the disclosure of business plans only to a minimal degree. Business plans are clearly productive information. Business plans enable the firm to determine how best to use its limited resources. A better allocation of firm resources increases the profitability, and hence the value, of the firm. However, business plans are also useful to rivals. If disclosed too early, a rival would copy the plan and appropriate for itself some or all of the profits that the firm making the husiness plan expected to enjoy. This would discourage the firm from making the plans in the first instance.[35] Accordingly, the timing of the disclosure of plans will be left to the discretion of the managers of the firm so as to maximize the net benefit to be enjoyed from the production and disclosure of business plans. Moreover, by providing managers with incentive pay whereby their incomes are tied to the value of the firm, managers will have a greater incentive to disclose business plans at that time which maximizes the net benefit of doing so.

There would be an agreement to item (e) (prompt disclosure of material changes) for perhaps two reasons. First, suppose there is a material change in the affairs of the issuer that arises because of a purely random event. Thus, changes in the affairs of the issuer caused by making business plans are excluded because business plans are not purely random events. By virtue of their positions, managers of the firm will typically acquire information about a purely random change before investors. This will make managers more informed than shareholders and other investors. If managers were permitted to trade in the firm's shares with this informational advantage, they could make trading gains at the expense of investors. If the random change were positive, managers wonld buy shares in the firm to enjoy the profits when the change was made public. If the random change were negative, managers could enjoy a profit by selling short whereas purchasing investors would suffer a loss.

This could have the effect of discouraging other investors from investing in the firm's shares altogether, since making a trade is likely to be a losing proposition given that managers always have an informational advantage. This in turn reduces the li-

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[33] See M. Jensen & W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership" (1976) 3 J. Finan. Econ. 305 at 308; and P. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems" (1995) 62 U. Chi. L. Rev. 1047.

[34] Jensen & Meckling, *ibid.* at 319; and Mahoney, *ibid.* at 1092.

[35] A business plan is like the discovery of an invention. As such, firms that make business plans will have difficulty appropriating the full value of the plans. Business plans cannot be protected by means of intellectual property laws such as patents, copyright, and trade-marks. Often, the primary means of exploiting a business plan is being the first to make and implement the plan: see J. Kattan, "Antitrust Analysis of Technology Joint Ventures: Allocative Efficiency and the Rewards of Innovation" (1993) 61 Antitrust L.J. 937 at 943. However, if the plan is disclosed before the firm is in a position to implement the plan, its first-mover advantage may be lost.

quidity of the firm's shares as it becomes more difficult for shareholders to find someone with whom to trade.[36] A solution to this problem is to prohibit managers from trading on non-public information about purely random changes in the affairs of the issuer. In other words, prohibiting insider trading reduces liquidity costs.[37]

A second reason why parties might agree to prompt disclosure of material charges is that, assuming that managers did not trade on non-public information about purely random changes in the affairs of the issuer, this would mean that there was some undisclosed information about the firm. It would be in the interest of investors to incur expenditures to obtain the information ahead of other investors and thereby make trading gains. Accordingly, such information is purely redistributive in nature. There are, therefore, mutual gains to be made from an agreement whereby the managers promptly disclose just a suffieient amount of information to remove the private incentive for investors to incur expenditures to acquire the information.[38]

Investors would reach an agreement about item (f), for the public disclosure of forecasts that relate purely to the future value of the firm's shares, since such information is redistributive in nature.

Also note that the prompt disclosure of such purely random changes has the added benefit of removing the temptation from managers of trading on such information. Thus, prompt disclosure of purely random material changes in the affairs of the issuer will reduce the private incentive to invest in information about random changes in the affairs of the issuer and it will reduce liquidity costs.

Finally, it should be noted that such agreements to disclose information would not completely remove the incentive for investors to try to uncover undisclosed information or to make forecasts about the future value of the firm.[39] This is because information can be both productive and redistributive in nature. For example, financial statements are used to monitor managers and, if disclosed on a regular basis, reduce

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[36] P. Milgrom & J. Roberts, *Economics, Organization and Management* (Englewood Cliffs, N.J.: Prentice Hall, 1992) at 468; D. Diamond & R. Verrecchia, "Disclosure, Liquidity, and the Cost of Capital" (1991) 46 J. Finance 1325.

[37] See D. Carlton & D. Fischel, "The Regulation of Insider Trading" (1983) 35 Stan. L. Rev. 857. The authors argue that there are efficiency benefits and costs to insider trading. They posit that it is therefore ambiguous whether insider trading is efficient or inefficient. This suggests, they further argue, that insider trading should be left entirely as a matter for private bargaining between the parties to the securities contract. However, it could be argued that the benefits to a rule that prohibits insider trading are likely to exceed the costs of such a rule where the issuer is small and its shares are closely held. Most parties to a securities contract would prefer that, when an issuer first goes public, which is when it is most likely to be relatively small and its shares closely held, there be a rule that prohibits insider trading until the issuer becomes large and its shares are widely held. Where that point occurs is, however, uncertain. If securities law plays an enabling role, there is room for a provision in the legislation for a rule to the effect that insiders of the issuer are prohibited from engaging in insider trading, which rule would apply during the initial stages of an issuer's public life.

[38] "Optimal Release of Information", *supra* note 18.

[39] See *ibid.* at 1088.

agency costs. However, once disclosed, they affect the market value of the firm. To the extent that an investor can obtain financial statements ahead of other investors, he can make a trading gain. However, financial statements cannot be produced instantaneously. If disclosed too early, there is a risk that they will be inaccurate. This in turn would make monitoring of the managers more difficult. Thus, the frequency with which financial statements are disclosed will require the balancing of the objective of avoiding inaccuracy in disclosure and the objective of discouraging private investments to uncover the information in the financial statements. Even where these two objectives are balanced, there will be some investors who still incur expenditures to uncover the information.

There is a similar problem with forecast information. Business plans, if not disclosed prematurely, will increase the value of the firm. The firm cannot disclose the business plans too early otherwise the benefit of making the plans may be lost. However, individual investors will then have an incentive to invest in information about undisclosed business plans. Once these business plans are uncovered, there will be a further incentive to make forecasts of the firm's future value based on the plans.

If private bargaining can efficiently determine the terms of the relationship between issuers, managers and investors, it might be asked what need there is for a securities regulator. However, there is an "enabling" role for the securities regulator to play.[40] By providing a model contract that the parties to securities contracts are free to adopt if they so choose, the securities regulator reduces transaction costs in that the parties avoid the cost of negotiating disclosure provisions, and liability and damages rules when disclosure is inaccurate. As such, the securities regulator "enables" the formation of securities contracts and thereby enhances economic activity. Given that the securities regulator performs its "enabling" function by providing a model securities contract, contract law principles can provide considerable guidance to the securities regulator about the rules for the disclosure of information and on liability and damages rules.

It might be objected that securities legislation is "mandatory" and that the concept of an "enabling" role for securities legislation is inconsistent with "mandatory" disclosure. However, it is inaccurate to describe disclosure legislation as "mandatory".[41] There are numerous ways to opt out of the statutory disclosure regime through the availability of automatic exemptions,[42] the discretionary exemption,[43] and blanket orders.[44] If an exemption or a blanket order is unavailable, then compliance with the

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[40] For a discussion on the "enabling" role played by corporate and securities law in general, see *Economic Structure*, *supra* note 10 at 11.

[41] Mahoney, *supra* note 33 at 1093.

[42] See *OSA*, *supra* note 1, ss. 72 and 73.

[43] *Ibid.*, s. 74.

