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Risk-shifting Through Issuer Liability and Corporate Monitoring

Martin Gelter*

Abstract
This article explores how issuer liability re-allocates 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 undermine 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 risk-shifting effect also has implications for the debate

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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 incentivise 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.

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 analysing 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 other core 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 commentators in the US believe that securities class actions serve no useful purpose, in part for reasons that are explored in this article.

Civil liability for misinformation in the capital markets has already appeared on the radar of EU law. Art. 6(1) of the Prospectus Directive[3] requires that Member

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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 and Andrei Shleifer, 'What Works in Securities Law?', 61 *Journal of Finance* (2006) p. 1; but see Howell Jackson and Mark J. Roe, 'Public and Private Enforcement of Securities Laws: Resource-based Evidence', 93 *Journal of Financial Economics* (2009) p. 207 (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 on La Porta, et al.'s Methodology', 16 *International Company and Commercial Law Review* (2005) p. 300 (criticising La Porta, et al.'s way of coding law).

3 Directive 2003/71/EC of the European Parliament and of 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, *OJ* 2004 L 345/64.

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 Directive[4] 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 hold either the issuing company or individuals that are 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, as 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

[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 *OJ* L 390/38.

[5] E.g., William W. Bratton and Michael L. Wachter, 'The Political Economy of Fraud on the Market', 160 *University of Pennsylvania Law Review* (2011) p. 69, at p. 72 ('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 and Reinier Kraakman, 'What is Corporate Law?', in Reinier Kraakman, et al., *The Anatomy of Corporate Law*, 2nd edn. (Oxford University Press 2009) p. 1, at pp. 29-32 (surveying patterns of corporate ownership).

fraud risk onto 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 on the extent to which creditors' claims should enjoy precedence over shareholders' claims for securities fraud.[7] In 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 be well 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 re-allocates 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 holds only against the backdrop of dispersed ownership, which is why it does not fully apply in Europe. Section 4 looks at how issuer liability allocates fraud risk between different groups of shareholders and creditors and how it 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 to overcome in the political economy of corporate governance. Section 6 concludes.

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

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

[9] *Morrison* v. *National 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 *Georgetown Journal of International Law* (2013) p. 411, at pp. 442-451.

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 because 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 liability[13] because of three aspects of circularity: 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]

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[10] E.g., Steven Shavell, *Foundations of Economic Analysis of Law* (Belknap Press of Harvard University Press 2004), at pp. 257-258.

[11] In the absence of tort law, a risk-averse potential claimant could eliminate risk by taking out insurance. E.g., Shavell, *idem*, at p. 268. To some extent, this raises the distributive question of which party can get insurance for a lower price. See, e.g., Gerhard Wagner, 5 *Münchener Kommentar zum BGB*, 5th edn. (C.H. Beck 2009), Vor § 823, ¶54-55 (pointing out this distributive consequence of tort law).

[12] Shavell, *idem*, at pp. 268-269 (discussing the 'development of insurance markets in the latter part of the nineteenth century'); see also Jean-Sébastian Borghetti, 'The Culture of Tort Law in France', 3 *Journal of European Tort Law* (2012) p. 158, at p. 164 (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 *Columbia Law Review* (2008) p. 1301, at pp. 1302-1303 ('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 *Arizona Law Review* (1997) p. 497, at pp. 509-515.

[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 they 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-*

In 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 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]

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und Wirtschaftsrecht (2003) p. 139, at p. 167 (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 *Arizona Law Review* (1996) p. 646; John C. Coffee Jr, 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation', 106 *Columbia Law Review* (2006) p. 1534, at p. 1556; James J. Park, 'Shareholder Compensation as Dividend', 108 *Michigan Law Review* (2009) p. 323, at p. 331; Merritt B. Fox, 'Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?', *Wisconsin Law Review* (2009) p. 297, at p. 302; Bratton and Wachter, *supra* n. 5, at p. 94.

