



Risk–shifting through Issuer Liability and Corporate Monitoring

Law Working Paper N° 228/2013

October 2013

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For comments, I thank Sean Griffith, Yuliya Guseva, Steve The1, and Urska Velikonja, as well as participants of the Wiener Unternehmensrechtstag at the University of Vienna (2012) and seminars at LSE and Fordham..

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Abstract

This article explores how issuer liability reallocates fraud risk and how risk allocation may reduce the incidence of fraud. In the US, the apparent absence of individual liability of officeholders and insufficient monitoring by insurers undermines the potential deterrent effect of securities litigation. The underlying reasons why both mechanisms remain ineffective are collective action problems under the prevailing dispersed ownership structure, which eliminates the incentives to monitor set by issuer liability. This article suggests that issuer liability could potentially have a stronger deterrent effect when it shifts risk to individuals or entities holding a larger financial stake. Thus, it would enlist large shareholders in monitoring in much of Europe. The same riskshifting effect also has implications for the debate about the relationship between securities litigation and creditor interests. Creditors' claims should not be given precedence over claims of defrauded investors (e.g. because of the capital maintenance principle), since bearing some of the fraud risk will more strongly incentivize large creditors, such as banks to monitor the firm in jurisdictions where corporate debt is relatively concentrated.

Keywords: issuer liability, securities law, securities class action, dispersed ownership, concentrated ownership, capital maintenance, fraud risk, compensation, deterrence, prospectus liability

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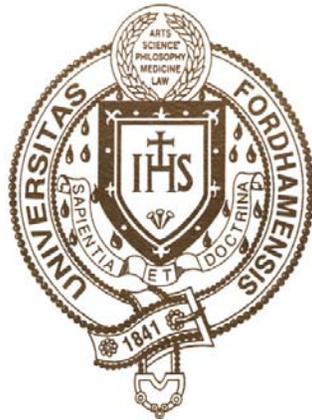
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* Associate Professor of Law, Fordham University; Research Associate, European Corporate Governance Institute. For comments, I thank Sean Griffith, Yuliya Guseva, Steve Thel, and Urska Velikonja, as well as participants of the *Wiener Unternehmensrechtstag* at the University of Vienna (2012) and seminars at LSE and Fordham.

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1. Introduction

Securities law has, without doubt, become an important field in many European countries during the past two decades. In a development traced by scholars analyzing convergence in corporate governance, formerly dormant markets across the Continent have experienced growth, and the concerns of shareholders have again become important in the public discussion. The motherland of securities law is of course the United States, whose model has been very influential, in particular with respect to the creation of capital markets regulators following the model of the SEC as an independent regulatory agency. Arguably, the second most important element of US securities law is the securities class action, most of all under SEC Rule 10b-5, which was made possible by the development of a “private right of action” by the courts.¹ The social value of securities class actions in the US is, however, deeply controversial. While economists such as La Porta et al. have identified the effectiveness of private enforcement of securities law as a strong predictor of capital market development in cross-country regression studies,² many legal com-

¹ Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D.Pa. 1946) (first case establishing a private right of action for injured investors).

² Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Law?* 61 J. FIN. 1 (2006); *but see* Howell Jackson & Mark J. Roe, *Public and private enforcement of securities laws: Resource-based evidence*, 93 J. FIN. ECON. 207 (2009) (including additional variables in La Porta et al.’s data and finding that the strength of public enforcement is more important); *see also* Mathias M. Siems, *What does not work in securities law: A Critique*

mentators in the US believe that securities class actions serve no useful purpose, in part for reasons that will be explored in this article.

Civil liability for misinformation in the capital markets has already appeared on the radar screen of EU law. Art. 6(1) of the Prospectus Directive³ requires that Member States provide liability of either “the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor, as the case may be.” Similarly, art. 7 of the Transparency Directive⁴ requires that “responsibility ... lies at least with the issuer or its administrative, management or supervisory bodies.” In short, as a minimum standard, Member States must either hold the issuing company or individuals responsible for misstatements liable.

The choice embodied in the directives closely relates to the objective of this article, namely to explore how the “fraud risk” created by misstatements is allocated among misled investors, other shareholders and creditors of the firm, and the responsible individuals, and how it consequently sets incentives to prevent securities fraud. Specifically, I investigate how the incentive effects of issuer liability depend on the company’s capital structure, which – at least to my knowledge – has not been done before in the literature. The core objective is to show that in Europe effective issuer liability *could indeed have a useful social purpose*. This argument may be somewhat surprising to those not familiar with theoretical debates about securities law, but it stands in sharp contrast to the debate in the US. Most scholars have concluded that the social benefits of issuer liability (if there are any) are highly dubious, given that it does not provide adequate deterrence and has highly problematic redistributive effects.⁵ In the European context, I diverge from the assessment of US securities law with respect to the *potential* effectiveness of civil liability, particularly the issuing corporation’s liability. I argue that the scathing criticism of issuer liability and its inability to deter rests on the assumption of a diffuse ownership structure, which is thought to be typical of publicly traded firms in the US.⁶ By contrast, many publicly traded firms in Continental Europe, as in much of the rest of the world, have at least some large shareholders who hold significant blocks of stock. I suggest that issuer liability could be used to enlist large shareholders to monitor management in order to reduce fraud risk. Blockholders should be both capable of and interested in preventing fraud, and in effective insurance plans. The reason is that issuer liability shifts a significant portion of the fraud risk on blockholders because their share in the company loses significant value from the payout after a judgment or settlement.

The risk-shifting effect of issuer liability also has implications for the debate to what extent creditors’ claims should enjoy precedence over shareholders’ claims for securities fraud.⁷ In

on La Porta et al.’s methodology, 16 INT’L COMPANY & COM. L. REV. 300 (2005) (criticizing La Porta et al.’s way of coding law).

³ Directive 2003/71/EC of the European Parliament and the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, 2004 O.J. (L 345) 64.

⁴ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, 2004 O.J. (L 390) 38.

⁵ E.g. William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 72 (2011) (“The fraud-on-the-market (FOTM) cause of action just doesn’t work. At least that is the consensus view among academics respecting the primary class action vehicle under the federal securities laws”).

⁶ See John Armour, Henry Hansmann & Reinier Kraakman, *What is Corporate Law?* in THE ANATOMY OF CORPORATE LAW 1, 29-32 (2nd ed., Reinier Kraakman et al. 2009) (surveying patterns of corporate ownership).

⁷ In the US, Bankruptcy Code § 510(b) subordinates claims by investors under securities law to creditors. *Infra* section 4.1.

several European countries, it has been debated whether the capital maintenance doctrine should preclude or limit issuer liability to shareholders. Recently, the ECJ has been asked to clarify the position of secondary EU law on that issue.⁸ I argue that, as a matter of policy, creditor interests should not be given priority. In Europe, corporate debt is also more concentrated than in the US, with bank lending being relatively more important compared to bond issues, the implication being that fraud risk would also marginally increase banks' incentives to monitor.

Thus, at a time when US law is, if anything, retrenching from private securities litigation vis-à-vis foreign issuers,⁹ European jurisdictions may well be advised to harness its power. There are significant hurdles that currently make it more difficult to hold an issuer responsible than in the US. While some legislatures have expanded private litigation in recent years, they might have to think about further steps in this direction.

This article proceeds as follows: Section 2 builds on the narrative dominating the US debate and explains why compensation cannot be the purpose of issuer liability, and why it also appears not to exert a meaningful deterrent effect in the US. Section 3 discusses how issuer liability reallocates fraud risk and imposes it on different groups of shareholders, and how it creates incentives for them to avoid capital market fraud. I suggest that the critique developed in the US applies only against the backdrop of dispersed ownership, which is why its application in Europe is limited. Section 4 looks at how issuer liability allocates fraud risk between different groups of shareholders and creditors, and how issuer liability can strengthen the role of creditors as monitors. Section 5 suggests that a stronger enforcement mechanism may be needed in Europe to create a meaningful deterrent effect, but there are still considerable hurdles in the political economy of corporate governance to overcome. Section 6 concludes.

2. The critique of securities litigation

2.1. Compensation and circularity

As is the case for other forms of liability, liability for false capital market information could serve two possible functions, compensation and deterrence. In economic terms, the purpose of compensating a victim is to assign risk to a good risk-bearer.¹⁰ If risk-averse individuals are exposed to potential harm, their ex ante decrease in utility from exposure to risk will be reduced by the expectation of compensation. In other words, from the plaintiff's perspective the function of liability is akin to that of insurance.¹¹ A compensation rationale for tort law is problematic be-

⁸ A case is currently pending before the ECJ, submitted by the Vienna Commercial Court. HG Wien, March 26, 2012, 51 Cg 243/11h, 2012 DER GESELLSCHAFTER (GESRZ) 196; ECJ Case C-174/12, *Hirmann v. Immofinanz*, Opinion of the Attorney General delivered on 12 September 2013..

⁹ *Morrison v. Nat'l Australia Bank*, 130 S.Ct 2869 (2010) (limiting the application of § 10(b) of the Securities Exchange Act to transactions taking place in the US); see, e.g. Yuliya Guseva, *Cross-Listings and the New World of International Capital: Another Look at the Efficiency and Extraterritoriality of Securities Law*, 44 GEO. J. INT'L L 411, 442-451 (2013).

¹⁰ E.g. STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* (2004) 257-258.

¹¹ In the absence of tort law, a risk-averse potential claimant could eliminate risk by taking out insurance. E.g. SHAVELL, *id.*, at 268. To some extent this raises the distributive question which party can get insurance for a lower price. See e.g. Gerhard Wagner in 5 MÜNCHENER KOMMENTAR ZUM BGB, *Vor § 823*, ¶54-55 (5th ed. 2009) (pointing out this distributive consequence of tort law).

cause insurance markets are highly developed and insurance is widely available today, other than during the formative period of modern civil law doctrine.¹²

But even if we accept a compensation rationale for tort law in general, the transfer of funds by means of compensation is particularly troublesome in the case of issuer liability¹³ because of three aspects of circularity, namely pocket-shifting, investor diversification, and redistribution between different classes of investors.

First, pocket-shifting arises because a judgment or payment made in settlement to the plaintiff investors in a securities lawsuit is typically paid by the issuing corporation.¹⁴ Consequently, the value of its shares decreases by the same amount.¹⁵ In the typical “secondary market” cases, where plaintiffs bought shares at an inflated price, the corporation does not even benefit through the payment received for a share issue.¹⁶ Thus, issuer liability shifts the “fraud risk” from the buyers to the corporation, and consequently to its entire body of shareholders pro rata.¹⁷

Diffusing risk to a larger group is the essential role of insurance and would at first glance seem beneficial.¹⁸ However, given that the composition of the body of shareholders is fluid, issuer liability has redistributive effects. First, the beneficiaries of the fraud, namely shareholders who sold at an inflated price (regardless of whether they knew that the market price did not reflect the true value), do not bear any of the cost of the remedy.¹⁹ By contrast, the defrauded shareholders partly finance their own remedy. This is obviously true if they still retain their shares, which will lose value. If they no longer hold the shares, they probably suffered additional harm because the market price at the time of the sale already anticipated the results of the lawsuit. Part of the fraud risk is dumped on innocent shareholders who simply held on to their shares. For

¹² SHAVELL, *id.* at 268-269 (discussing the “development of insurance markets in the latter part of the nineteenth century”); *see also* Jean-Sébastien Borghetti, *The Culture of Tort Law in France*, 3 J. EUR. TORT L. 158, 164 (2012) (pointing out that both the French social security system and private insurance provide compensation).

¹³ Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship between public and private enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1302-1303 (2008) (“Most commentators now agree that the private right of action implied under Section 10(b) ... cannot be defended on compensatory grounds”); *but see* James D. Cox, *Making Securities Fraud Actions Virtuous*, 39 ARIZ. L. REV. 497, 509-515 (1997).

¹⁴ The issuer may be vicariously liable under general principles of *respondeat superior*, as in the US, or because of explicit statutory rules implementing the options of art. 6(1) of the Prospectus Directive and art. 7 of the Transparency Directive. Directors and officers responsible for the misstatements typically do not have the deep pockets to be attractive defendants, even though the personally likely benefited from them. In Germany, the equivalent is § 31 BGB.

¹⁵ This assumes – realistically – that the corporation is unable or unwilling to seek reimbursement from individuals responsible for misinformation. *But see e.g.* Theodor Baums, *Haftung wegen Falschinformation des Sekundärmarkts*, 167 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT 139, 167 (2003) (defending issuer liability against the circularity argument because it is only persuasive if board members are ultimately not held liable).

¹⁶ Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 646 (1996); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1556 (2006); James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 331 (2009); Merritt B. Fox, *Why civil liability for disclosure violations when issuers do not trade?* 2009 WIS. L. REV. 297, 302; Bratton & Wachter, *supra* note 5, at 94.