[44] The securities regulator may find that applications for a discretionary exemption under s. 74 of the *OSA* occur with sufficient frequency in a particular type of transaction that the regulator's time could

statutory regime is required. In this sense the statutory disclosure regime is "mandatory". However, exemptions and blanket orders cover many if not virtually all of the situations where issuers, investors, and managers would want to opt out of the statutory disclosure regime. Accordingly, the statutory disclosure regime is arguably more "enabling" in nature than "mandatory".

II. Agreement on Liability and Damages Rules

The securities contract will include provision for the continuous disclosure of information outlined above in Part I. In exchange for the service of providing continuous disclosure, managers receive compensation. However, there is a timing problem in that shareholders may not be able to immediately observe whether the information provided by managers is accurate or sufficiently prompt.[45]

This gives rise to a principal-agent problem. There is opportunity for managers to behave opportunistically. They could avoid the effort of producing accurate information, simply make disclosure without regard to its accuracy or timeliness, and then quit after being compensated for providing it. Not ouly would shareholders have paid good money to managers for inaccurate disclosure, the inaccurate disclosure will likely affect the value of their investment and they may suffer a trading loss when the inaccuracy is uncovered.[46] Another form of managerial opportunistic behaviour by managers would be to produce accurate information, make inaccurate disclosure over- or understating the true state of affairs, and then trade in the firm's stock to make trading gains when the true state of affairs is eventually revealed. Shareholders who buy from or sell to managers will suffer a loss. [47]

If at the time shares are issued, the issuer offers no provision in the securities contract to control opportunistic behaviour, investors simply will not acquire stock in

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be saved by granting a "blanket" order whereby an exemption applies to all transactions of that type (see Gillen, *supra* note 3 at 258).

[45] The making of promises typically involves deferred exchanges – time passes before the exchange is completed. This gives rise to the risks and uncertainties of opportunistic behaviour which, in the absence of enforceable contracts, would discourage the making of mutually beneficial exchange between parties to a potential transaction. Since at least the time of Thomas Hobbes, it has been recognized that one of the principal purposes of contracts law is to enforce promises so that the benefits of mutually beneficial exchange or co-operation can be enjoyed (see R. Posner, *Economic Analysis of Law*, 5th ed. (New York: Aspen, 1998) at 103).

[46] However, the parties on the other side of the transaction will enjoy a gain that will offset the trading loss. But to avoid any loss, investors would have a private incentive to make investigations into the accuracy and the timeliness of the disclosure provided by managers.

[47] The more efficient the market for the firm's shares, however, the less the scope for making trading gains by behaving opportunistically in this manner. See S. Ross, "Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory" in F. Edwards, ed., *Issues in Financial Regulation* (New York: McGraw-Hill, 1979) 177 at 181.

the firm.[48] The result will be that the promoters of the firm will be unable to pursue the investment project that they wish to finance by the issuance of shares. If the firm's investment project does not proceed, the gains from an agreement between the firm's promoters and investors (whereby promoters sell shares in the firm in exchange for financing by investors) are lost.

One mechanism to resolve the problem is for shareholders to withhold compensation from managers until it is determined that the disclosure they made was accurate. Alternatively, managers might be required to post a bond. However, managers may not have the financial resources to finance their personal consumption or to cover a bond until it is determined that the disclosure they made was accurate. It might be considered whether managers could turn to an ordinary lender to borrow money for this purpose. The lender would lend money to managers on the condition that the money would be repaid once it was determined that the disclosure was accurate. At that point in time, the manager/borrower would also receive his or her compensation from the shareholders so that he or she would have the resources to repay the loan. But this would then shift onto the lender the problem that shareholders face in being unable to immediately observe whether the disclosure the managers made was accurate. Accordingly, the manager may be unable to turn to an ordinary lender.

The shareholders are likely in a better position than an ordinary lender to monitor whether the disclosure the managers made was accurate. Another mechanism to deal with the principal-agent problem, therefore, is a liability rule whereby managers, in exchange for receiving payment at the time of making disclosure, agree to pay damages in the event that it is later discovered that the disclosure is inaccurate. In Part II.A, a liability regime where managers are personally and solely liable is considered. It is argued that shareholders and managers will agree that in the event that disclosure contains a material error, managers who fail to take reasonable care in the production and disclosure of information will pay damages to shareholders. Moreover, managers and shareholders will agree that managers will not be liable for investment losses suffered by shareholders but will be liable for the implicit price paid by shareholders for the disclosure, namely the wages paid to managers to produce and disclose the infor-

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[48] If the manager intends to stay employed with the firm on a long-term basis, the incentive to engage in opportunistic behaviour will be reduced. Long-term relationships tend to be self-enforcing because market mechanisms operate to deter opportunistic behaviour. For example, the managerial labour market will assess the value of the manager based on his or her past performance, including performance with previous employers. If the manager shirks his duties with one employer and this is discovered after he quits, there will be a corresponding downward revision of the manager's compensation (see E. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J. Polit. Econ. 288 at 295-304). However, problems with opportunistic behaviour are encountered toward the end of the relationship. If managers are close to retirement or the gains from shirking or cheating are large enough, this market mechanism may not be effective. Specific contractual mechanisms to deal with such opportunistic behaviour are required. The contractual mechanisms proposed herein very likely complement market mechanisms. Because of the presence of market mechanisms to deal with opportunistic behaviour, shareholders are less likely to have to rely on the legal system to enforce their contractual rights.

mation. The managerial liability rule is consistent with general principles on the law of damages where there is breach of contract. This should be so if securities are viewed simply as being specialized contracts.

In Part II.*B*, the Allen Committee's proposals for a vicarious liability rule are considered in more detail. A managerial liability rule contemplates only managers being held liable and, if they are liable, liability is to all shareholders. The Allen Committee proposes, in addition to this, that the issuer be vicariously liable for damages in the event that disclosure contains a material error and managers failed to take reasonable care.[49] Further, it is proposed that not all shareholders would be able to recover damages.[50] As well, investment losses would be recoverable against the issuer but the amount that is recoverable may be limited.[51] Nonetheless, as is argued below, issuers, managers, and shareholders might agree to a rule of issuer vicarious liability and limited recovery of investment losses.

A. Managers Personally and Solely Liable for Disclosure: The Existing Liability Rule

Within the liability regime where managers are personally and solely liable, there are two possible liability rules: an absolute liability rule and a reasonable-care liability rule. Under an absolute liability rule, the manager receives compensation upon making disclosure but promises to compensate the shareholders for any losses that shareholders may suffer in the event that it is later discovered that disclosure is not reasonably accurate or is not accurate to a certain degree. Under this liability rule, the manager guarantees a certain level of accuracy of disclosure and promises to pay damages to shareholders for losses suffered if that level of accuracy is not achieved. Under a reasonable-care liability rule, however, the manager guarantees that he will take a certain level of care when making disclosure and promises to pay damages to shareholders if that level of care is not achieved.

The question then becomes, as between these two liability rules, which rule maximizes the gains from trade between shareholders and managers? It is in the interests of shareholders and managers to choose that rule that maximizes the gains from trade.

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[49] The Allen Committee proposes that the issuer be held liable when a misrepresentation is made (see *Allen Committee Final Report, supra* note 3 at 63).

[50] The Allen Committee proposes that a cause of action be available to any person who acquires or disposes of shares in the period between the time when the misrepresentation was made and wheu it was corrected (*ibid.* at 63).

[51] The Allen Committee proposes that plaintiffs be entitled to recover "damages". But "damages" are defined in such a way as to include investment losses or the difference between the price paid for the share and its price after the inaccurate disclosure is made (*ibid.* at 63 and 69).

1. Absolute Liability Rule

Under an absolute liability rule, managers guarantee the level of accuracy of disclosure and promise to pay damages that shareholders may suffer if disclosure does not reach that level. What level of accuracy will managers guarantee? An efficient contract between shareholders and managers would maximize the sum of the expected net benefits of disclosure enjoyed by managers plus the sum of expected net benefits of disclosure enjoyed by shareholders.[52] Managers enjoy expected benefits from disclosure because they reduce agency costs that managers bear.[53] Because managers exclusively enjoy the benefits of a reduction in agency costs, they will pay the costs of producing disclosure that reduces agency costs. Shareholders also enjoy expected benefits from disclosure in that disclosure reduces liquidity costs and reduces the private incentive to incur expenditures uncovering undisclosed information about the issuer and forecasts about the future value of the issuer. Since shareholders alone enjoy these expected benefits, they will bear the costs of producing disclosure for these purposes.

Producing and disclosing information, whether used by managers or shareholders, requires the use of managerial effort and other resources. It is reasonable to suppose, however, that managers cannot perfectly control the accuracy of disclosure because the process is also partly determined by exogenous random events. Managers can only control the level of care taken to produce accurate disclosure. Thus, despite the care taken by management to produce accurate disclosure, disclosure may still be inaccurate due to events outside the control of managers. But it is assumed that the more care managers take in the production and disclosure of information, the more accurate the information likely will be.[54]

Therefore, the best that managers can do is take that level of care that maximizes the joint expected net gains of the parties. We might define this level of care to be "reasonable" care. If managers take "reasonable" care, or alternatively, use cost-justified precautions when producing and disclosing information, their behaviour is economically efficient. The level of accuracy that will be guaranteed is that level of accuracy that is expected to be achieved when managers take reasonable care in the production and disclosure of information. We might define this level of accuracy to be "reasonable" accuracy. If disclosure is not reasonably accurate, then managers are liable to pay any damages suffered by shareholders. Thus, managers bear the risk of inaccurate disclosure. It may alternatively be said that, effectively, managers insure shareholders against the risk of less than reasonably accurate disclosure.

A reasonable assumption to make, however, is that managers are averse to risk. Shareholders are also likely to be risk-averse but they can virtually eliminate the un-

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[52] See *supra* note 17.

[53] See *supra* note 33 and accompanying text.

[54] A similar assumption is made to analyze the negligence rule in tort law (see Cooter & Ulen, *supra* note 11 at 271).

compensated risk that they bear through diversification of their investment portfolios.[55] Thus, shareholders are actually risk-neutral because a large risk can become quite small when spread among a large group of shareholders.[56] Managers, however, cannot spread risks so easily.[57] Their primary asset is their human capital, which may be firm-specific, or tied to the issuer[58] and very difficult to diversify.[59]

A liability rule that results in risk-averse managers insuring risk-neutral shareholders against the risk of inaccurate disclosure is inefficient. Because managers are more risk-averse than shareholders, managers would insist upon being paid a risk premium for bearing the risk of inaccurate disclosure. Since risk-neutral shareholders are prepared to bear the risk without being paid any risk premium, a more efficient agreement between managers and shareholders would be one where shareholders bore the risk of inaccurate disclosure instead of managers.[60]

2. Reasonable-Care Liability Rule

An alternative to an absolute liability rule would be to hold managers liable if they failed to take a reasonable level of care to ensure that disclosure was accurate. Provided that managers took reasonable care to ensure disclosure is accurate, they would not be liable for any damages in the event that disclosure was inaccurate. However, if they failed to take reasonable care, they would be liable. Such a liability rule would give managers the incentive to be efficient in the production of disclosure. By definition, reasonable care in the production and disclosure of information is economically efficient in that, as seen above, it is that level of care that maximizes the expected joint net benefits for managers and shareholders from disclosure. Provided that managers took reasonable care in the performance of their duty to produce disclosure, they would enjoy income certainty. Investors would bear the risk of inaccurate disclosure. However, investors could eliminate this risk through portfolio diversification.

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[55] Posner, *supra* note 45 at 471-76 for a discussion on how portfolio diversification can eliminate uncompensated risk.

[56] A. Sykes, "The Economics of Vicarious Liability" (1984) 93 Yale L.J. 1231 at 1235; and "Optimal Damages", *supra* note 10 at 640-41.

[57] *Economic Structure*, *supra* note 10 at 99-100.

[58] Firm-specific human capital is skill and knowledge developed by an employee that are useful only if he is employed under a specific employer. It includes methods of production and management that are idiosyncratic to the firm. The employee will have invested time and energy learning about these idiosyncratic methods of production and management. Moreover, the employee and employer will share in the cost of acquiring this information. However, if the employment relationship is terminated before the employee is able to recoup the cost of his/her share of the investment, the employee suffers a loss. The employee therefore takes a risk when he/she invests in firm-specific human capital. The employee can, however, diversify his/her risk if he/she invests in general human capital, which is useful with a variety of employers. For a discussion on firm-specific human capital, see G. Becker, *Human Capital*, 2d ed. (New York: National Bureau of Economic Research, 1975) at 16-37.

[59] Posner, *supra* note 45 at 478.

[60] Sykes, *supra* note 56 at 1235.

The reasonable-care liability rule is therefore more efficient than an absolute liability rule in that it ensures that managers end up doing what they do best, efficiently producing disclosure, and that investors end up doing what they do best, insuring against the risk of inaccurate disclosure through portfolio diversification. For this reason, there will not be an agreement whereby managers guarantee the level of accuracy of disclosure.

3. A Refinement to the Reasonable-Care Rule: Material Errors

When managers take reasonable care to produce and disclose information, it is expected *ex ante* that disclosure will be reasonably accurate. *Ex post*, or after disclosure is made, an assessment can be made relatively easily as to whether the disclosure achieved the expected degree of accuracy, which is reasonable accuracy. One of the problems with a reasonable-care liability rule, however, is that it may be difficult to observe the level of care that managers take when producing and disclosing information. Further, *ex post*, it is likely to be costly to gather evidence to prove that managers did or did not take reasonable care. But it is, arguably, likely to be less costly to determine *ex post* whether disclosure was accurate or not.

If *ex post* disclosure were reasonably accurate, shareholders would likely not be concerned about investigating the actual level of care taken by managers to produce and disclose information. Since the information is reasonably accurate, which is relatively easy to observe, it is likely the case that managers took reasonable care. There is therefore likely to be little point in incurring the expense of finding out whether managers actually took reasonable care. However, if disclosure is not reasonably accurate, which again is relatively easy to observe, then there is a better chance that managers failed to take reasonable care. In this case it is likely to be more worthwhile to incur the expense of determining whether managers took reasonable care.

Thus, a threshold question will be considered before incurring the expense of inquiring whether reasonable care was taken: does the disclosure contain any material errors? An efficient liability rule would be to hold managers liable to shareholders where disclosure contained a material error. However, managers would have the defence available to them that they would be relieved of liability where it was demonstrated that they took reasonable care to ensure that disclosure was accurate. Since managers are in a better position than shareholders to prove that they took reasonable care to produce and disclose information, the burden of proof should be on managers.

4. Damages

What would be an efficient damages rule under a liability rule where managers agree to be personally and solely liable if they fail to take reasonable care in their disclosure? Would managers and shareholders agree that managers would be liable ouly for the implicit price paid to managers to produce and disclose information? Or would the parties agree that managers also would be liable for investment losses suffered by investors where it transpires that the managers failed to take reasonable care to produce accurate information? It is argued here that the parties will agree that the managers would be liable ouly for the implicit price paid for the production and disclosure of information. But the implicit price paid for the information is nothing other than the wages paid by shareholders to the managers.