¹⁷ Fox, *id.*, at 303 n.6 suggests that the injury is spread across the shareholders of the firm at the time when the suit is filed. Obviously, shares can be bought and sold between the filing and the payment of damages. However, from the time of the discovery of the fraud, the market price should in theory capture the risk of a possible payment to the plaintiffs.

¹⁸ Fox, *id.*, at 304-305; Langevoort, *supra* note 16, at 649.

¹⁹ Coffee, *supra* note 16, at 1557-1558. Indirectly, the sellers may have contributed to the remedy because the firm paid insurance premia.

these as well, insult is added to injury, since they not only suffer financially from the remedy,²⁰ but also have to bear the loss of the firm's value due to the reputational fallout from the exposure of fraud.²¹

Second, the *diversification* of many investors implies that they do not benefit from the prospect of compensation *ex ante*. A diversified investor will sometimes be a member of the plaintiff class gaining from a securities class action, and sometimes a holding shareholder who loses.²² It is often argued that the law does not need to protect investors who could have avoided the utility loss by diversifying.²³ Diversification thus allows investors to self-insure, rendering liability superfluous.²⁴ However, it is argued that non-diversified investors serve an important function in the market and thus should be protected from fraud risk. This would include information traders, whose research pushes stock prices to better reflect the intrinsic value of firms,²⁵ as well as potential acquirers planning a hostile takeover.²⁶

Third, *redistributive effects* of compensation are probably the most damning argument against issuer liability. To avoid overall losses from fraud, an investor not only needs to be diversified, but also needs to both sell and purchase stock equally often. Retail investors typically tend to buy and hold their shares over an extended period, which is why they do not enjoy the risk

²⁰ Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 639 (1985); Park, *supra* note 16, at 332. See also Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Regulation*, 2009 WIS. L. REV. 333 (344) (pointing out that these shareholders were also affected by the fraud because they missed out on information that would have been useful to discipline management).

²¹ Park, *id.*, at 330; see also Richard A. Booth, *The Future of Securities Litigation*, 4 J. BUS. & TECH. L. 129, 140 (2009). The reputational loss may exceed the actual payment by far and develop as the consequence of public scrutiny independently from a suit. *E.g.* Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1703 (2011) (referring to the empirical literature).

²² Park, *supra* note 16, at 328-329; see also Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1502 (1996); Fox, *supra* note 16, at 307-308; Fisch, *supra* note 20, at 337; Booth, *supra* note 21, at 139; *cf.* in Germany ALEXANDER HELLGARDT, *KAPITALMARKTDELIKTSRECHT* 141 (2008); but see Thomas M.J. Möllers, *Efficiency as a Standard in Capital Market Law – The Application of Empirical and Economic Arguments for the Justification of Civil Law, Criminal Law and Administrative Law Sanctions*, 2009 EUR. BUS. L. R. 243, 265 (rejecting the argument on grounds of “equalizing justice”). See Coffee, *supra* note 16, at 1558 (giving the example of a pension funds with stakes in 1000 corporations, of which 100 are sued over a certain time period, where the fund is a plaintiff in 50 cases and a holding shareholder in 50 others).

²³ Fox, *id.*, at 307; Bratton & Wachter, *supra* note 5, at 94-96. An empirical study commissioned by the U.S. Chamber of Commerce seems to confirm the diversification argument for institutional investors. See ANJAN V. THAKOR, JEFFREY S. NIELSEN & DAVID A. GULLAY, *THE ECONOMIC REALITY OF SECURITIES CLASS ACTION REGULATION* 13-15 (2005) (suggesting that profits and losses approximately balance for institutional investors, that securities class actions often result in overcompensation, and that losses from fraud risk are small compared to other losses). But see James. D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 EUR. COMPANY & FIN. L. REV. 180 n.42 (2009) (criticizing that lack of disclosure of the firms included in the THAKOR ET AL. study).

²⁴ Booth, *supra* note 21, at 139-140; Richard A. Booth, *The End of Securities Fraud as We Know It*, 4 BERKELEY BUS. L. J. 1, 17 (2007).

²⁵ Park, *supra* note 16, at 342-344; see also Fisch, *supra* note 20, at 347; but see Booth, *id.*, at 16 (contending that information traders often have widely spread portfolios); Cox & Thomas, *supra* note 23, at 176-177 (discussing hedge funds).

²⁶ *E.g.* Booth, *supra* note 24, at 14-15. Moreover, some shareholders are not able to diversify, most of all employees who are contractually obligated to retain their employer's shares for a certain period. Booth, *id.*, at 15; Cox & Thomas, *supra* note 23, at 176. Retail investors may not always be able to adequately diversify. See *e.g.* Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 234-236 (2007).

reduction benefits of frequent trades.²⁷ Moreover, “buy-and-hold” investors are more likely to be among the “innocent” holding shareholders whose shares lose value because of a judgment or settlement, than in the plaintiff class of buying shareholders, given that they adjust their portfolio less often than institutional investors.²⁸ Consequently, the effects of issuer liability on different groups are reversed: Badly diversified groups of shareholders, for which compensation as such would be more valuable, are more likely to suffer, whereas diversified institutional investors, for whom compensation is unimportant, are more likely to gain.²⁹ In other words, issuer liability redistributes from unsophisticated retail investors to sophisticated institutional investors.³⁰

2.2. Mismatch between plaintiffs’ losses and the social cost of fraud

If compensation cannot provide a persuasive explanation for issuer liability, the objective must be deterrence of capital market fraud. Independently of the distribution of risk, liability should therefore reduce fraud risk and thus reduce capital cost for firms.³¹ However, under the prevailing view, it fails at that task as well. One major issue is that it does not create sanctions corresponding to the harm created by securities fraud in order to incentivize actors to take appropriate care, which the basic law and economics model of issuer liability would normally postulate.³² Adjusting penalties to the socially optimal level therefore normally requires them to be tied to the harmful act’s social cost.³³ In plain vanilla tort cases, social cost typically is identical to the

²⁷ Evans, *id.*, at 232-234. *But see* Alicia J. Davis, *Are Investors’ Gains and Losses from Securities Fraud Equal Over Time? Theory and Evidence*, UNIVERSITY OF MICHIGAN LAW SCHOOL EMPIRICAL LEGAL STUDIES CENTER WORKING PAPER NO. 09-002 (10/2010), <http://ssrn.com/abstract=1121198> (suggesting, based on a simulation study, that while the average results for institutional investors are neutral, there is considerable variance between the outcomes for specific institutional investors).

²⁸ Langevoort, *supra* note 16, at 649-650; Coffee, *supra* note 16, at 1559-1560; Bratton & Wachter, *supra* note 5, at 97. In the US, almost all buyers are typically members of the plaintiff class because of the opt-out model of the class action.

The adverse consequences described above seem to be hard to avert for retail investors, who typically pay higher fees for trading than institutional investors, and also suffer more from information asymmetry in the stock market. Coffee, *id.*, at 1560. The problem seems even greater for employees who are required to hold on to their shares. Booth, *supra* note 24, at 15.

²⁹ *E.g.* Booth, *supra* note 21, at 147; Alexander, *supra* note 22, at 1502; *see also* Fox, *supra* note 16, at 304 (pointing out that “holding” shareholders will typically not be more diversified than plaintiffs, which is why compensation does not result in a better distribution of risk).

³⁰ A possible objection is that compensation may be required to encourage information traders to invest and to do research that enhances market efficiency. Arguably, the objective of securities regulation is to facilitate competitive trading by such market participants. *See generally* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L. J. 711 (2006).

³¹ *But see* Georg Eckert, *Emittentenhaftung für fehlerhafte Kapitalmarktinformation und aktienrechtliche Kapitalerhaltung*, 2010 DER GESELLSCHAFTER (GesRZ) 88, 95 (correctly pointing out that liability redistributes risk between shareholders because of circularity, but disregarding the risk-reducing deterrence effect).

³² Regarding the appropriate level of damages to internalize social cost *see, e.g.* SHAVELL, *supra* note 10, at 178. ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 300-302 (3rd ed. 2000); Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1532 (1984); A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 874, 887-896 (1998). Traditional Continental scholars sometimes argue that deterrence cannot be the objective of tort law, given that a damages payment will deter all harm. *E.g.* HELMUT KOZIOL, *BASIC QUESTIONS OF TORT LAW FROM A GERMANIC PERSPECTIVE* ¶ 3/5 (2013). This is not persuasive because economic analysis does not even purport to strive for complete deterrence.

³³ *E.g.* HELLGARDT, *supra* note 22, at 366; Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2188-2189 (2010) (discussing the issue in the context of securities markets).

harm incurred by the plaintiff. However, this is *not* the case in securities cases. While investors can sue for the difference between the actual purchase price of the shares and the hypothetical price after adjusting for the false information,³⁴ this has nothing to do with social harm. While the plaintiff clearly lost some money, there are always beneficiaries who gained precisely that amount, namely those who sold stock at an inflated price. Looking only at this redistributive effect, there would be no social cost, and therefore no reason to prohibit securities fraud.³⁵

Securities fraud, however, creates at least five types of social costs that all entail a misallocation of resources.³⁶ First, the corporation perpetrating the fraud often incurs expenses to hide it,³⁷ while some shareholders may feel compelled to monitor more closely – and therefore have higher expenses – than in the absence of fraud risk.³⁸ Second, in the case of a new stock issue, incorrect share prices will lead to a misallocation of scarce capital, since investment will be directed toward issuers of overvalued shares.³⁹ Third, even when the issuer does not trade, fraud risk increases volatility and therefore reduces utility for risk-averse investors.⁴⁰ Since this risk affects all traded firms and cannot be eliminated through diversification, investors will expect higher risk premia.⁴¹ Fourth, misinformation can affect the agency relationship between shareholders and managers, and specifically increase agency cost by undermining the price mechanism as a means for principals to monitor their agents.⁴² Managers producing seemingly good financial results will be viewed more favorably than they should be by all markets they operate in, including the managerial labor market,⁴³ executive compensation,⁴⁴ and the takeover market.⁴⁵ Fifth,

³⁴ For a comparative overview, see Klaus J. Hopt & Hans-Christoph Voigt, *Grundsatz- und Reformprobleme der Prospekt- und Kapitalmarktinformationshaftung*, in PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG 9, 86-89 (Klaus J. Hopt & Hans-Christoph Voigt eds. 2005).

³⁵ E.g. Richard A. Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159, 169-170 (1986); Paul G. Mahoney, *Precaution Cost and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 629-630 (1992); Fox, *supra* note 16, at 302; Hopt & Voigt, *id.*, at 56; Thomas M.J. Möllers & Franz Clemens Leisch, in KÖLNER KOMMENTAR ZUM WPHG, § 37b, c ¶274 (2007); HELLGARDT, *supra* note 22, at 140-141 (all discussing the secondary market); Marcel Kahan, *Securities laws and the social costs of “inaccurate” stock prices*, 41 DUKE L.J. 977, 1006-1007 (1992).

³⁶ ANDREAS SCHÖNENBERGER, ÖKONOMISCHE ANALYSE DER NOTWENDIGKEIT UND EFFIZIENZ DES BÖRSENGESETZLICHEN HAFTUNGSREGIMES 106-107 (2000). Similarly, the social harm of theft is not the loss of utility for the victim (which may be compensated or even exceeded by the gain in utility for the thief), but the cost incurred by private parties to prevent theft, and maybe more importantly the erosion of the function of ownership as a legal institution. In the absence of secure property rights, owners have fewer or no incentives to invest in assets under their control. See SHAVELL, *supra* note 10, at 12 (discussing reduce incentives to invest in the absence of property rights); Dean Lueck & Thomas J. Miceli, *Property Law*, in 1 HANDBOOK OF LAW AND ECONOMICS 184, 229 (A. Mitchell Polinsky & Steven Shavell eds. 2007) (discussing the “efficient theft” argument and the social cost of theft).

³⁷ Posner, *supra* note 35, at 170; Easterbrook & Fischel, *supra* note 20, at 623; Mahoney, *supra* note 35, at 631.

³⁸ Posner, *id.*; Easterbrook & Fischel, *id.*; Mahoney, *id.*, at 629-630; HELLGARDT, *supra* note 22, at 142; see also Rose, *supra* note 33, at 2179 (discussing the possibility to get information from other sources); Evans, *supra* note 26, at 231 (pointing out that institutional investors spend considerable time analyzing financial information which may not be completely rational given their high degree of diversification); Davis, *supra* note 27.

³⁹ Easterbrook & Fischel, *supra* note 20, at 623-624; Kahan, *supra* note 35, at 1006-1007; see also Easterbrook & Fischel, *id.*, at 624-625 (noting that false information can induce investors to underestimate risk and thus lower risk premia); Kahan, *id.*, at 1013; Mahoney, *supra* note 35, at 633-634 (both noting that these effects only apply when firms issue new shares).

⁴⁰ Posner, *supra* note 35, at 170; see also Kahan, *id.*, at 1026-1027; HELLGARDT, *supra* note 22, at 142.

⁴¹ Rose, *supra* note 33, at 2179.