To see why this is so, consider the agreement to disclose accounting information. Accounting information is produced for the purpose of enabling shareholders to monitor managers. If shareholders can monitor managers better, this reduces agency costs. However, as previously noted, agency costs are ultimately borne by managers not shareholders. Managers bear agency costs in the form of lower compensation. Accordingly, if agency costs are reduced, managers will enjoy greater compensation. A dollar reduction in agency costs should result in a dollar increase in compensation for managers. But managers are compensated before it is known whether the information they disclose is accurate; however, compensation in advance is on the condition that if disclosure is not reasonably accurate and managers failed to take reasonable care, they will pay damages.

If managers disclose inaccurate accounting information and failed to take reasonable care, this will have two effects. First, it will increase agency costs. Since managers bear agency costs and agree to take reasonable care in the production and disclosure of information used by shareholders to monitor managers, the payment of damages must at least involve repayment of the wages that the managers were paid.

The second effect that inaccurate disclosure will have is to cause some shareholders to suffer consequential losses. In addition to being used to monitor management, accounting information is used by shareholders and the market to assess the future prospects of the firm. On the strength of the accounting information disclosed by the managers, the market may reach the conclusion that the prospects of the firm are better than previously anticipated. This may cause the market to value the issuer more highly than its underlying value. Those shareholders who purchased shares between the date that the disclosure was originally made and when the error is uncovered will suffer an investment loss.[61]

The argument made here is that under a rule where managers are personally and solely liable for inaccurate disclosure, shareholders and managers would not reach an agreement between themselves where managers bore the risk of investment loss due to inaccurate disclosure. If managers agreed to compensate shareholders for these investment losses, in effect, managers insure shareholders against investment risks. Shareholders would have no incentive to take precautions to protect themselves against investment loss. They could over-rely on the disclosure and invest all their wealth in the issuer without fear of suffering any investment loss due to inaccurate disclosure. However, investment loss is a risk that shareholders can bear better than can managers, due to shareholders' ability to diversify their portfolios.

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[61] Conversely, those who sold their shares will enjoy an investment gain. The investment losses of those who purchased shares will offset the investment gains of those who sold their shares.

Managers also agree to provide information to shareholders for purposes other than enabling shareholders to monitor them. For example, managers agree to promptly disclose information, because it will decrease liquidity costs for shareholders. Also, managers agree to disclose certain information because it reduces the private incentive for shareholders to incur expenditures to uncover undisclosed information about the issuer and to make forecasts about the future value of the issuer. Damages for inaccurate information would compensate shareholders for the increased liquidity costs they incur as a result of inaccurate disclosure. Damages would also compensate for the increased incentive to incur expenditures to uncover undisclosed information and to make forecasts about the future value of the issuer. However, as with inaccurate accounting information, damages for investment losses caused by the disclosure of inaccurate information that is used primarily for other purposes would not be recoverable because that would remove the incentive for investors to take precautions to prevent or to insure against investment losses through portfolio diversification.

The function that damages serve, therefore, is to provide an incentive for managers to take reasonable care. The level of damages that achieves this may be called "optimal" damages. By definition, reasonable care is the economically efficient level of care to take when producing and disclosing information. If damages are set at a level that will induce managers to take either more or less than reasonable care, damages are not optimal. Therefore, if damages are set at a level that makes managers exactly indifferent between taking more or less reasonable care, damages will be optimal. That level of damages will be approximately equal to the wages that the managers were paid on the condition that they take reasonable care in the production and disclosure of information. This is so because if they fail to take reasonable care and they are obliged to return the wages they were paid, they receive no benefit whatsoever for having failed to take reasonable care.[62] Conversely, if they take reasonable care, they are compensated at their market wage rate for the time and energy they devoted to take reasonable care. As a result, managers would be just indifferent between taking more or less than reasonable care.

Accordingly, shareholders and managers would agree that the damages that managers would be liable to pay, if the information they produce is inaccurate and they fail to take reasonable care, should be approximately equal to the increased wages that the managers were paid on the condition that reasonable care be taken. This would

[62] In fact, they will be worse off because one of the purposes for disclosure is to reduce agency costs. If managers take reasonable care in their disclosure, managers can increase their wages by more than it costs them in time and energy to provide reasonable disclosure. Therefore, if managers take less than reasonable care and they are obliged to return their wages, their income will decrease by more than what it would have cost them to take reasonable care.

also provide shareholders with an incentive to take adequate precautions to prevent or insure against investment losses through portfolio diversification.[63]

The foregoing provided an explanation as to why, when shareholders and managers make private arrangements between themselves, they would agree that managers would not be liable for investment losses. From a social perspective, such arrangements are also optimal. What is socially optimal is to minimize the harm caused in the aggregate by inaccurate disclosure. However, in the aggregate, the harm caused from investment losses resulting from inaccurate disclosure is zero. This follows since for every investor who suffers a trading loss, there is another investor who enjoys a trading gain. What has occurred in effect is a redistribution of wealth from those investors who suffer trading losses to those who enjoy trading gains. Those investors who suffer trading losses have suffered private losses but they are not losses from a social perspective. From a social perspective, damages should only be awarded to prevent

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[63] A similar result is achieved elsewhere in contracts law. Contracts law has a general hostility toward consequential damages: *Hadley* v. *Baxendale* (1854), 96 R.R. 736 (Ex. Ct.). Consider the example used by Posner, *supra* note 45 at 140-41 to illustrate the underlying principle of *Hadley* v. *Baxendale*:

> A commercial photographer purchases a role of film to take pictures in the Himalayas for a magazine. The cost of developing the film is included in the purchase price. The photographer incurs heavy expenses (including the hire of an airplane) to complete the assignment. He mails the film to the manufacturer, but it is mislaid in the developing room and never found.

The full consequences of the breach include the hire of the airplane and the profits the photographer would have made from the sale of the photographs to the magazine. Is the film manufacturer liable for the price of the film or the full consequences of the breach? Consider the perverse incentive effects that would result if the film manufacturer were liable for the full consequences of the breach. The photographer would be indifferent between, on the one hand, successful completiou of the assignment and earning a profit and, on the other hand, failure of the assignment with compensation for consequential damages from the film manufacturer. However, the photographer is in a better position to take precautions to prevent the loss because he knows the value of the film whereas the film manufacturer does not. The film manufacturer cannot easily identify invaluable films from films without value that come into its lab. In order to prevent such losses, the film manufacturer would have to take extreme measures to care for all rolls of film that came into the lab. This could only be achieved at great cost and would result in care being taken for rolls of film that were not valuable. It would also raise the cost of film developing by a considerable amount. But the photographer could take relatively inexpensive measures to prevent the loss. For example, he could use two rolls of film instead of one, or he could request special handling when he sends the film in to be developed. Accordingly, in order to induce the photographer to take these inexpensive precautions, the courts deny him consequential damages and limit his damages to the price of the film. A similar result follows, if the manager is liable to pay for investment losses suffered by investors as a result of inaccurate disclosure. This makes the investor indifferent between, on the one hand, the manager making accurate disclosure with no investment loss being suffered and, on the other hand, the manager making inaccurate disclosure and being liable to compensate the investor for the full consequences of the breach. The investor has no incentive to take relatively inexpensive steps, such as portfolio diversification, to spread the risk of investment loss. For this reason, the investor should not be entitled to recover his full investment loss if there is inaccurate disclosure. He should be limited to the price paid for the disclosure.

losses to society. Therefore, it is not necessary to award damages to prevent investment losses since they do not represent losses to society. However, managers cannot avoid liability altogether if they are negligent in their disclosure for they would otherwise have no incentive to take care when making disclosure.[64] Requiring managers to repay the wages they were paid on the condition that they take reasonable care in providing disclosure removes the incentive to take less than reasonable care.