⁴² Mahoney, *supra* note 35, at 634; Rose, *supra* note 33, at 2179.

⁴³ See Cox, *supra* note 13, at 510; Coffee, *supra* note 16, at 1562; Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Market: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 702-703, 720-734 (lending empirical support to this thesis).

securities fraud also affects other groups besides shareholders. As long as a firm's business situation appears good, managers may act accordingly, and expand the firm, offer low prices to consumers, and hire more personnel.⁴⁶ Various "stakeholders" of the firm may take individually disadvantageous decisions, such as creditors, who will be more likely to lend to the firm on favorable terms, as well as employees planning their career.⁴⁷ Velikonja suggests that the effects on employees (who may have foregone alternative career opportunities) are often severe, since human capital cannot be diversified like financial capital.⁴⁸

2.3. Insufficient incentives for deterrence

The bottom line from the mismatch between social cost and the plaintiffs' injury is that compensation as such set the theoretically correct incentives to deter, since the sanction would have to correspond to the five types of social cost discussed in the preceding section. Since the amount of the claim has nothing to do with the social cost, it is clear that the purpose of liability cannot be to further the individual interests of the plaintiff; it must deterrence, whose objective is to enhance the functioning of the securities market. Nevertheless, in the US, it is disputed whether securities class actions create under- or overdeterrence.⁴⁹

Some authors argue that the personal losses incurred by plaintiff shareholders are likely a lot larger than the losses in social welfare.⁵⁰ Others argue that disclosure of false information is always socially harmful and should be deterred completely.⁵¹ In the end, overdeterrence is not particularly plausible. First, false and misleading information is not normally published primarily to benefit the company, but usually because managers expect personal advantages,⁵² in particular when they are facing a last-period problem and are trying to avoid a nearly inevitable collapse of the firm.⁵³ Possible benefits to the company tend to be incidental.

⁴⁴ Rose, *supra* note 33, at 2182; *see also* Coffee, *id.*, at 1572-1573 (pointing out managers' incentives to front-load profits in order to gain from high stock prices).

⁴⁵ Kahan, *supra* note 35, at 1035-1037; Mahoney, *supra* note 35, at 634.

Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1915-1929 (2013).

⁴⁷ Velikonja, *id.*, at 1916-23.

⁴⁸ Velikonja, *id.*, at 1919.

⁴⁹ Overdeterrence would mean that firms might excessive resources (e.g. legal fees) on trying to avoid violations of securities law. Rose, *supra* note 33, at 2190, 2192, 2194; Langevoort, *supra* note 16, at 652. Moreover, it would make it impossible for firms to make a reasonable judgment whether keeping certain information confidential or disclosing it to the public is more advantageous. *See* Alexander, *supra* note 22, at 1499-1500; Mahoney, *supra* note 35, at 635.

⁵⁰ Easterbrook & Fischel, *supra* note 20, at 625; Alexander, *supra* note 22, at 1497-1498 (estimating the social cost to amount to approximately 9% of plaintiff investors' losses and interpreting much lower settlement values as indicating lower social cost); Langevoort, *supra* note 16, at 646-647; SCHÖNENBERGER, *supra* note 36, at 110, 118-119 (using a model to estimate that investors' losses correspond to approximately 400 times the amount of allocative losses); *but see* Goshen & Parchomovsky, *supra* note 30, at 775 (suggesting that all trading shareholders must be compensated to achieve sufficient deterrence since not all information traders will buy or sell); HELLGARDT, *supra* note 22, at 385.

⁵¹ *E.g.* Arlen & Carney, *supra* note 43, at 692, 718; Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 UC DAVIS L. REV. 1281, 1340 (2011) ("there is no social value in aggressive accounting").

⁵² *E.g.* Coffee, *supra* note 16, at 1562 (suggesting that managers are interested in securing their position and maximizing compensation); Fox, *supra* note 16, at 280.

⁵³ Arlen & Carney, *supra* note 43, at 715, 725; Cox, *supra* note 13, at 510; Langevoort, *supra* note 16, at 654.

Second, it is unlikely that firms overspend trying to ascertain the accuracy of their disclosures. Since firms typically employ professionals already (e.g. accountants), it is not difficult for managers to determine whether disclosures are truthful.⁵⁴

Third, to have a deterrent effect, the person facing liability must actually be in control of the firm i.e. managers have to be personally liable.⁵⁵ Typically, the defendant in a securities case is the issuer because of its deeper pockets. Individuals are rarely held personally liable,⁵⁶ and typically only contribute to settlements financially when the corporation is insolvent, when there is no insurance coverage, or when they agree to do so to avoid criminal prosecution.⁵⁷

Fourth, and most importantly, directors and officers (D&O) insurance all but eliminates incentives that might create a deterrent effect.⁵⁸ Since the late 1990s, D&O insurance in the US typically covers both individual and issuer liability (including litigation cost).⁵⁹ Insurance not only extinguishes the remaining deterrent effect on potentially liable individuals, who no longer face a possible monetary sanction,⁶⁰ but any incentive for shareholders to better select directors to avoid misrepresentations to the capital market in the first place.

In theory, insurers should want to avoid liability, which is why they will either monitor the insured or create incentives for directors and officers to avoid liability cases, e.g. through risk-adjusted insurance premia or deductibles. Insurance should theoretically have the advantage of avoiding the collective action problem that impedes monitoring by shareholders in a corporation with a dispersed ownership.⁶¹ However, empirical research by Baker and Griffith shows that securities claims in the US typically settle close or slightly above the limit of D&O coverage, and that insurers make few efforts to reduce liability risk (such as monitoring or financial incentives).⁶² Their main explanation is agency cost. Since managers have little reason to act in the

⁵⁴ Velikonja, *supra* note 51, at 1340.

⁵⁵ Langevoort, *supra* note 16, at 653. Jurisdictions differ with respect to how easily they allow plaintiffs to hold individuals liable. For the US, *see* SECURITIES ACT § 11(a) (holding various individuals, including managers and signatories of the registration statement liable); SECURITIES EXCHANGE ACT § 20(a) (providing liability of “controlling persons”). By contrast, the equivalent German statutes (§ 21 WPPG, §§ 37b, 37b WPHG) do not explicitly provide for a direct liability of individuals to investors, which is why claims, if they are possible at all, have to be based on general civil law. *See* WOLFGANG GROSS, KAPITALMARKTRECHT § 21 WpPG ¶35 (5th ed. 2012). For the very similar Austrian situation under § 11 KMG *see* Friedrich Rüffler, *Organaußenhaftung für Anlegerschäden*, 133 JURISTISCHE BLÄTTER (JBL) 69 (2011); for a comparative overview, *see* Hopt & Voigt, *supra* note 34, at 120-121.

⁵⁶ Alexander, *supra* note 22, at 1499; Coffee, *supra* note 16, at 1551; Fisch, *supra* note 20, at 337; Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1068-1074 (2006) (noting that since 1980 there have only been cases of securities class actions where directors were personally held liable).

⁵⁷ Coffee, *supra* note 16, at 1551; *see also* Alexander, *id.*, at 1498. *But see* Amanda M. Rose, *Better Bounty Hunting: How the SEC’s New Whistleblower Program Changes the Securities Fraud Class Action Debate*, VAND. U. L. SCHOOL PUB. L. & LEGAL THEORY WORKING PAPER 13-34 (2013), at 18 (suggesting that personal stock ownership and possible reputational losses may incentivize directors to avoid fraud).

⁵⁸ D&O insurance is typically bought by the corporation.

⁵⁹ Coffee, *id.*, at 1570 (suggesting that 90% of issuers were covered in 2002). *See also* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 46 (2010).

⁶⁰ BAKER & GRIFFITH, *id.*, at 60-61.

⁶¹ *Cf.* Arlen & Carney, *supra* note 43, at 712.

⁶² *See* Tom Baker & Sean J. Griffith, *How the merits matter: directors’ and officers’ insurance and securities settlements*, 157 U. PA. L. REV. 755, 760-761 (2009) *see also* Fox, *supra* note 16, at 305; Cox, *supra* note 13, at 512 (finding that the settlement amount is covered by insurance in 96% of cases); Bratton & Wachter, *supra* note 5, at 100; BAKER & GRIFFITH, *supra* note 59, at 137 (providing an anecdote about directors who, after initially worrying about a securities lawsuit, quickly move on to lunch after learning there is insurance coverage).

interest of shareholders when taking out insurance, they choose plans that limit their personal exposure to liability and thus do not set the right incentives.⁶³

3. Issuer liability and shareholders' incentives to monitor

3.1. Issuer liability and corporate governance

As described in the previous section, issuer liability neither creates substantial social value by compensating investors, nor does it seem to incentivize management to avoid false information of securities market. However, conceivably it could achieve deterrence indirectly, namely through effects on the corporation's governance that reduce fraud risk. In the remainder of the paper, I will investigate this possibility. Specifically, I argue that different financial structures make a difference for the effects of issuer liability, and that the criticism of the lack of a deterrent effect in the US (in spite of vigorous enforcement through securities class actions), is a consequence of the dispersed ownership structure.

To a certain extent, the existing literature deals with the interaction of issuer liability and corporate governance. Arlen and Carney, referring to the debate on enterprise liability in general, suggest that corporate liability is superior to individual liability when (1) the corporation can impose greater ex post sanctions than a court, (2) it is better positioned to apprehend the responsible individuals than an outside plaintiff, or (3) when it is more capable of deterring fraud ex ante.⁶⁴ They are of course correct to point out, however, that these conditions do not apply in the context of securities fraud: There is little reason to believe that the corporation can and will impose sanctions on misbehaving managers.⁶⁵ While in some cases, a corporation may be better able to identify individuals responsible for misconduct than the person actually harmed, this is not the case for securities lawsuits, since investors can easily identify directors and officers.⁶⁶ Most of all, the board of directors is typically not inclined to sue managers that are directly responsible for misrepresentations to the capital market.⁶⁷ The fact that a board of directors is unlikely to pursue claims against its own members, or against officers that it appointed and with which it closely collaborates, is exactly the reason why there are derivative actions in corporate law. The same applies to ex ante monitoring. It is of course true that there has been a movement to strengthen the

⁶³ BAKER & GRIFFITH, *id.*, at 72-74. For the corporation, it rarely makes sense to sue individuals for reimbursement, since this primarily results in litigation cost that uses up insurance coverage. Thomas E. Dubbs, *A Scotch Verdict on "Circularity" and other Issues*, 2009 WIS. L. REV. 455, 462.

⁶⁴ Arlen & Carney, *supra* note 43, at 707; *see also* Sharon Oded, *Inducing corporate compliance: A compound corporate liability regime*, 31 INT'L REV. L. & ECON. 272, 273-275 (2011) (discussing the role of corporate liability for compliance; *but see* Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Control*, 93 YALE L. J. 857, 867-888 (1984) (discussing individual liability as a backup making up for insufficiency of sanctions imposed on the firm).

⁶⁵ Arlen & Carney, *supra* note 43, at 708; *see also* Velikonja, *supra* note 51, at 1308. A firm's ability to punish employees (and managers) is often limited to dismissal, while private lawsuits are limited – like those of investors – at most to the employee's assets (if financial penalties are possible at all. *E.g.* A Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?* 13 INT'L REV. L. & ECON. 239, 240 (1993); Steven Shavell, *The Optimal Level of Corporate Liability Given the Limited Ability of Corporations to Penalize Their Employees*, 17 INT'L REV. L. & ECON. 203, 203 (1997).

⁶⁶ Arlen & Carney, *id.*, at 710.

⁶⁷ Arlen & Carney, *id.*, at 711-712; *see also* Fox, *supra* note 16, at 281 (favoring individual liability).

role of independent board members in recent decades.⁶⁸ In an ideal world, one would expect these to improve corporate monitoring and thus, among other things, prevent false and misleading reporting,⁶⁹ In fact there is some evidence suggesting that independent audit committees enhance the accuracy of financial reporting.⁷⁰ However, other research suggests that directors rarely suffer a reputational penalty when letting financial fraud happen.⁷¹ Generally, considerable skepticism about the monitoring capabilities of corporate boards abounds today.⁷² In the context of securities litigation, the general view in the US is therefore that issuer liability does not create better deterrence than individual liability.⁷³

One could theorize that issuer liability might create incentives to select managers more thoroughly.⁷⁴ However, given that boards in large corporations are in practice often self-perpetuating bodies, the core question is whether directors have incentives to act in the interest of investors when selecting managers.⁷⁵ The same applies to the implementation of internal compliance systems that might prevent the disclosure of false information. In this case, much depends on how well the board will use the information received. In those cases when fraud is most likely to be committed, namely when the firm is failing, managers and directors often have strong incentive not to let any information leak that might cost them their jobs.

3.2. Ownership structure and the incentive to monitor

Directors are of course not the only possible monitor in corporate governance. As suggested in section 2.3, individuals are rarely held personally liable in securities class actions and therefore not subject to strong incentives themselves. Moreover, the discussion of D&O insurance has illustrated the classical agency problem between shareholders and directors in the securities law context: Shareholders might prefer better enforcement, but directors have no strong reason to provide it.