5. Conclusions

Before discussing the vicarious liability rule proposed by the Allen Committee, it is argued that a managerial liability rule already exists under corporate law. The disclosure provided for under the existing statutory disclosure regime is productive information and it is useful to shareholders *as a group*. Disclosure is used by shareholders *as a group* to monitor managers more effectively. Also, it is of equal benefit to all shareholders, hence to shareholders *as a group*, in that it increases the liquidity of the firm's shares. Finally, it is of equal benefit to all shareholders, hence to shareholders *as a group*, in that it reduces the private incentive for all individual investors to incur wasteful expenditures uncovering undisclosed information about the firm or to make forecasts of the future value of the firm's shares.

However, it must not be forgotten that the entire group of shareholders is simply the corporation itself. Therefore, if managers make inaccurate disclosure, the interests of shareholders as a group, or, alternatively, the corporation, are hurt. But the corporation already has a remedy available to it if managers make inaccurate disclosure and they fail to take reasonable care in the production and disclosure of information.

Corporate law statutes impose a duty on officers and directors in exercising their powers to use the care, diligence, and skill that a reasonably prudent person would use in comparable circumstances.[65] Further, if managers make inaccurate disclosure purely for opportunistic or self-interested purposes and thereby act against the interests of the corporation, they are arguably in breach of the fiduciary duty that they owe to the corporation.[66] The corporation could therefore bring an action under corporate legislation against the managers to recover damages if the managers breach their obligations to the corporation. The managers and not the shareholders, however, have the power to decide whether the corporation will commence any action against the managers for any breach of their obligations to the corporation. But if the managers were to fail to cause the corporation to commence an action that was against them, it is open to an individual shareholder to apply to the court under corporate legislation to commence a

[64] See also *Allen Committee Interim Report*, *supra* note 3 at 59.
[65] See *CBCA*, *supra* note 13, s. 122(1)(b); *OBCA*, *supra* note 13, s. 134(1)(b).
[66] See *CBCA*, *ibid.*, s. 122(1)(a); *OBCA*, *ibid.*, s. 134(1)(a).

derivative action on behalf of the corporation against the managers.[67] Moreover, it is open to the court to award interim costs to such a shareholder.[68]

B. Vicarious Liability Rule: The Allen Committee's Proposals

Under the liability rule considered in Part II.A, managers were personally and solely liable only if disclosure was not reasonably accurate or contained a material error and managers failed to take reasonable care. The burden was on managers to show that they took reasonable care. Shareholders were permitted to recover the implicit price they paid for the production and disclosure of the information, namely the wages paid to managers. However, they were not able to recover their investment losses.

The liability and damages rules proposed by the Allen Committee shares some similarities with the liability and damages rules proposed above. In particular, the Allen Committee proposes that managers be liable where they make disclosure that contains a misrepresentation unless they show that they took reasonable care.[69] The term "misrepresentation" used by the Allen Committee has a similar meaning to the term "material error" used above.[70] Under the Allen Committee's proposals, even if there is a material error, managers are not liable unless they fail to show that they took reasonable care in their disclosure. Thus, the burden is on managers to prove that they took reasonable care.[71] This, too, is consistent with the managerial liability rule. Under the Allen Committee's proposals, a manager's total liability is limited to the greatest of $25,000 or half his income.[72] This is consistent with the notion that managers should be liable to repay their wages if their disclosure is inaccurate.

In other respects, however, the liability and damages rules considered above are inconsistent with the proposals made by the Allen Committee. In particular, the managerial liability rule contemplates managers being liable to *all* shareholders of the firm or, alternatively, to the corporation. However, the Allen Committee proposes that only persons who disposed of or who acquired shares in the firm between the dates when the inaccurate disclosure was made and when it was uncovered have a cause of action against managers.[73] Further, the managerial liability rule contemplates a cause of action against only the managers. In contrast, the Allen Committee proposes that both the issuer and managers be liable.[74] In this sense the liability rule proposed by the Allen Committee is a vicarious liability rule. Further still, the managerial liability rule

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[67] See *CBCA*, *ibid.*, s. 239; *OBCA*, *ibid.*, s. 246.

[68] See *CBCA*, *ibid.*, s. 242(4); *OBCA*, *ibid.*, s. 246(4).

[69] *Allen Committee Final Report*, *supra* note 3 at 63 and 64.

[70] The Allen Committee defines "misrepresentation" to mean untrue statements of material fact or an omission to state a material fact (*ibid.* at 63).

[71] *Ibid.*

[72] *Ibid.* at 70.

[73] *Ibid.* at 63.

[74] *Ibid.* at 63 and 70.

does not contemplate recovery of investment losses. However, the Allen Committee proposes that plaintiffs be able to recover their investment losses from the issuer provided that total damages recovered from the issuer do not exceed certain limits where these damages are likely to exceed the wages paid to managers for producing disclosure in the first instance.[75]

Would the parties to the securities contract agree to a vicarious liability rule? Arguably, they might so agree. Managers have limited assets and enjoy the protection of bankruptcy laws in the event that their assets do not cover a damage award against them. This gives rise to the problem of moral hazard. If managers do not have to pay damages, their incentive to take reasonable care in disclosure is diminished. Thus, some other mechanism to ensure that the managers exercise reasonable care is required.

One such mechanism to consider is to hold others, who are in a position to control management, vicariously liable where management fails to take due care. Who then are these others? One group of persons to consider is the shareholders themselves. The shareholders may not be able to observe until after disclosure is made whether the disclosure is accurate. However, the shareholders may have the ability to observe the degree of care that managers exercise while they are producing information. They also know that the more care that is taken in the production of information, the more likely it is to be accurate. Moreover, the shareholders have the legal power to dismiss managers if it appears that they are being careless in the production of information. Thus shareholders may have a degree of power to prevent inaccurate disclosure from being made by monitoring the managers while they produce information and by threatening them with dismissal if they fail to take care. Holding shareholders liable when managers fail to take reasonable care to produce disclosure would provide shareholders with an incentive to monitor managers.[76]

However, under a rule where managers are held personally and solely liable, which is the liability rule considered in Part II.A, *all* shareholders have a cause of action against managers. But under a vicarious liability rule, if all shareholders had a right to sue, shareholders would be liable to themselves. Accordingly, if there is to be a vicarious liability rule with shareholder liability, it must involve some but not all shareholders having the right to sue and some but not all shareholders being liable when managers fail to exercise reasonable care when providing disclosure. Which shareholders should be liable and which shareholders should have the right to sue?

To answer this question, we may conceptually suppose that there are two periods of time. In the first period, managers produce and disclose information. The investors who are shareholders of the firm during this period are called "existing" shareholders. It is also assumed that during this period, no trading of shares takes place. The second period is the period of time that elapses after disclosure is made and until it is deter-

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[75] *Ibid.* at 68-69.

[76] See Sykes, *supra* note 56 for a general discussion on the economics of vicarious liability.

mined whether the disclosure is accurate or not. During this period, some shareholders may sell their shares. These shareholders are called "former" shareholders. The shareholders who buy their shares are called "new" shareholders. The remaining shareholders continue on as shareholders. These shareholders may be called "continuing" shareholders. No one in this last group of shareholders buys or sells shares in the firm during this period. For simplicity, it is assumed, however, that at the beginning of the second period, the decision whether an existing shareholder sells his or her share or continues as a shareholder is determined by exogenous factors.