Shareholders might themselves monitor to some extent, or put pressure on the company to appoint directors who will. Whether that is the case depends of course strongly on whether they have the appropriate incentives, and whether they are in the position to take the initiative. Ultimately, whether issuer liability has deterrent effects depends on the incentives it sets for shareholders whose value suffers from liability.⁷⁶ The discussion of circularity in section 2.1 has shown that the individuals most likely to suffer from securities litigation (because they effectively finance the remedy) are “innocent” buy-and-hold investors, in other words a diffuse group of

⁶⁸ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1472-1509 (2007).

⁶⁹ Cox, *supra* note 13, at 511-512;

⁷⁰ Gordon, *supra* note 68, at 1504-1505 (summarizing empirical evidence).

⁷¹ Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J. L. & ECON 365 (2006).

⁷² E.g. Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 75 (2007) (“The overall weight of the findings is that there is no solid evidence suggesting that independent directors improve corporate performance.”); Velikonja, *supra* note 51, at 1306 (“even the best audit committees are ill equipped to catch willful accounting fraud”); Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783, 796-797 (2011); Stephen M. Bainbridge & M. Todd Henderson, *Boards-R-Us: Reconceptualizing Corporate Boards*, 20-26, at <http://ssrn.com/abstract=2291065> (discussing problems of the board); in the context of securities violations Langevoort, *supra* note 16, at 654-655.

⁷³ Coffee, *supra* note 16, at 1564 (noting, however, that issuer liability makes litigation more likely)..

⁷⁴ Posner, *supra* note 35, at 169-170;

⁷⁵ Arlen & Carney, *supra* note 43, at 714.

⁷⁶ Cox, *id.* at 511; Fox, *supra* note 16, at 303 n.6.

relatively unsophisticated individuals with typically only small stakes in the firm. More generally speaking, the issue is connected to the classic problem in dispersed ownership corporations, which predominate in the US capital markets, namely the separation of ownership and control. The collective action problem resulting from it means that shareholders' financial interest in avoiding issuer liability is not fully passed on to the board of directors.⁷⁷ For the individual shareholders owning a tiny portion of the corporation, there is hardly any incentive to ensure that directors will be elected who will in turn select officers who will not commit securities fraud.

It follows that the critique of the lack of a deterrent effect of securities litigation in the US rests on the prevalence of dispersed ownership structures.⁷⁸ Dispersed ownership entails collective action problems between shareholders who otherwise might have stronger incentives and the capability to pre-screen directors and monitor them to reduce fraud risk, and who might otherwise be better able to push for more risk-reducing D&O insurance. True, there is some debate about whether the dominance of dispersed ownership has been exaggerated in the literature,⁷⁹ and in fact ownership by institutional investors has increased in the past decades.⁸⁰ However, the most important institutional investors, mutual funds, tend not to engage in shareholders' activism.⁸¹ Moreover, as the discussion of circularity has shown, institutional investors are more likely to be among the plaintiffs in a securities class action than retail investors. It therefore seems unlikely that increased institutional ownership will result in stronger internal monitoring against securities fraud, in particular with a view to the endgame situations where it most frequently occurs.

To summarize, we can say the deterrent effects of issuer liability are small in the US because of the prevailing share ownership structures. By contrast, it is a staple narrative of comparative corporate governance that Continental European companies are often dominated by large shareholders.⁸² Figure 1 shows the largest shareholder's voting share and the "stable" shareholders' voting share (defined as those known to support management) in 16 European countries and the US. In all countries except the UK and the US, the largest shareholder controls a stake far in excess of 10%, and there is typically an even larger coalition of "stable" shareholders. If anything, these data underestimate ownership concentration because the survey is limited to the largest firms (e.g. 40 in the US), with the effect being most pronounced in the larger economies.

⁷⁷ Arlen & Carney, *supra* note 43, at 693; *see generally* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 740-744 (1997).

⁷⁸ E.g. Armour et al., *supra* note 6, at 29 (noting the prevalence of dispersed ownership in the US); *see also* Rose & Squire, *supra* note 21, at 1689 (noting that the securities class actions can be better justified with deterrence if there are large, non-diversified shareholders).

⁷⁹ Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377 (2009) (controversially suggesting that dispersed ownership is a myth).

⁸⁰ E.g. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Cost of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 886-888 (2013); Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 954 (2013).

⁸¹ E.g. Leo E. Strine, *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 687 (2005) (describing mutual funds as "relatively docile shareholders"); *see generally* Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843 (2009).

⁸² E.g. Marco Becht & Alisa Roëll, *Blockholdings in Europe: An international comparison*, 43 EUR. ECON. REV. 1049 (1999); Raphael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate ownership around the world*, 54 J. FIN. 471 (1999); Mara Faccio & Larry H.P. Lang, *The ultimate ownership of Western European Corporations*, 65 J. FIN. ECON. 365 (2002) 379-380; PETER A. GOUREVITCH & JAMES SHINN, *POLITICAL POWER AND CORPORATE CONTROL* 18 (2005) (creating an index for concentration of stock ownership in different countries).

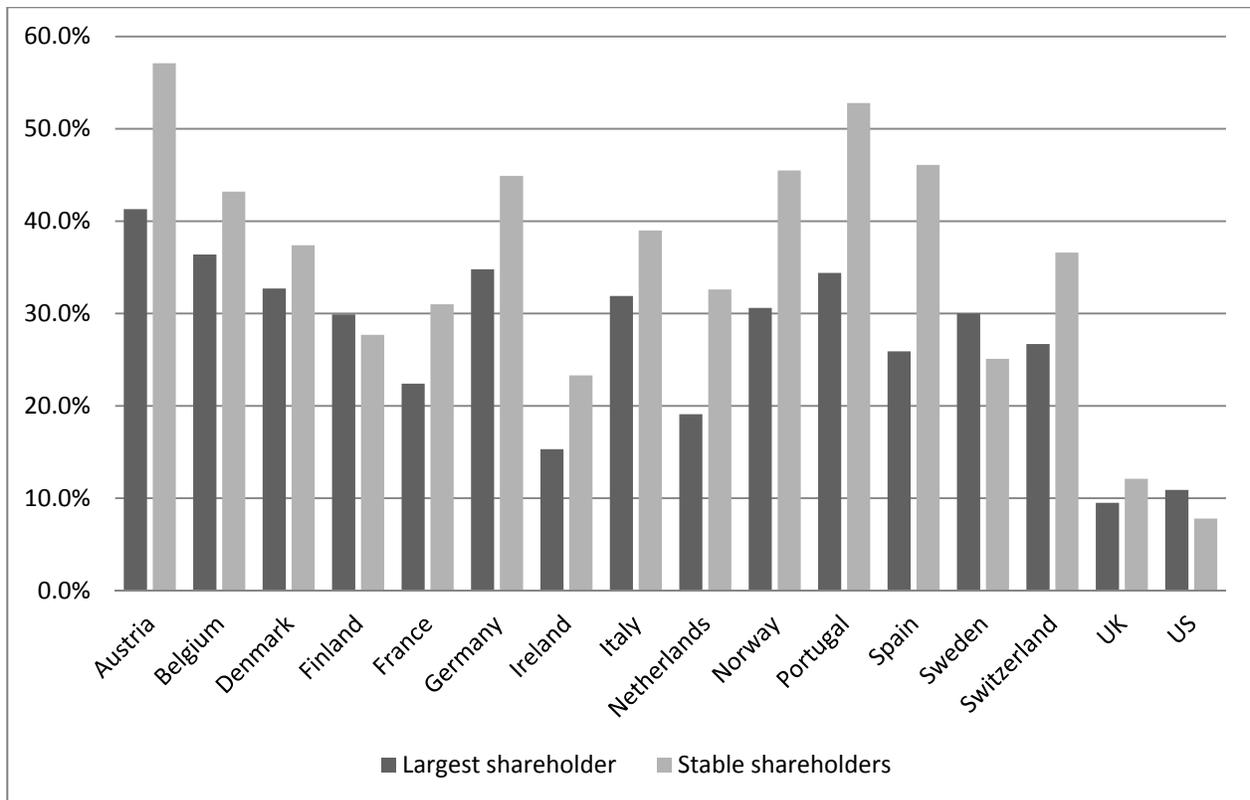


Figure 1: Average ownership concentration in Europe and the US in 2004.⁸³

The presence of large (often controlling) undiversified shareholders makes an obvious difference for the impact of issuer liability. It is well-known that they create a tradeoff for corporations: While large shareholders are known to cause additional agency problems because they tend to extract private benefits of control if not prevented by strong corporate law, they also monitor management because it is in their self-interest to do so.⁸⁴ First, a large shareholder owning a significant portion of the firm loses a significant amount of the value of his assets when the corporation has to make a large damages payment. The incentives to prevent misconduct by management with costly consequences should therefore be stronger than for diffuse shareholders, thus overcoming the classic collective action problem. Second, in contrast to small shareholders in firms of the “Berle-Means” type, large shareholders often are in fact capable of influencing the board and management. “Core shareholders” are not only often informally consulted before important transactions, but typically represented on the board with one or more confidants.⁸⁵ In much of Conti-

⁸³ Data from PEPPER D. CULPEPPER, QUIET POLITICS AND BUSINESS POWER 31-32 (2011). The higher share of stable shareholders compared to the largest shareholder in Sweden, Finland, and the US can be explained with the different sample sizes of Culpepper’s two surveys. I use Culpepper’s data because they seem to be the most recently published ones.

⁸⁴ E.g. Shleifer & Vishny, *supra* note 77, at 754; Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785-786 (2004); Alex Edmans, *Blockholders and Corporate Governance* 3, at <http://ssrn.com/abstract=2285781>.

⁸⁵ E.g. Johannes Semler, *The Practice of the German Aufsichtsrat*, in COMPARATIVE CORPORATE GOVERNANCE. THE STATE OF THE ART AND EMERGING RESEARCH 267, 269 (Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch & Stefan Prigge eds. 1998) (describing how supervisory board members are often nominated by shareholders); Claus Luttermann & Jean J. du Plessis, *Banking on Trust: The German Financial Sector, Global Capital Markets and Corporate Finance and Governance*, in GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND

mental Europe, a non-compliant director or officer would typically risk being removed and replaced by the firm's large shareholder.⁸⁶ If there is single controlling shareholder, the firm may even be characterized by a “‘command and control’ system”, in which management has little power.⁸⁷

Large shareholders thus do not only monitor, but also well-positioned to influence the information policies of the corporation through the selection and removal of managers.⁸⁸ The same applies if there are several large blockholders, who will typically coordinate. The data on “stable shareholders” typically supporting management cited in Figure 1 suggests the prevalent presence of stable coalitions in many Continental European firms that can at least jointly monitor and influence the selection of management. Large shareholders therefore both have much better incentives and a higher capability to prevent capital market fraud. There are of course cases where controlling shareholders collusively engage in capital market fraud with management; John Coffee suggests that the involvement of controlling shareholders in financial scandals is a typical pattern of concentrated ownership systems.⁸⁹ Whether or not a blockholder is involved in the fraud, he will suffer from the award or settlement and therefore have stronger incentives to either monitor or refrain from fraud.

Concentrated ownership structures tend to be relatively stable; blockholders tend to sell their stock only in the course of a major economic rearrangement. Since issuer liability shifts fraud risk from the plaintiffs (usually outside investors) to large shareholders, it thus helps to harness their monitoring capability. Given that issuer liability does not require proof of the blockholder's involvement, it always sets the incentive irrespective of whether there is evidence of personal implication in it. It thus parallels strict liability in tort law. The implication is that in a concentrated ownership system, the deterrent effect of issuer liability is greater assuming an equal level of enforcement.

The argument in favor of issuer liability is particularly strong in “primary market” cases, where the corporation itself sells stock and benefits from the inflated price. Consequently, the corporation's old shareholders profit at the expense of the new ones.⁹⁰ Because the remedy is often rescission,⁹¹ the redistributive effect of fraud is reverted so that – at least to a certain extent, the remedy even conforms to a compensation rationale. From a deterrence perspective, if the firm emerged from an IPO, the cost of issuer liability is ultimately borne to a large extent by the origi-

EUROPEAN CONTEXT 329, 335-336 (2nd ed., Jean J. du Plessis et al. 2012) (discussing the ability of banks to control supervisory boards through ownership stakes).

⁸⁶ E.g. Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 HARV. INT'L L. J. 129, 156-161 (2009), and Sofie Cools, *Europe's Ius Commune on Director Revocability*, 8 EUR. COMPANY & FIN. L. REV. 199, 204-205 (2011) (both discussing large shareholders' ability to remove directors).

⁸⁷ John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe differ*, 21 OX. REV. ECON. POL'Y 198, 204 (2005).

⁸⁸ E.g. Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006).

⁸⁹ Coffee, *supra* note 87, at 206-207 (discussing the role of controlling shareholders in scandals such as Parmalat).