1. Loss Suffered by New Shareholders Where There is Overly Optimistic or Insufficiently Pessimistic Disclosure

It is arguable that holding the issuer liable to pay damages for investment losses[77] suffered by new shareholders when there is overly optimistic or insufficiently pessimistic disclosure will induce existing shareholders to monitor managers more carefully. When managers make disclosure that is overly optimistic or insufficiently pessimistic, this is equivalent to failing to accurately disclose bad news about the firm. This means that the uncovering of the error will have the effect of reducing the market value of the firm's shares. The new shareholders suffer an investment loss as a result. As between new shareholders and existing shareholders, existing shareholders are in a better position than new shareholders to supervise and control management so as to prevent the inaccurate disclosure. If the new shareholders were to have the right to sue the existing shareholders (or equivalently, the former and continuing shareholders) to recover damages related to the new shareholders' investment losses, the existing shareholders' expected liability would provide existing shareholders with the incentive to supervise management more carefully in its productiou and disclosure of information so as to deter management from taking less than reasouable care.

Provided shareholder turnover is relatively small, holding the issuer liable is a close approximation to holding the former and continuing shareholders liable. The benefit enjoyed by new shareholders as plaintiffs in being able to name the issuer as defendant in any lawsuit is that a plaintiff only has to sue and enforce judgmeut against one entity, the issuer, instead of against all the former and continuing shareholders. The damage award paid by the issuer to new shareholders will reduce the value of the issuer, including the value of shares held by the new shareholders. But payment of the damage award is also shared by continuing shareholders. Since the continuing shareholders effectively pay more than a pro rata share of the damage award, new shareholders recover a positive amount if the issuer is required to pay damages to new shareholders where management fails to take reasonable care and disclosure is less than reasonably accurate.

[77] In Part II.*B*.3, below, it is argued that recovery of investment losses should be limited to optimal damages, namely that level of damages needed to induce managers to take reasonable care.

It might be noted, however, that if only the issuer is liable, former shareholders apparently avoid liability. While they were existing shareholders, former shareholders were also in a position to exercise control over management to ensure that reasonable care was taken in the production and disclosure of information but they are not liable to pay any damages once they become former shareholders. Arguably, this reduces the incentive for existing shareholders to monitor management. This is because at the time disclosure is made, existing shareholders do not know whether they will dispose of their shares in the issuer, in which case they will become former shareholders, or whether they will be continuing shareholders. If they are continuing shareholders, they expect the firm will be liable to pay damages if disclosure is inaccurate. If they become former shareholders, they will not be liable. The prospect that any given existing shareholder will become a former shareholder provides existing shareholders with somewhat of a reduced incentive to supervise management prior to disclosure.

However, to the extent that the incentive to supervise management is reduced, the incentive can be increased by raising the expected level of liability of existing shareholders. The expected level of liability of existing shareholders is increased by increasing the level of damages (about which more will be said below) that continuing shareholders effectively pay. The prospect that any existing shareholder will be a continuing shareholder that must pay increased damages provides existing shareholders with an increased incentive to supervise management.

Also, if former shareholders were liable, this would discourage existing shareholders of the issuer from disposing of their shares until they could determine that the disclosure was accurate. Waiting is a type of cost and it essentially reduces the liquidity of the firm's shares. All shareholders therefore benefit slightly from increased liquidity if they know at the time they acquire their shares that when they sell their shares, they are not responsible for any inaccuracy in disclosure made beforehand. The benefit of increased liquidity may in part offset any resulting reduction in the incentive to monitor management.

If the firm's shares are widely held, however, the free-rider problem deters individual shareholders, hence shareholders as a group, from directly supervising management in its disclosure and from mounting a campaign to dismiss management in the event that management takes less than reasonable care when making disclosure. Since each shareholder's interest in the issuer is small, if any one shareholder goes through the trouble of monitoring and supervising management in its disclosure, other shareholder's benefit without incurring any cost. This discourages individual shareholders from monitoring management.[78] Thus, for any given level of damages, the free-rider problem will reduce the incentive effect that liability has on shareholders to supervise management. But even in the presence of the free-rider problem, shareholders are in a better position to control management than outside investors. Therefore, former and continuing shareholders would always be in relatively better position than

[78] However, the incentive to monitor can be increased by raising damages or the expected level of liability.

new shareholders to prevent inaccurate disclosure. Accordingly, there may be some benefit to holding continuing shareholders liable.

2. Loss Suffered by Former Shareholders Where There is Overly Pessimistic and Insufficiently Optimistic Disclosure

In Part II.*B*.1, it was argued that holding the issuer liable to new investors for investment losses will induce existing shareholders of issuers to monitor management's disclosure more carefully. In this part, a similar argument is made with respect to issuer liability to former shareholders. Suppose now that disclosure is overly pessimistic or insufficiently optimistic. This means that when the error in disclosure is uncovered, the value of the firm will increase. Former shareholders will suffer a loss and new shareholders will enjoy a windfall gain. If the issuer were liable to the former shareholders for an amount not in excess of the investment loss suffered by them as a result of the inaccurate disclosure, the value of the issuer would decrease by a corresponding amount. Effectively, new shareholders would return some, but not all, of their windfall gain to former shareholders. Continuing shareholders effectively would pay the balance of the damage award. Since continuing shareholders essentially pay more than a pro rata share of the damages, this provides existing shareholders with an incentive to monitor management carefully before disclosure is made.

However, holding the issuer liable leads to the somewhat anomalous result that former shareholders, who were once in a position to monitor managers, are able to recover damages caused by their own failure to monitor managers when they were existing shareholders. If former shareholders are able to recover damages, they avoid responsibility for inaccurate disclosure just as they did in the case where disclosure was overly optimistic or insufficieutly pessimistic. This will tend to reduce the incentive to monitor management in the first instance.

This reduced incentive to monitor can be restored, however, by increasing the level of damages that the issuer has to pay. Furthermore, if former shareholders can sue, this reduces their incentive to delay in selling shares until it is determined that the disclosure is accurate. This in turn is a benefit to all shareholders bccause if they know that they will not be responsible for errors in disclosure made after they sell, this will increase the liquidity of the shares. This slight benefit will partially offset the adverse effects from the reduced incentive to monitor managers.

Finally, as a practical matter, errors of this sort are not likely to occur too often since managers have an incentive to overstate good news rather than to understate it and to understate bad news rather than to overstate it. This is because they usually receive incentive pay that varies with the value of the firm. Thus, their income will tend to increase in the face of good news and decrease in the face of bad news. Their income will therefore be too low if they understate good news or overstate bad news. They have a personal interest in seeing that this does not occur.

3. Damages

Under the managerial liability rule discussed in Part II.A, managers were personally and solely liable where disclosure was not reasonably accurate and managers failed to take reasonable care. It was argued that the optimal level of damages was approximately equal to wages managers were paid in advance on the condition that the information they produced and disclosed was reasonably accurate and reasonable care was taken. It was also argued in the previous section that investment losses suffered by those who traded in the firm's shares between the dates when inaccurate disclosure was made and when the error was uncovered were not recoverable. If investment losses were recoverable, this would mean that managers were insuring shareholders against investment risk. But shareholders are in a better position than are managers to insure against investment risk because shareholders have the ability to diversify their portfolios at very little cost. If investors could recover their investment loss, they would have little incentive to diversify their portfolios and there would be sub-optimal risk sharing.

Under the liability rule considered in this part, however, it was assumed that shareholders who traded in shares between the dates when disclosure was made and when it was discovered to be inaccurate could recover damages from the issuer and managers for their investment losses. Thus, there is an apparent incousistency between the approaches taken to investment losses under the managerial liability rule and in the vicarious liability rule.

But there is no inconsistency provided that the amount of investment losses recovered does not exceed the optimal level of damages. In other words, investment losses, provided they are limited, can serve as a proxy for optimal damages. Thus, there is some sense in the Allen Committee's proposal in permitting those who traded in the firm's shares between the dates when inaccurate disclosure was made and when the inaccuracy was uncovered to recover their investment losses but to limit the amount that can be recovered. In particular, the Allen Committee recommends that there be a limit on investment losses that are recovered. As already noted, it proposes that where an individual manager is liable to pay damages for investment losses, that there be a limit on the amount that the manager pays equal to the greater of $25,000 and half the manager's income.[79] It also proposes that where the issuer is liable to pay damages for investment losses, that there be a limit on the amount the issuer pays equal to the greater of $1,000,000 and 5% of the market value of the firm.[80]

Nevertheless, the Allen Committee's recommendations do pose some possible problems. First, there is no guarantee that the proposed limits on investment losses recoverable bear any relation to optimal damages in any given situation. Second, where optimal damages are less than the damage limits proposed by the Allen Committee, there is no guarantee that a court would limit recovery of investment losses to the

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[79] *Allen Committee Final Report*, *supra* note 3 at 70.

[80] *Ibid.* at 68-70.

amount of optimal damages. If a court allowed recovery of investment losses in excess of the optimal damages, it would encourage too much care on the part of managers. Further, a problem could arise if the limits proposed by the Allen Committee are below the optimal damages. In this case, damages would not induce enough care on the part of managers.

Under the Allen Committee's proposals, there is a chance that the damages that an issuer is liable to pay would exceed the damages that a manager is liable to pay. This makes sense for at least two reasons. First, as already discussed, the free-rider problem reduces the incentive for individual shareholders to monitor managers. The incentive to monitor managers, however, can be increased by raising the amount of damages that the issuer must pay above the level that managers must pay. Second, under the liability rule considered in this part, although the issuer is liable to pay damages, *former* shareholders are not required to pay damages. This may, as previously discussed, have the effect of reducing the incentive for existing shareholders to monitor managers. Again the incentive for existing shareholders to monitor managers can be increased by raising the amount of damages the issuer must pay above the level that the manager must pay. Thus, it will likely be the case that it is necessary to award greater damages against the issuer to induce former shareholders to monitor managers than what is awarded against managers in order to induce them to take reasonable care.

4. Who Should Have Standing to Sue?

In the discussion above, it was assumed that those shareholders who suffered investment losses would have standing to sue managers and the issuer. The argument was that if these plaintiffs could sue to recover their investment losses up to certain limits, the prospect of liability to pay damages would provide managers with an incentive to take reasonable care when providing disclosure and existing shareholders to monitor management to ensure that it took reasonable care when providing disclosure. In this sub-section of the paper, it is argued that it is economically efficient to allocate the exclusive right to sue to persons who suffered trading losses because, *prima facie*, they are in the best position to commence an action against managers and issuers. To the extent that they are not the most efficient prosecutors of actions, then rules are required to make it easier to ensure that the right to sue ultimately ends up in the hands of those persons who are the most efficient prosecutors of actions.

Damages are not intended to compensate investors for their investment losses but to deter managers from taking less than reasonable care in making disclosure to shareholders and to provide an incentive to existing shareholders to supervise management in its disclosure. If damages were intended to compensate investors who suffered trading losses, it would be important that the persons who suffered trading losses had the right to sue in order to ensure that they were compensated. However, if damages were intended to compensate investors for their investment losses, this would mean that investors were being insured against investment risks. But for reasons already discussed, investors can adequately insure themselves against investment risks through portfolio diversification. What deters managers from taking less than reasonable care when making disclosure is the liability they face if they take insufficient care. What deters existing shareholders from not supervising management is that the issuer may be liable if they do not supervise and managers take insufficient care.

If the goal is to deter managers and issuers from inappropriate behaviour, it is arguable that it does not matter who has the right to sue. Rather, it may be argued, what is important is that *someone* has the right to sue and is entitled to damages. This is because the entitlement to damages will provide the plaintiff, whoever that is, with the incentive to sue for damages. Moreover, it is the threat of liability that deters managers from taking less than reasonable care and issuers from failing to monitor managers. Does this mean that anyone who wishes to sue should have standing to sue in the event that managers make inaccurate and careless disclosure?

On the one hand, giving standing to *anyone* who wishes to sue will increase the likelihood that managers and issuers will be sued which in turn will provide the desired deterrent effect against the lack of reasonable care by managers and the absence of adequate supervision by issuers. On the other hand, the right to sue and enforce a judgment may be regarded as a type of property right. If there are no standing rules so that *anyone* may sue to recover damages for inaccurate disclosure, this effectively makes the right to sue public property. Generally, whenever property is public, it tends to be overused.[81] A similar result will occur if the right to sue is public property. It will potentially result in a free-for-all among plaintiffs as they race to be the first to obtain a judgment against issuers and managers.[82] This in turn may result in litigation proceeding at an inefficiently fast speed as plaintiffs press the defendants toward trial. The faster the matter is pushed toward trial, the more costly the lawsuit will tend to be. Litigation will therefore be excessively intensive. Moreover, although liability should be limited to optimal damages for the reasons already discussed above,[83] the defendants nevertheless would be subjected to multiple lawsuits with each plaintiff claiming entitlement to damages. In the result, if *anyone* may sue, the benefits from encouraging careful disclosure by management will be dissipated by excessively intensive and extensive litigation.[84]

Thus, standing must be allocated to *someone* who has the *exclusive* right to sue in order to prevent wasteful litigation. To whom, then, should the right be allocated? One possible solution is to allocate that right to the securities regulator. This, however, gives rise to two problems. First, because the employees of the securities regulator do

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[81] See H.S. Gordon, "The Economic Theory of a Common-Property Resource: The Fishery" (1954) 62 J. Polit. Econ. 124 reprinted in R. Dorfman & N.S. Dorfman, eds., *Economics of the Environment*, 2d ed. (New York: W.W. Norton & Company, 1977) at 130.

[82] See generally T.L. Anderson & P.J. Hill, "The Race for Property Rights" (1990) 33 J. L. & Econ. 177.

[83] See Part II.*B*.3, above.

[84] When property is publicly owned, the economic rents to be earned from the property are dissipated as the property will tend to be used beyond the economically efficient level (see Gordon, *supra* note 81).

not have a personal stake in the outcome of the litigation, they may not diligently prosecute the managers and issuer.[85] This is a type of principal-agent problem since the employees of the securities regulator act as agents for taxpayers who are the principals. Whenever a government agency is given the exclusive right to protect public property, it can be expected that agency costs will be incurred.[86] Moreover, the free-rider problem will discourage individual taxpayers from monitoring the employees of the securities regulator. The result is that the securities regulator cannot be expected to efficiently prosecute actions against managers and issuers.

The second problem with giving the exclusive right to sue to the securities regulator is that the regulator may face budgetary coustraints that prevent it from vigorously pursuing managers and issuers. Indeed, concern about the under-funding of the securities regulator was a concern underlying the Allen Committee's proposal that securities legislation be amended to provide for a statutory civil cause of action.[87]

An alternative might be to randomly allocate the right to sue to individual plaintiffs. The opportunity to recover damages would give the randomly selected plaintiffs a personal stake in the outcome of the litigation. This would address the principal-agent problem. However, the state would then have to administer a lottery system of allocating the right to sue, which would be costly. Further, the right to sue might not eud up in the hands of the most efficient prosecutors of actions. This latter problem could be addressed if the right to sue could be traded. The right to sue would end up in the hands of the most efficient prosecutors since they would be the ones willing to pay the highest price to acquire the right to sue. But if there are transaction costs in trading the right to sue, the state may as well simply auction off the right to sue to the highest bidder so that the public treasury is benefited. This, however, would require the securities regulator to maintain an administration that closely monitors the disclosure of managers and issuers, determining that disclosure was inaccurate and then running an auction to sell the right to sue. This too would be costly.