⁹⁰ E.g. Easterbrook & Fischel, *supra* note 20, at 638-639; *see also* Coffee, *supra* note 16, at 1556; Booth, *supra* note 24, at 25.

⁹¹ E.g., in the US, under § 12(a) of the Securities Act the plaintiff can “recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.”

In jurisdictions where only damages are possible, the plaintiff may ultimately bear part of the cost the remedy himself if he remains a shareholder of the issuer.

nal shareholders if they still retain shares (whose value will drop). Quite obviously, these are the shareholders best positioned to avoid false disclosures in the first place.

3.3. Possible objections

There are of course a number of possible objections. First, as described in section 2.3, in the US it is arguably D&O insurance that eliminates the deterrent effects of issuer liability. However, ownership structure plays a core role in that argument as well. Critics have attributed the lack of risk reduction by insurance to agency problems between dispersed shareholders and directors. By contrast, a blockholder should be interested in having a functional insurance in place. A large shareholder is not automatically insured by diversification and should therefore not want the corporation to be excessively burdened with liability claims. It will therefore be interested in having an effective insurance mechanism that reduces fraud risk, since it will ultimately have to foot the bill for liability.

If agency problems are ultimately to blame for the ineffectiveness of US securities class actions, could a similar argument be made against the backdrop of concentrated ownership? After all, there are also considerable agency problems between controlling shareholders and outside investors. A controlling shareholder might not favor a strong disclosure regime that reduces opportunities to obtain private benefits of control through tunneling.⁹² Consequently, it may not be interested in insurance that actually improves monitoring in the firm, since he may benefit from misinforming outside investors. The obvious response is that a large shareholder – other than the group of managers dominating a firm with dispersed ownership – absorbs a large part of the cost of both high insurance premia (due to high fraud risk) and the reduction in the stock price resulting from a damages award, which managers in a dispersed ownership firm does not do. According to Baker and Griffith, D&O insurers in the US take block ownership into account when calculating premia, given that “a controlling shareholder may be a substitute for the governance constraints embedded in corporate law or charters, and significant insider share ownership may indicate an alignment of shareholder and management interests.”⁹³

Second, one might object that corporate stock is sometimes held by other corporations, most extremely in the form of a “stock pyramid” in which the ultimate controller of the entire corporate group holds only a small percentage of the last firm in the chain.⁹⁴ Such a shareholder might dominate the issuer with his voting rights, but only bear a small share of the cost of an award or settlement, the majority of which is financed by outside investors, which would eliminate the incentive effect of issuer liability.

There are two responses. First, the difference between an individual direct blockholder and the controller of a stock pyramid is gradual. Empirical research shows that the financial stake of the controller of a pyramid approximates the financial stakes of a manager in a dispersed ownership firm only in rare cases.⁹⁵ Second, if firm A is at the bottom of a pyramid, a large damages

⁹² Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation around the World*, 2 BROOK. J. CORP. & FIN. L. 81, 87-92 (2007).

⁹³ Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 522 (2007).

⁹⁴ E.g. Lucian Arye Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual-Class Equity*, in CONCENTRATED CORPORATE OWNERSHIP 295, 297-301 (Randall K. Morck ed. 2000); Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 117 J. ECON. PERSP. 117, 119-121 (2007) (discussing examples of pyramids).

⁹⁵ See e.g. La Porta et al, *supra* note 82, at 498-500, 511 (concluding that, while pyramids are common, the magnitude of deviations from the one-share-one-vote ideal tends to be small); Julian Franks & Colin Mayer, *Ownership*

award against it would first indirectly reduce the assets of firm B, which might e.g. own 30% of A's stock and which is controlled by X through a hierarchy of other firms. The award against A would likely negatively affect the financial position of B, for which it might become e.g. more difficult to borrow if its assets are less valuable. The reputation and personal wealth of B's managers might also be affected, who may therefore push for measures at the level of the issuer to avoid expensive liability awards.⁹⁶

In practice, of course, much will depend on the individual relationship between X on the one hand, and the management of B and A on the other. Thus, it is probably fair to say that a pyramid structure likely mitigates the incentive effects of issuer liability, but it does not eliminate them completely.

3.4. Transient blockholders

A third possible objection is that this change in incentives resulting from different ownership structures is only effective when the controlling shareholder at the time when false information is publicized (when he possibly benefits from it) is still the same at the time when a liability payment is made (and therefore there is an incentive effect). When a large shareholder begins to "unwind" and successively sells several blocks of shares, thus permitting the corporation to transition into dispersed ownership, there might be no incentive effects the seller does not suffer from the remedy. Moreover, the threat of liability could conceivably create an incentive to sell all shares as quickly as possible before the inaccuracy of the publicized information has been revealed.

Most likely these cases reduce the social utility of issuer liability, but do not eliminate it completely. First, most likely a "departing" large shareholder will absorb at least some of the liability in the sales transaction. A buyer might discover additional information indicating problems during a due diligence investigation and therefore bargain for a reduced price to adjust for the increased risk.⁹⁷ If he does not, the selling blockholder might still be exposed to a contractual remedy if vital information was not made available to the buyer.

While blockholders typically sell their shares in a private transaction,⁹⁸ a large shareholder might try to avoid this by selling out on the stock market, where investors do not have this advantage. However, information about substantial sales by a large shareholder is likely to become publicly known soon – through mandatory disclosures or otherwise – but even otherwise a large volume of sales during a short period will normally reduce prices and alert investors. Moreover, a large shareholder will partly internalize the fraud risk through the insurance premia paid by the

and Control of German Corporations, 14 REV. ECON. STUD. 943, 950-951 (2001) (reporting an average ratio between voting and cash flow rights of 1.6 in a sample of 38 German firms with a pyramidal ownership structure); F. Jens Köke, *New Evidence on Ownership Structures in Germany*, 34 KREDIT UND KAPITAL 257, 280-281 (2001) (reporting that in only 10% of a sample of 5788 German manufacturing firms with a pyramidal structure in only 10% of them the ratio of cash flow rights to voting rights was less than 75%); Faccio & Lang, *supra* note 82, at 392 (reporting mean ratios of cash flow to control rights between .740 and .941 for 13 Western European countries); Roberto Barontini & Lorenzo Caprio, *The Effect of Family Control on Firm Value and Performance. Evidence from Continental Europe*, 12 EUR. FIN. MGMT. 689, 698 (2006) (reporting an average wedge between voting and control rights of 6.8%).

⁹⁶ For a similar argument in the context of actions are harming employees *see* Gelter, *supra* note 86, at 163.

⁹⁷ This does not imply that the acquirer pays less than the market price, since larger packages of shares are typically sold at a premium.

⁹⁸ Coffee, *supra* note 87, at 204-205.

corporation long before a securities lawsuit materializes.⁹⁹ A large shareholder will want this risk to be low in order to minimize cost.

Overall, under *ceteris paribus* conditions, i.e. under the counterfactual assumption that securities lawsuits are equally likely and the expected award or settlement is the same, the deterrent effect of issuer liability should be greater in economies dominated by concentrated ownership than in the US. Thus, the social utility of issuer liability would seem to depend on the availability of a good private enforcement mechanisms and the persistence of concentrated ownership; we will return to these issues in section 5.

4. Issuer liability and creditors' incentive to monitor

4.1. Subordination to creditors under US law

So far I have argued that risk-shifting through issuer liability can be used to create incentives to monitor for large shareholders. The argument developed in the previous section can be extended to creditors. In the US, the degree to which creditors should bear the fraud risk in publicly traded firms has been debated in the context of § 510(b) of the Bankruptcy Code of 1978 (modified in 1984), which reads:

„For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.“

This section stipulates that damages claims because of securities fraud, as well as claims resulting from the rescission of a securities purchase or sale, are assigned the same rank as shares; in other words, such claims are subordinated to those of “regular” creditors. Securities fraud claims of bondholders are even subordinated to claims arising directly from the equivalent bonds.¹⁰⁰ In historical perspective, the 1978 Act reversed the previously prevailing policy. In a 1937 decision following the collapse of a bank, the US Supreme Court had decided that the claims of a shareholder whose acquisition of stock had been rescinded because of fraud were ranked with those of unsecured creditors.¹⁰¹ The change in the Bankruptcy Code's policy – to

⁹⁹ See Park, *supra* note 16, at 345 (pointing out that shareholders benefiting from false disclosures bear part of the cost of insurance).

¹⁰⁰ E.g. Jessica Ansell Hauser, *Nonconsensual Appeal of Third-Party Beneficiary Contract Rights: Senior Creditors under Subordination Agreements*, 8 CARDOZO L. REV. 1244 (1997). Until the 1984 amendments claims arising from the acquisition of stock were even subordinated to the stock itself. See e.g. COLLIER ON BANKRUPTCY P.510.LH (16th ed. 2012) (attributing the original version to a drafting error).

¹⁰¹ *Oppenheimer v. Harriman Nat'l Bank & Trust Co.*, 301 U.S. 206, 214-215 (1937). An interesting wrinkle to this is that under the banking law before 1953, shareholders were subject to personal liability amounting to their stocks' par value, which also applied to the plaintiff whose shares had been rescinded. See John J. Slain & Homer Kripke, *The Interface between Securities Regulation and Bankruptcy – Allocating the Risk between Securityholders and the Issuer's Creditors*, 48 NYU L. REV. 261, 283-284 (1973); Kenneth B. Davis, Jr., *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L. J. 1, 8. Prior cases of appellate courts had subordinated investors' claims. See Slain & Kripke, *id.*, at 272-279; Davis, *id.*, at 4-7.

which the SEC then objected – is often attributed to the influence of a 1973 article by John Slain and Homer Kripke.¹⁰² Slain and Kripke understood the issue of subordination as one about who should bear the firm’s risk, including both the risk of business failure and fraud risk. Given that equity investors have the chance of high profits, they argued that it was an implicit term of the contract between creditors, shareholders and the issuer for shareholders to also bear the risk of loss.¹⁰³ Creditors, on the other hand, should be able to rely on a certain cushion of equity.¹⁰⁴ Permitting shareholders to convert his equity claim into a debt claim would create an option that would allow them to participate in potential profits without bearing the risk of loss at the same time.¹⁰⁵

US law to some extent moved away from the policy of de-prioritizing defrauded investors in recent years. § 308(a) of the Sarbanes-Oxley Act of 2002¹⁰⁶ created a provision on „*Fair Funds for Investors*“ that allows the SEC to create a fund from penalties for violations of securities law agreed upon with the issuer in a settlement in order to disgorge these funds to defrauded investors. While the federal courts have recognized that this provision is to some extent at odds with the policy of § 510(b), they found in the cases of *Adelphia*¹⁰⁷ and *WorldCom*¹⁰⁸ that these funds should not be subordinated under this provision based on a simple literal interpretation and brushing the purpose aside. Unsurprisingly, some have criticized that the provision undermines the purposes of subordination under bankruptcy law.¹⁰⁹

4.2. Distribution of risk among shareholder and creditors

There are parallel discussions in several European countries. Interestingly, the question is not framed as one of subordination of investors’ claims, but of the capital maintenance principle. A payment by the issuer to shareholders could be seen as a restitution of capital, or a distribution to shareholders outside of the usually permissible types of distributions, such as dividends, reductions of capital, and liquidation, in which cases specific creditor protection rules apply.¹¹⁰ There have been extensive debates about the issue in Germany and Austria, where the courts have in recent years allowed issuer liability to go forward in spite of these objections,¹¹¹ as well as Den-

¹⁰² Slain & Kripke, *id.*, at 261. Regarding the article’s influence on the legislation *see* H.R. 595-95 (1977) 194-196 (citing the article); Davis, *supra* note 101, at 10-11; Hauser, *supra* note 100, at 1244.

¹⁰³ Slain & Kripke, *supra* note 101, at 286-287.

¹⁰⁴ Slain & Kripke, *id.*, at 288-291; *contra* Davis, *supra* note 101, at 19-24.

¹⁰⁵ Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L. J. 293, 299-300 (1982); Davis, *supra* note 101, at 34-43; Nicholas L. Georgakopoulos, *Strange Subordinations: Correcting Bankruptcy’s § 510(b)*, 6 BANKR. DEV. J. 91, 95 (1999).

¹⁰⁶ PUBLIC LAW 107-204, July 30, 2002.

¹⁰⁷ *In re Adelphia Commc'ns Corp.*, 327 B.R. 143, 168-170 (Bankr. S.D.N.Y. 2005); *Ad Hoc Adelphia Trade Claims Comm. v. Adelphia Commc'ns Corp.*, 337 B.R. 475, 478 (S.D.N.Y. 2006); For an overview, *see* Wendy S. Walker, Alan S. Maza, David Eskew & Michael E. Wiles, *At the Crossroads: The Intersection of the Federal Securities Laws and the Bankruptcy Code*, 63 BUS. LAW. 125, 141-145 (2007).

¹⁰⁸ *SEC v. WorldCom*, 273 F. Supp 2d 431, 434 (S.D.N.Y. 2003); Official Comm. Unsecured of Creditors of WorldCom Inc. v. SEC, 467 F.3d 73, 85 (2d Cir. 2006).

¹⁰⁹ Walker et al., *supra* note 107, at 141, 145; Zack Christensen, *The Fair Funds for Investors Provision of Sarbanes-Oxley: Is it Unfair to Creditors of a Bankrupt Debtor?* 2005 U. ILL. L. REV. 339; 368-373; *but see* Douglas A. Henry, *Subordinating Subordination: WorldCom and the Effect of Sarbanes-Oxley’s Fair Funds Provision on Distributions in Bankruptcy*, 11 EMORY BANKR. DEV. J. 259, 293-300 (2004) (apparently favoring subordination).

¹¹⁰ A comparative overview is provided by Country reports Hopt & Voigt, *supra* note 34, at 60-62

¹¹¹ For Germany, *see* BGH 9.5.2005, NJW 2005, 2450; BGH 3.3.2008, NZG 2008, 386; for Austria, *see* OGH 30.3.2011, 7 Ob 77/10i, GESRZ 2011, 251, and OGH 15.3.2012, 6 Ob 28/12d, GesRZ 2012, 252 (all rejecting the

mark¹¹², Norway¹¹³ and Sweden.¹¹⁴ In the Nordic countries, creditor interests have traditionally been given preference,¹¹⁵ and in Sweden it was still not clear whether the issuer can be liable at all in 2012.¹¹⁶ The discussion is sometimes framed as a “clash of principles”, in which the sanctity of capital is juxtaposed to the alleged necessity of issuer liability.¹¹⁷ Besides the principle of capital maintenance, it is also often pointed out, in the German-speaking countries in particular, that corporate law is also characterized by the “theory of the defective association” (*Lehre vom fehlerhaften Verband*), according to which members of a business association cannot normally withdraw their contribution by showing that they have been enticed to become a member through fraud or error.¹¹⁸ As with respect to capital maintenance, the underlying policy is to protect creditors, who are thought to be more distant from the business risk than these members.¹¹⁹ The theory has also been given recognition in Art. 12 of the recodified First Directive¹²⁰ at least to some extent, as it limits the national legislatures’ ability to provide for the nullity of the company to a limited set of cases and to an *ex nunc* effect, which might imply that a rescission on the of an acquisition of shares from the firm on the grounds of fraud is not permissible.¹²¹

While courts in Germany and Austria (and many scholars) have recently favored issuer liability,¹²² some scholars seem to favor the capital maintenance to the extent that it should completely preclude issuer liability to shareholders.¹²³ Others have taken an intermediate position and suggested that it should rule out liability only to the extent that it would reduce the issuer’s equity below its legal capital; in other words, only funds that would otherwise be available for a divi-

proposition that capital maintenance precludes or limits issuer liability). By contrast, the former German *Reichsgericht* generally gave precedence to creditor interests. RGZ 54, 128; RGZ 62, 29.

¹¹² Catarina af Sandeberg, *Prospectus Liability in a Scandinavian Perspective*, 2002 EUR. BUS. L. REV. 323, 329-330; Catarina af Sandeberg, *From caveat emptor to caveat venditor - the winding road to prospectus liability in Scandinavian countries*, 2003 J. BUS. L. 91, 97-98; Paul Krüger Andersen, *Denmark*, in PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG, *supra* note 34, at 401, 411.

¹¹³ Sandeberg, *Prospectus Liability*, *id.*, at 330; Sandeberg, *Caveat emptor*, *id.*, at 97-98.

¹¹⁴ Sandeberg, *Prospectus Liability*, *id.*, at 329; Sandeberg, *Caveat emptor*, *id.*, at 98; Rolf Skog, *Sweden*, in PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG, *supra* note 34, at 935, 939-940; *see also* Fabian Walla, *The Swedish Capital Markets Law from a European Perspective*, 2012 EUR. BUS. L. REV. 211, 220.

¹¹⁵ Sandeberg, *Prospectus Liability*, *id.*, at 323, 333-334; Sandeberg, *Caveat emptor*, *id.*, at 92-93, 101.

¹¹⁶ Walla, *supra* note 114, at 220.

¹¹⁷ *E.g.* Walter Bayer, *Emittentenhaftung versus Kapitalerhaltung*, 67 WERTPAPIER-MITTEILUNGEN 961, 961 (2013).

¹¹⁸ In the context of issuer liability, *see* Carsten Schäfer, *Kapitalmarktinformatiionshaftung und die Lehre vom fehlerhaften Verband*, 33 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2421 (2012).

¹¹⁹ Christoph Andreas Weber, *Kapitalmarktinformatiionshaftung und gesellschaftsrechtliche Kapitalbindung – ein einheitliches Problem mit rechtsformübergreifender Lösung?* 176 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT (ZHR) 184, 193 (2012).

¹²⁰ Directive 2009/101/EC of the European Parliament and the Council of 16 September 2009 on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent, 2009 O.J. (L 258) 11.

¹²¹ Arguably, the ECJ accepted the theory in *E. Friz GmbH v. Carsten von der Heyden*, Case C-215/08, where a consumer attempted to withdraw from a closed-end real estate investment fund.

¹²² *Supra* note 111.

¹²³ *E.g.* Norbert Horn, *Zur Haftung der AG und ihrer Organmitglieder für unrichtige oder unterlassene Ad-hoc-Information*, in FESTSCHRIFT FÜR PETER ULMER 817, 826-827 (2003); Carsten Schäfer, *Effektivere Vorstandshaftung für Fehlinformation des Kapitalmarkts?* 2005 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT 985; Michael Gruber, *Prospekthaftung der AG versus Kapitalerhaltung*, 2010 DER GESELLSCHAFTER (GESRZ) 73, 75; Eckert, *supra* note 31, at 98.

dend could be awarded to plaintiffs.¹²⁴ Some authors have favored subordination of investor claims (following US law).¹²⁵ The question not only arises on the level of national corporate laws, but also on the level of EU law, which enshrines the prohibition against distributions to shareholders outside dividends in art. 15 of the Second EU Company Law Directive, and at the same time gives the option of implementing issuer liability to the Member States.¹²⁶ For this reason, a preliminary reference case is currently pending before the ECJ.¹²⁷

The main (although not only) argument of both the German¹²⁸ and Austrian courts¹²⁹ in their leading decisions is that the claims of plaintiff shareholders are no different from other liability claims; corporate assets are not affected in a different way than claims of non-shareholders creditors.¹³⁰ Conceptual arguments of this type unfortunately permeate the doctrinal debate, even though they are not helpful for a policy analysis.¹³¹ To adequately address the policy question underlying the legal debate, it does not suffice to say that the legal capital system has been subject to intense scrutiny in the past ten years, with most economically sophisticated scholars believing it to be of no real use to creditors.¹³² It is of course true that creditors cannot rely on the availability of the firm's stated capital, which can be easily dissipated through losses without violating legal capital rules.¹³³ Relatedly, those who prioritize issuer liability sometimes argue that creditors cannot expect capital not to be dissipated by issuer liability claims, as they cannot rely on its protection from any other managerial actions.¹³⁴ As we shall shortly see, applying the capital maintenance principle to issuer liability clearly would have a redistributive effect that changed the incentives for the affected parties. The other line of criticism against legal capital is to doubt the necessity of creditor protection as a whole, given that many (but not all) creditors can protect themselves through covenants, risk premia in the interest rate they charge, and the simple refusal

¹²⁴ E.g. SUSANNE KALSS, ANLEGERINTERESSEN 221 (2001); Rüdiger Veil, *Die Ad-hoc-Publizitätshaftung im System kapitalmarktrechtlicher Informationshaftung*, 167 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT (ZHR) 365, 395 (2003); Peter Doralt & Martin Winner, in 1 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, § 57 ¶261 (3rd ed. 2008).

¹²⁵ E.g. Baums, *supra* note 15, at 170; Katja Langenbacher, *Kapitalerhaltung und Kapitalmarkthaftung*, 2005 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 239, 244-245.

¹²⁶ Günter H. Roth, *Kapitalerhaltung versus Prospekthaftung: Die europäischen Richtlinien*, in 134 JURISTISCHE BLÄTTER (JBL) 73, 74 (2012); Weber, *supra* note 119, at 188.

¹²⁷ *Supra* note 8.

¹²⁸ BGH NJW 2005, 2452; *see also* BGH NZG 2008, 387.

¹²⁹ OGH GesRZ 2011, 253; OGH GesRZ 2012, 254.

¹³⁰ BGH NJW 2005, 2452.

¹³¹ Another question is which principle is the *lex specialis* and the *lex posterior*. E.g. Walter Bayer, in 1 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, § 57 ¶20 (3rd ed. 2008). This is of obvious relevance for legal interpretation, but entirely irrelevant for the policy argument made in this paper. Under EU law, a conceptual question is whether a payment to shareholders under an issuer liability claim constitutes a distribution under art. 15 of the Second Directive. E.g. Bayer, *supra* note 117, at 966-967.

¹³² Hopt & Voigt, *supra* note 34, at 63. *See also* Möllers & Leisch, *supra* note 33, ¶40 (suggesting that issuer liability should take precedence because it facilitates obtaining capital from the stock market). Equivalently, one might say that stronger capital maintenance marginally makes taking out credit marginally easier. *See* Weber, *supra* note 119, at 201 (pointing out that creditors, like shareholders, are capable of adjusting on the market).

¹³³ E.g. Luca Enriques & Jonathan R. Macey, *Creditors versus Capital Formation: The Case against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165, 1186 (2001).

¹³⁴ Baums, *supra* note 15, at 169; Holger Fleischer, *Konturen der kapitalmarktrechtlichen Informationsdeliktshaftung*, 26 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1805, 1811 (2005); Matthias Casper, *Haftung für fehlerhafte Information des Kapitalmarktes*, 2006 DER KONZERN 32, 37.

to extend credit.¹³⁵ As we have seen above, there are equivalent arguments for shareholders, who can protect themselves against fraud risk through diversification.¹³⁶

The discussion in the US has shown that the policy question underlying the shareholder-creditor debate is about who should bear risk that investors are defrauded if only the issuer is available as a defendant, either creditors or investors themselves.¹³⁷ Risk-bearing also plays a role in the German debate: Proponents of subordination of investor claims argue that fraud risk is typical for equity and therefore should remain with shareholders.¹³⁸ It has been suggested that shareholders have more influence on the corporation and are therefore positioned to ensure that individual directors and officers are ultimately held liable.¹³⁹ By contrast, advocates of the primacy of issuer liability claims have argued that shareholders bear greater risk and therefore need to be better protected than creditors.¹⁴⁰

Including US law and the various possible interpretation of capital maintenance, there are at least four possible options (table 3 below).

First, if capital maintenance completely precludes liability to shareholders, the defrauded investors bear the risk. There is no additional risk for creditors, and not even the other shareholders, since there is no risk-spreading (as described in section 2.1) (1).

Second, if capital maintenance limits liability to distributable reserves, risk is spread across shareholders except if there are no distributable reserves. In this case, however, shares will typically have little or no value anyway (2).

Third, if the claims of investors are subordinated (as in the US), the risk is in principle spread across shareholders. However, no risk-spreading happens if the firm is in bankruptcy (which is presumably a smaller set of circumstances than the situation where there are merely no distributable reserves), given that typically shareholders will not receive anything. In this case (as in the second one), creditors might still face a somewhat increased risk because payments that happen before insolvency (or as long as there are distributable reserves) will increase the probability that the firm will later become insolvent (3).

Finally, if the claims of investors are assigned the rank of unsecured creditors, creditors share the fraud risk with the defrauded shareholders if the firm becomes insolvent (If the firm is not insolvent, the fraud risk is spread across shareholders as described in section 2.1) (4).

¹³⁵ *E.g.* Enriques & Macey, *id.*, at 1188-1195; John Armour, *Legal Capital: An Outdated Concept?* 7 EUR. BUS. ORG. L. REV. 5, 16-17 (2006). Of course this does not apply to tort creditors. In the given context of issuer liability see NIKOLAI VOKUHL, *KAPITALMARKTRECHTLICHER ANLEGERSCHUTZ UND KAPITALERHALTUNG IN DER AKTIENGESELLSCHAFT* 170-171 (2007). Even though this argument is correct, capital maintenance may not be pointless if the courts apply a “concealed distributions” doctrine that forces firms to treat all shareholders equally and restricts asset transfers between the corporation and its shareholders to certain transparent paths, such as dividend payments and reduction of capital, which makes looting the company harder. See *e.g.* Peter O. Mülbart & Max Birke, *Legal Capital – Is There a Case against the European Legal Capital Rules*, 3 EUR. BUS. ORG. L. REV. 695, 705-706 (2002); Luca Enriques & Martin Gelter, *Regulatory Competition in European Company Law and Creditor Protection*, 7 EUR. BUS. ORG. L. REV. 417, 426-427 (2006); THOMAS BACHNER, *CREDITOR PROTECTION IN PRIVATE COMPANIES* 122-138 (2009).