An efficient standing rule would allocate the right to sue to the persons who value it most highly.[88] These persons in turn are likely to be the persons who are able to prosecute any lawsuit against the defendants most efficiently. The argument made in Part I of this paper is that investors will demand that the issuer disclose information in order to provide better monitoring of management, to address liquidity cost concerns, and to remove the private incentive for investors to generate information about the value of the firm. *Ex ante*, investors do not demand disclosure in order to enable them to make better investment decisions. Nevertheless, after disclosure is made, the information will have a bearing on the value of the firm. It may be that the disclosure of the informatiou suggests that the market price of the firm is understated. This will in-

[85] Posner, *supra* note 45 at 566.

[86] See M.J. Trebilcock, "Economic Analysis of Law" in R.F. Devlin, ed., *Canadian Perspectives on Legal Theory* (Toronto: Emond Montgomery, 1991) 103 at 114-15.

[87] *Allen Committee Final Report*, *supra* note 3 at 37.

[88] Posner, *supra* note 45 at 640-41.

duce some investors to trade on that information. However, by trading on the information, this will bid the price of the firm's share up until the price fully reflects all the available information about the firm. *Prima facie*, we would expect those persons who relied on the disclosure to make a decision to invest in the issuer to value the right to sue most highly. It is expected that these persons would be better situated than other persons would be to prove the inaccuracy of the disclosure. One of the elements of the cause of action against managers and issuers would be that the disclosure was not reasonably accurate. Thus, inaccuracy of disclosure will have to be proved in any lawsuit, requiring knowledge of what information was disclosed in the first instance. Those who relied on the inaccurate disclosure will have that knowledge.[89] A further alternative might then be to allocate the exclusive right to sue to those investors who relied on the inaccurate disclosure.

There is a difficulty with this scheme, however, if those investors who relied upon the inaccurate disclosure must prove that there was reliance on their part. Some investors will have traded in the firm's shares without having relied on the inaccurate disclosure. It will be costly for those investors who relied on the inaccurate disclosure to distinguish themselves from those who traded in the firm's securities but did not rely on the inaccurate disclosure. If the shares of the issuer are held widely, then the amount that each investor who has the right to sue would be awarded is likely to be relatively small. The cost of proving that there was reliance may exceed any damages that are recovered. Those who relied on the inaccurate disclosure will therefore likely have little incentive to sue. As a result, it is unlikely that allocating the exclusive right to sue to those shareholders who relied on the inaccurate information to trade in the firm's shares will generate much of a deterrent to managers and issuers from making inaccurate and careless disclosure.

One potential solution to this problem is to give standing to all investors who traded in the firm's shares, regardless of whether they relied on the inaccurate disclosure. This will obviate the need to prove that there was reliance. Further, it is reasonable to expect that some portion of these investors would have relied on the inaccurate disclosure so that some of them at least would be able to prove that disclosure was inaccurate. However, there is a cost to allocating the right to sue to all investors who traded in the firm's shares.

Allocating the right to sue to individual investors will result in procedural problems. First, there will be a free-rider problem because if one investor incurs the cost of proving that there was inaccurate disclosure and therefore that the investor is entitled to damages, the result of that investor's lawsuit will make it less costly for other investors to sue. Evidence adduced at trial will be publicly available. Other investors will simply wait for someone else to sue first and then free-ride on that person's efforts. But if all investors behave the same way, then no investor will want to be the

[89] It must be acknowledged, however, that those who relied on the inaccurate disclosure are only marginally better situated than are others to prove that disclosure was inaccurate. This is because the information that is needed to provide the proof is so easily transferred to others.

first to commence an action. Second, if the issuer's shares are widely held, the damages that may be recovered by any one individual shareholder may be outweighed by the costs of litigation. This would discourage individual investors from commencing a lawsuit.

One way around these problems is for an investor to apply to the courts under class proceedings legislation for an order certifying a class action suit and appointing him as the representative plaintiff.[90] If the representative investor is paid a sufficiently large share of the damages that each member of the class would receive, this will ensure that the reward is large enough to provide an incentive for someone to come forward to be a representative plaintiff. This in turn will ensure that potential liability will provide an adequate deterrent for managers and issuers. The court would then have a supervisory role to ensure that the representative plaintiff is likely to prosecute the action diligently. One problem with class proceedings legislation is that class members have the right to opt out of the class action.[91] This gives rise to the risk of a multiplicity of lawsuits.

5. Conclusions

An argument can be made that the parties to the securities contract would agree to a vicarious liability rule. Such a rule may have an advantage over the managerial liability rule. Under a managerial liability rule, managers are liable to pay damages if they fail to take reasonable care in the production and disclosure of information. If managers are judgment proof, they may not have an incentive to take reasonable care. By holding the issuer liable, this provides an incentive for existing shareholders of the issuer to monitor management more carefully in its disclosure and to use the threat of dismissal against managers as an incentive to take care when making disclosure.

However, where shares of the issuer are widely held, because of the free-rider problem, it may be that the incentive for individual shareholders to monitor the care taken by managers is not that great. Further, under a vicarious liability rule, there is a risk of a multiplicity of lawsuits because so many persons have the right to sue.

Conclusion

It was argued in this paper that, in the absence of transaction costs, the parties to the securities contract would negotiate an agreement providing for the disclosure of information that would provide a benefit to all shareholders. In the presence of transaction costs, there is room for the securities regulator to "enable" the formation of securities contracts by enacting legislation that serves as the model contract that most parties to a securities contract would want to adopt. Much of the information that is-

[90] See *e.g. Class Proceedings Act, 1992*, S.O. 1992, c. 6, s. 2.
[91] *Ibid.*, s. 9.

suers are required to disclose under our existing disclosure laws can be explained by this "contractarian" theory of disclosure.

The parties to the securities contract would also agree upon liability and damages rules. Two liability rules were considered here: a managerial liability rule where managers are liable to shareholders, or, alternatively, to the corporation if they fail to disclose reasonably accurate information, and they fail take reasonable care in the production and disclosure of information. The parties to the securities contract would not agree that managers would guarantee the accuracy of disclosure because that would result in managers bearing the risk of inaccurate disclosure. Shareholders can bear that risk better than managers can. For similar reasons, managers would not be liable to pay damages for investment losses suffered by investors as a result of inaccurate disclosure. Managers would, however, be liable to repay the wages they were paid on the condition that they take reasonable care in the production and disclosure of information. Such a liability rule already does exist under corporate law in that managers have a general duty to exercise a reasonable degree of diligence when managing the affairs of the issuer. Arguably, a failure to take reasonable care in the production and disclosure of information is a breach of this general duty.

The Allen Committee has proposed an alternative liability rule where both the issuer and the manager are liable to investors who bought or sold shares between the dates when the inaccurate disclosure was made and when it was corrected. Liability will result where the information disclosed is not reasonably accurate, and the managers failed to take reasonable care in the production and disclosure of the information. Plaintiffs will be entitled to recover their investment losses up to certain limits. This liability rule was termed the "vicarious liability rule".

It was argued in this paper that the parties to the securities contract might also agree to the vicarious liability rule. The additional benefit that the vicarious liability rule provides over the managerial liability rule is that it enlists the support of existing shareholders of an issuer to monitor the care taken by managers when making disclosure. However, it was concluded that where shares of the issuer are widely held, the free-rider problem reduces the incentive for individual shareholders to monitor management's disclosure. Further, there is a risk of a multiplicity of lawsuits under a vicarious liability rule. Such a risk does not exist under the managerial liability rule because only the corporation or a shareholder that had applied for the right to commence a derivative action could sue the managers. On balance, therefore, it is not clear whether the vicarious liability rule is superior to the managerial liability rule.