¹³⁶ *Supra* section 2.1.

¹³⁷ Weber, *supra* note 119, at 202.

¹³⁸ Baums, *supra* note 15, at 170; Langenbucher, *supra* note 125, at 242.

¹³⁹ Langenbucher, *id.*; Peter Kindler, *Gesellschaftsrechtliche Grenzen der Emittentenhaftung am Kapitalmarkt – Eine Nachlese zum Fall “EM.TV” vor dem Hintergrund zwischenzeitlicher Entwicklungen*, in *FESTSCHRIFT FÜR UWE HÜFFER ZUM 70. GEBURTSTAG* 417, 424 (Peter Kindler, Jens Koch, Peter Ulmer & Martin Winter eds. 2010).

¹⁴⁰ *E.g.* Hartwig Henze in 2 *GROßKOMMENTAR AKTIENGESETZ*, § 57 ¶ 20 (Klaus Hopt & Herbert Wiedemann eds. 4th ed. 2000/2012).

Rule	Plaintiff shareholders	Other shareholders	Creditors
(1) Capital maintenance precludes liability	Full risk	No Risk	No fraud risk
(2) Liability if distributable reserves available	Risk proportionate to share (full risk if no distributable reserves)	Risk proportionate to share (no risk if no distributable reserves)	Risk of loss smaller than under (3), but greater than under (1)
(3) Subordination (§ 510(b) US Bankruptcy Code)	Risk proportionate to share (de facto full risk if insolvent)	Risk proportionate to share (de facto no additional risk if insolvent)	Increased risk because of liability
(4) Full liability	Risk proportionate to share	Risk proportionate to share	Full risk if firm is insolvent

Table 1: Allocation of fraud risk through issuer liability

In Table 3, the risk borne by creditors increases from (1) to (4). The risk under rule (3) will typically be higher than under rule (2) because financial statements will often not show a distributable surplus even if the firm is not yet insolvent.

4.3. Incentivizing creditors to monitor

Slain and Kripke argued that creditors should be able rely on a certain cushion of equity and saw subordination of shareholder claims as a means to that.¹⁴¹ Similar arguments have been brought forward in the German debate.¹⁴² Taking this argument to its logical conclusion, one would have to choose rule (1) above and not permit any issuer liability, in which case creditors would bear no fraud risk at all. Even the other shareholders' risk would be eliminated, which means that the monitoring incentive described in section 3.2 would disappear. Moreover, as mentioned above, the argument that creditors can rely on a particular equity in the firm has long been discredited in the capital maintenance debate. One can both argue that sophisticated creditors are able to adjust to risk, just as sophisticated investors can adjust prices to take a marginally higher risk of fraud into account. It is thus more promising to investigate whether shareholders or creditors are the better risk-bearers by virtue of being better diversified or able to adjust to fraud

¹⁴¹ Slain & Kripke, *supra* note 101, at 288-291.

¹⁴² *E.g.* Kindler, *supra* note 139, at 422 (arguing that shareholders collectively committed capital to current and future creditors); Schäfer, *supra* note 118, at 2422 (suggesting that shareholders entered a "community of risk" by obtaining shares in a new issue and, to protect the interests of third parties, therefore cannot easily withdraw their contribution). These arguments, however, are largely conceptual in nature and rest on the question whether these investors should be considered shareholders, given that their decision to buy was based on false information. *E.g.* Fleischer, *supra* note 134, at 1810; Langenbucher, *supra* note 125, at 242 (both noting that an unlawful action preceded the acquisition of shares); Casper, *supra* note 134, at 37 (suggesting that these individuals should be considered creditors rather than shareholder). The controversy illustrates that a largely conceptual discussion that does not primarily consider the incentives set by risk for the parties involved is not likely to yield fruitful results.

risk.¹⁴³ Bondholders or banks with a broadly spread portfolio of outstanding loans can also be good risk-bearers.¹⁴⁴

I have argued above, given circularity and the mismatch between social cost and investor claims, that the policy objective of issuer liability is not the compensation of investors, but enhancing the functioning of the capital market (section 2). For this reason, risk spreading is primarily important also for creditors because it creates incentives to prevent capital market fraud (section 3). While there has been some discussion about the allocation of fraud risk between shareholders and creditors, there has been little discussion about the incentives it sets.

The overall policy decision should therefore favor a priority of issuer liability to investors, since it will strengthen incentives for financial institutions to monitor. The decisive question is therefore whether plaintiff shareholders or creditors would ex ante be better positioned to monitor management.¹⁴⁵ In spite of changes during the past 20 years, Continental European corporate governance still tends to a large extent to be bank-centric. Compared to the US and the UK, bank loans (and sometimes loans from consortia of banks) still play a greater role in the debt structure of Continental European companies.¹⁴⁶ Generally, debt is thought to be diffused in the US, and comparatively concentrated both in the UK and Continental Europe.¹⁴⁷

Large banks should normally be capable of protecting themselves against credit risk of from business lenders, but they also often interact closely with and monitor management.¹⁴⁸ This applies in particular in the traditional situation where one financial institution serves as an industrial firm's *Hausbank* (main bank) and is therefore included in many important decision-making processes.¹⁴⁹ Such a position would enable a financial institution to reduce the probability of false

¹⁴³ See also Davis, *supra* note 101, at 63 (discussing the broader spread of risk).

¹⁴⁴ For a similar argument, see Weber, *supra* note 119, at 206.

¹⁴⁵ Davis, *supra* note 101, at 66; see also Georgakopoulos, *supra* note 105, at 95.

¹⁴⁶ EUROPEAN CENTRAL BANK, CORPORATE FINANCE IN THE EURO AREA 13 (OCCASIONAL PAPER NO. 63/2007), at <http://www.ecb.int/pub/pdf/scpops/ecbocp63.pdf> (showing that bank loans amounted to 29.1% of firm's capital in 2005, compared to 3.5% for debt securities excluding derivatives); EUROPEAN CENTRAL BANK, *id.* at 17 (showing that loans amounted to 89.2% and debt securities to 10.8% of total debt in the Eurozone, compared to 60.7% for loans and 39.3% for securities in the US, and 73.5% for loans and 26.5% for securities in the UK).

¹⁴⁷ John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1763-1777 (2002) (describing the development of debt structure in evolutionary terms).

¹⁴⁸ On monitoring by creditors, see generally Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever in Corporate Governance*, 154 U. PA. L. REV. 1209, 1242-1250 (2006); Joanna M. Shepherd, Frederick Tung & Albert H. Yoon, *What else matters for corporate governance? The case of bank monitoring*, 88 B.U. L. REV. 991 (2008); Frederick Tung, *Leverage in the Boardroom: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009); Charles K. Whitehead, *Creditors and Corporate Governance*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 68, 73 (Claire A. Hill & Brett H. McDonnell eds. 2012).

¹⁴⁹ The role of the *Hausbank* has traditionally been strong in Germany and has often been studied in the literature on business finance and corporate governance. E.g. Theodor Baums, *Corporate Governance in Germany: The Role of the Banks*, 40 AM. J. COMP. L. 503 (1992); David Charny, *The German Corporate Governance System*, 1998 COLUM. BUS. L. REV. 145, 151-157; Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 500-501 (2001). However German banks seem to have reduced their industrial share holdings in recent years, partly because of the 2000 elimination of a capital gains tax on equity sales and some changes to corporate law. Cheffins, *id.*, at 502-503; Dariusz Wojcik, *Change in the German model of corporate governance: evidence from blockholdings 1997-2001*, 35 ENV'T & PLAN. A 1431 (2003); Sigurt Vitols, *Das „neue“ deutsche Corporate Governance-System: Ein zukunftsfähiges Modell?* in PERSPEKTIVEN DER CORPORATE GOVERNANCE 76, 82-83 (Ulrich Jürgens, Dieter Sadowski, Gunnar Folke Schuppert & Manfred Weiss eds. 2007) (tracing the decline of ownership concentration); Luttermann & du Plessis, *supra* note 85, at 332-333.

information by management to the capital markets. Even if the role of large, voluntary lenders seems to have decreased in Europe in the past 20 years, they are still likely better able to monitor than many other groups, in particular the typical plaintiffs in a securities lawsuit.¹⁵⁰ It follows that a rule that permits issuer liability and shifts some of the risk to creditors is preferable.¹⁵¹ Incentives for creditors seem particularly important when the corporation is approaching insolvency and both managers and large shareholders may be “gambling for resurrection.”

When we compare the various rules proposed in Table 1, the complete preclusion of liability because of the capital maintenance principle appears particularly problematic, given that the risk is not even shifted to other shareholders. In many European countries, large shareholders often retain significant positions even after going public, and sometimes they are in fact involved in capital market fraud. It is particularly important for large shareholders to retain an incentive to monitor. If capital maintenance took precedence, incentives of both large shareholders and creditors to prevent misinformation would be reduced. From a doctrinal perspective, it seems absurd how prioritizing capital maintenance distorts the doctrine’s usual purpose to an opposite effect: Normally, the capital maintenance principle is intended to prevent the flow of corporate assets to large shareholders, to the detriment of both minority shareholders and creditors. Here, capital maintenance would benefit large shareholders to the detriment of outside investors. Rules (2) and (3) would increase the risk for lenders, and hence the incentive to monitor, to some extent, but not as much as rule (4), which completely prioritizes issuer liability.

In order to set the right incentives, ideally one would want to expose only large lenders to the risk of issuer liability, and not e.g. small suppliers or even tort creditors, who are obviously not well-positioned to monitor. As discussed in section 3, the same applies to shareholders. In principle one could, as some authors have suggested, subordinate or preclude claims by large shareholders only,¹⁵² or treat issuer liability to investors as a restitution of capital to the large shareholder, thus exposing the latter to liability to the firm in the wake of an investor suit.¹⁵³ With respect to creditors, similar mechanisms would be more difficult to put into place, since their incentives to monitor are only set by the somewhat increased likelihood of the issuer’s insolvency resulting from liability claims against the issuer. A mechanism that would burden only large creditors that are actually positioned to monitor might not be possible to create without foregoing an important advantage of issuer liability, namely that it is not necessary to personally implicate the creditor in a securities lawsuit. Creating some risk for other, smaller creditors in the process may be a small price to pay for a solution that does not require major changes in the legal framework. The marginal risk borne by e.g. a small supplier is likely negligible, both in terms of creating incentives and the danger of such creditors getting into financial difficulty themselves.

A possible objection could be that financial institutions, given their centrality for the economy, should not shoulder too much risk. Given the numerous bank bailouts in recent years, one might argue that bearing additional risk from loans to firms subject to issuer liability claims might push some financial institutions over the edge. In the end, however, it is important to note that this is an unlikely scenario. A risk of loss will only materialize if the borrower is subject to

¹⁵⁰ Weber, *supra* note 119, at 202-203 (pointing out that it may have made sense to impose the risk on shareholders in the late 19th and early 20th century, but not today, when most investors are not personally known to the issuer’s management).

¹⁵¹ *But see* Eckert, *supra* note 31, at 95 (suggesting that it would be absurd to expect creditors to monitor the issuer’s information policies).

¹⁵² JOHANNES REICH-ROHRWIG, GRUNDSATZFRAGEN DER KAPITALERHALTUNG 365-366 (2004) (proposing a relatively low limit of €40,000 under Austrian law based on an analogy).

¹⁵³ Susanne Kalss, *Kapitalmarktinformationshaftung – Runde wie viel?* 2012 DER GESELLSCHAFTER (GESRZ) 150.

large issuer liability claims that ultimately result in its insolvency. Even if the loan is large and the issuer is an important client, this marginal risk should not be an excessive burden for a bank with a well-diversified loan portfolio to shoulder. Other than those toxic assets that caused severe problems for many financial institutions in recent years, the risk of issuer liability claims in different firms are typically not correlated. However, the remaining risk may still create a marginal incentive for the individuals within the bank in charge of specific issuers to push the borrower to avoid the publication of false or misleading information to the capital markets.

5. Should Europe strengthen private enforcement of securities law?

As the discussion of the cost of securities fraud in section 2.2 has shown, the objective of securities litigation cannot be to serve the private interests of misled investors, but a broader goal of a better working capital market. One could therefore argue that enforcement should be in the hands of a public regulator, such as the SEC, whose goal it clearly should be to eliminate frictions in the market caused by opportunistic behavior. This might lead us to abandon investor litigation, given its considerable cost and the mismatched incentive of private plaintiffs. In fact, Jackson and Roe's finding that across countries, strong regulators are better predictors of developed securities markets than effective private enforcement¹⁵⁴ might be read in support of this view.¹⁵⁵ Nevertheless, this does not mean that private enforcement cannot be part of a cocktail of enforcement mechanisms.¹⁵⁶ Private actors motivated by monetary gains may ensure enforcement where, for example, regulators shy away from it for fear of antagonizing powerful economic and political actors. Private actions may in fact be more valuable in smaller countries, where politics and the business world are often very closely intertwined, than in the U.S., where economic power is relatively dispersed. Moreover, the analysis of the interaction of securities litigation with financial structures in sections 3 and 4 has shown that it might be a relatively easy way of incentivizing monitoring. Given the relative scarcity of securities litigation in Continental systems with concentrated financial structures, one could even argue that strong private enforcement of securities law has not been tried where it might be most effective.

Given these structures, Continental Europe seems to have a sharp instrument available, but it first must muster the strength to pick it up. Private enforcement of securities law still faces more hurdles than in the United States, where securities class actions are common. Since these are based on an opt-out system, an entire class of plaintiffs is automatically involved, which creates a strong threat against the defendant.¹⁵⁷ The incentive structure is based on the idea of the “*private attorney general*”, in other words private enforcement with – hopefully beneficial – public effects.¹⁵⁸ The plaintiff attorney often receives a contingency fee of about 20-30% of the damages award or the settlement.¹⁵⁹ In combination with the American system of having each party

¹⁵⁴ Jackson & Roe, *supra* note 2.

¹⁵⁵ See also Rose, *supra* note 57, at 45-49 (suggesting that the SEC's new whistleblower program may undermine the need for securities class actions).

¹⁵⁶ See James D. Cox, Randell S. Thomas & Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L. J. 737, 763-77 (2003) (finding that the SEC tends to target smaller firms than class actions).

¹⁵⁷ E.g. Manning Gilbert Warren III, *The U.S. Securities Class Action: An Unlikely Export to the European Union*, 37 BROOK. J. INT'L L. 1075, 1082 (2012).

¹⁵⁸ E.g. Möllers, *supra* note 22, at 261; Fox, *supra* note 16, at 318-319; Gerard Hertig, Reinier Kraakman & Edward Rock, *Issuers and Investor Protection*, in ANATOMY OF CORPORATE LAW, *supra* note 6, at 275, 295-296.

¹⁵⁹ E.g. Park, *supra* note 16, at 348.

pay its own litigation cost independent of who wins the case, there are strong incentives to bring suits without particularly high risks for the plaintiff.¹⁶⁰ Moreover, pre-trial discovery permits the parties at a relatively early stage in the trial to ask the court to order the opponent to make pertinent information and documents accessible.¹⁶¹ Consequently, a claim that is good enough to survive an early motion to dismiss has a very high potential payoff. Punitive damages make securities class actions even more attractive.¹⁶²

This article does not seek to substantiate that securities class actions in the US are socially beneficial. Indeed, the very opposite may be the case, and plaintiff lawyers may well be able to earn significant rents. I have argued that issuer liability would be potentially more valuable in Continental Europe. The problem is, however, that securities lawsuits tend to be comparatively difficult, since the factors just listed tend to be absent in Europe.¹⁶³ Various wheels and cogs in the machine would have to be replaced to facilitate litigation and thus to harness the powers of issuer liability.

The social cost of liability is not harm to investors, but various allocative inefficiencies that are spread out across a variety of market participants.¹⁶⁴ Any compensation paid to investors should therefore be seen as a bounty awarded to the plaintiff who called out those who violated the rules of the market. Given the possible benefits for the capital market, the nuisance of some additional litigation by alleged “predatory shareholders” may be a relatively small price to pay to improve deterrence. Moreover, the stronger the deterrent effect, the fewer opportunities to sue there will be.

Notably, there have been steps in several jurisdictions, notably Germany,¹⁶⁵ the UK¹⁶⁶, and Italy¹⁶⁷, to facilitate collective lawsuits by investors. The Dutch Act on the Collective Settlement of Mass Claims of 2005 has maybe gone the farthest by allowing model suits brought by

¹⁶⁰ E.g. Möllers, *supra* note 22, at 267. The effects of the “English rule” of litigation risk should not be overestimated, since usually cost is reimbursed on the basis of the official rate set by the bar association. E.g. § 91 II ZPO (Germany); § 41 Abs 2 ZPO (Austria). See Martin Gelter, *Why do shareholder derivative suits remain rare in Continental Europe*, 37 BROOK. J. INT’L L. 843, 863-864 (2012) (discussing Germany, France, and Italy). Regarding the incentives set by damages awards, including punitive damages, see also Warren, *supra* note 157, at 1082.

¹⁶¹ FEDERAL RULES OF CIVIL PROCEDURE, Rule 26. See e.g. Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement*, ECGI WORKING PAPER. NO. 40, 50-51 (2005), <http://ssrn.com/abstract=730403>; Möllers, *supra* note 22, at 267; Nathan M. Crystal & Francesca Giannoni-Crystal, *Understanding Akzo Nobel: A Comparison of the Status of In-House Counsel, the Scope of the Attorney-Client Privilege, and Discovery in the U.S. and Europe*, 11 GLOBAL JURIST 1, 23-24 (2011); Warren, *id.*, at 1082.

¹⁶² Warren, *id.*, at 1082.

¹⁶³ For a comparison, see Warren, *id.*, at 1085-1087.

¹⁶⁴ Section 2.2 above.

¹⁶⁵ Germany introduced the KAPITALANLEGER-MUSTERVERFAHRENSGESETZ – KAPMUG (Law on Model Investor Litigation), BGBl I S. 2437, in 2005. The act was reformed in 2012, (BGBl. I S. 2182). Model litigation under the act does not truly provide a class action and still necessitates individual suits, but has the effect of an ascertainment of facts that are binding on parallel suits. The 2012 reform allows plaintiffs to register claims in order to avoid preclusion (§ 10 II KapMuG). E.g. Burkhard Schneider & Heiko Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, 2012 BETRIEBS-BERATER (BB) 2703, 2705.

¹⁶⁶ See Eilís Ferran, *Are US-Style Investor Suits Coming to the UK?* 9 J. CORP. L. STUD.315, 321-322 (2009) (pointing out that CIVIL PROCEDURE (AMENDMENT) RULES 2000, SI 2000/221), art. 9 and schedule 2 facilitate “case management of claims which give rise to common or related issues of fact or law by means of a group litigation order (GLO)”).

¹⁶⁷ Art. 140-bis CODICE DEL CONSUMO permits consumer associations or groups of consumers to initiate litigation, among others, against issuers. Individuals must opt in to participate. See Paolo Giudici, *Representative Litigation in Italian Capital Markets: Italian Derivative Suits and (if ever) Securities Class Actions*, 6 EUR. COMPANY & FIN. L. REV. 246, 258-264 (2009).

entities with the objective to represent specific interests (such as consumers or investors) requiring members of the group to opt out if they do not want to be bound by the decision.¹⁶⁸ In Austria, in several cases plaintiffs have assigned their claims to the Consumer Protection Association, which then enforced them in joint lawsuits.¹⁶⁹ Given that these European procedural laws' features do not resemble those of US class actions most inviting to abusive litigation (they are based on an opt-in model and do not provide contingency fees), the latter does not seem to be a large risk.

Generally, there is considerable skepticism regarding a further diffusion of the American class action model. Following the 2011 Public Consultation on Collective Redress,¹⁷⁰ the EU Commission issued a recommendation on the topic in 2013.¹⁷¹ In line with the responses to the consultation, the Commission advises against contingency fees, the "American rule" on litigation cost, punitive damages, and even an opt-out model.¹⁷² It may thus be more promising to use the Sarbanes-Oxley Act's "Fair Funds for Investors" rule as a model in securities law,¹⁷³ or, as suggested in the recommendation,¹⁷⁴ develop other litigation models that are primarily publicly funded, which could be based on existing models in the area of consumer protection, where consumer associations sometimes are given standing.¹⁷⁵

Politically, stronger securities litigation may be hard to come by in Europe. First, in Europe as in the US, there are of course often discussions about abusive litigation. To have a deterrent effect, litigation needs to be more than a nuisance to defendants. While there have been efforts to rein in securities class actions in the US,¹⁷⁶ maybe they were allowed to develop over the decades because they did not hurt those groups dominating business interest very much, while at the same time creating benefits for another powerful group, namely lawyers.

Second, the interest groups involved in corporate governance lawmaking differ between Europe and the US. While managers are obviously not thrilled about litigation based on their perceived wrongdoing on either side of the Atlantic, the ostensible beneficiaries are investors. Given how widespread share ownership is in the US, in part because of retirement savings, the interest of shareholders has in recent decades increasingly been identified with the public interest, which would have made it politically very difficult to abolish securities class actions.¹⁷⁷ Even if the ac-

¹⁶⁸ BURGERLIJK WETBOEK art. 3:305a; see Deborah R. Henssler, *The Future of Mass Litigation: Global Class Actions and Third-Party Litigation Funding*, 79 GEO. WASH. L. REV. 306, 310-320 (2011).

¹⁶⁹ Susanne Kalss, *Civil Law Protection of Investors in Austria – A Situation Report from Amidst a Wave of Investor Lawsuits*, 13 EUR. BUS. ORG. L. REV. 211, 215-217 (2012).

¹⁷⁰ See Public Consultation: Toward A Coherent Approach on Collective Redress, at http://ec.europa.eu/competition/consultations/2011_collective_redress/index_en.html.

¹⁷¹ Commission Recommendation of 11 June 2013 on common principles for injunctive and compensatory collective redress mechanisms in the Member States concerning violations of rights granted under Union Law, 2013/396/EU, 2013 O.J. L 201/60.

¹⁷² Commission Recommendation, *id.*, art. 13, 21, 29-31; see also Warren, *supra* note 157, at 1112 (summarizing the results of the public consultation responses); see also Stephan Madaus, *Die Kontrolle unternehmerischen Handels durch eine europäische class action – eine unmögliche Quadratur des Kreises*, in JAHRBUCH JUNGER ZIVILRECHTSWISSENSCHAFTLER 2010, 103, 114-115 (Daphne Aichberger-Beig et. al. eds. 2011) (suggesting that a toned-down European action that incorporates the critique of US class actions would have been ineffective).

¹⁷³ *Supra* notes 106-109 and accompanying text; Warren, *id.*, at 1109-1110.

¹⁷⁴ Art. 4-7.

¹⁷⁵ See Gerhard Wagner, *Collective Redress – Categories of Loss and Legislative Options*, 127 L.Q. Rev. 55, 57 (2011).

¹⁷⁶ Private Securities Litigation Reform Act of 1995, PUB. L. 104-67, 109 STAT. 737 (heightening pleading standards for 10b-5 suits).

¹⁷⁷ Bratton & Wachter, *supra* note 5, at 136-142.

tual governance effects of these lawsuits were negligible, the existence of a shareholder remedy may have created the perception of a functioning system and thus preempted more intrusive regulation.¹⁷⁸ In comparative perspective, share ownership does not have the political salience in much of Europe that it has in the US, in part because of the relatively small importance of securities markets over many decades, in part because of differences in the pension system.¹⁷⁹ Shareholders are not identified with the median voter. Moreover, there may be a second, more sinister force at work: Given the effects on how issuer liability shifts fraud risks on large shareholders and creditors, stronger shareholder litigation might actually have had a significant – and therefore unpleasant – deterrent effect than in the US. Political pressure from powerful corporate governance players may therefore be more strongly stacked against it.

6. Conclusion

This article has attempted to make two major points. First, the objective of liability for misstatements on the capital markets (including both prospectus liability and liability on secondary markets) cannot be compensation, but only deterrence. The optimal level of deterrence should therefore be at the center of policy debates.

Second, given the limitations of individual liability, issuer liability could be a powerful mechanism to deter securities fraud. Contrary to the situation in the US, where the penalty implicit in issuer liability is spread out across a diffuse mass of investors with little power to influence management, in Continental Europe there are often large shareholders with some preventative capability that could be incentivized to better select and monitor management. Even after 15 years of debate about convergence in corporate governance and some “unwinding” of blockholders in countries such as Germany¹⁸⁰, structures where large shareholders or coalitions of shareholders dominate firms persist to a significant degree across the Continent. Even in the UK, where steps to facilitate investor suits have been taken in recent years, share ownership is less dispersed than in the US, which might create some potential for socially valuable litigation.

If issuer liability’s function is rather public than private, there is an argument that it should be replaced with stronger regulation.¹⁸¹ Arguably, criminal enforcement in the US has become significantly more effective since the Sarbanes-Oxley Act was passed.¹⁸² The effects of regulation, however, depend on how well regulators are endowed. It seems more persuasive to see regulation and litigation as two complementary forms of enforcement. Weaker liability may be compensated by stronger regulation, and vice versa.

¹⁷⁸ Bratton & Wachter, *supra* note 5, at 147.

¹⁷⁹ Gelter, *supra* note 80, at 963-968.

¹⁸⁰ *Supra* note 149 and accompanying text.

¹⁸¹ *Cf.* Fox, *supra* note 16, at 319-320 (expressing skepticism from the perspective of a cost-benefit analysis).

¹⁸² Bratton & Wachter, *supra* note 5, at 115-117.

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