17 Fox, *idem*, at p. 303, in footnote 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. See also Paul Davies, 'Liability for Misstatements to the Market: Some Reflections', 9 *Journal of Corporate Law Studies* (2009) p. 295, at pp. 299-300.

18 Fox, *idem*, at pp. 304-305; Langevoort, *supra* n. 16, at p. 649.

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

20 Frank H. Easterbrook and Daniel R. Fischel, 'Optimal Damages in Securities Cases', 52 *University of Chicago Law Review* (1985) p. 611, at p. 639; Park, *supra* n. 16, at p. 332. See also Jill E. Fisch, 'Confronting the Circularity Problem in Private Securities Regulation', *Wisconsin Law Review* (2009) p. 333, at p. 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, *supra* n. 16, at p. 330; see also Richard A. Booth, 'The Future of Securities Litigation', 4 *Journal of Business & Technology Law* (2009) p. 129, at p. 140. The reputational loss may exceed the actual payment by far and develop as the consequence of public scrutiny independently of a suit. E.g., Amanda M. Rose and Richard Squire, 'Intraportfolio Litigation', 105 *Northwestern University Law Review* (2011) p. 1679, at p. 1703 (referring to the empirical literature).

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 has 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 reduction benefits of frequent

[22] Park, *supra* n. 16, at pp. 328-329; see also Janet Cooper Alexander, 'Rethinking Damages in Securities Class Actions', 48 *Stanford Law Review* (1996) p. 1487, at p. 1502; Fox, *supra* n. 16, at pp. 307-308; Fisch, *supra* n. 20, at p. 337; Booth, *supra* n. 21, at p. 139; Davies, *supra* n. 17, at p. 300; cf. in Germany, Alexander Hellgardt, *Kapitalmarktdeliktsrecht* (Mohr Siebeck 2008), at p. 141; 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', 20 *European Business Law Review* (2009) p. 243, at p. 265 (rejecting the argument on grounds of 'equalising justice'). See Coffee, *supra* n. 16, at p. 1558 (giving the example of a pension fund with stakes in 1000 corporations, 100 of which are sued over a certain time period, where the fund is a plaintiff in 50 cases and a holding shareholder in the other 50).

[23] Fox, *supra* n. 16, at p. 307; Bratton and Wachter, *supra* n. 5, at pp. 94-96. An empirical study commissioned by the US Chamber of Commerce seems to confirm the diversification argument for institutional investors, see Anjan V. Thakor, Jeffrey S. Nielsen and David A. Gullay, 'The Economic Reality of Securities Class Action Regulation' (2005), at pp. 13-15 (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 and Randall S. Thomas, 'Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law', 6 *European Company and Financial Law Review* (2009) p. 180, n. 42 (criticising the lack of disclosure of the identity of the firms included in the Thakor, et al. study).

[24] Booth, *supra* n. 21, at pp. 139-140; Richard A. Booth, 'The End of Securities Fraud as We Know It', 4 *Berkeley Business Law Journal* (2007) p. 1, at p. 17.

[25] Park, *supra* n. 16, at pp. 342-344; see also Fisch, *supra* n. 20, at p. 347; but see Booth, *idem*, at p. 16 (contending that information traders often have widely spread portfolios); Cox and Thomas, *supra* n. 23, at pp. 176-177 (discussing hedge funds).

[26] E.g., Booth, *supra* n. 24, at pp. 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, *idem*, at p. 15; Cox and Thomas, *supra* n. 23, at p. 176. Retail investors may not always be able to adequately diversify. See, e.g., Alicia Davis Evans, 'The Investor Compensation Fund', 33 *Journal of Corporation Law* (2007) p. 223, at pp. 234-236.

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 incentivise actors to take appropriate care, which the basic law and economics model of issuer liability would normally postulate.[32]

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[27] Evans, idem, at pp. 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), available at: <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* n. 16, at pp. 649-650; Coffee, *supra* n. 16, at pp. 1559-1560; Bratton and Wachter, *supra* n. 5, at p. 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, *supra* n. 16, at p. 1560. The problem seems even greater for employees who are required to hold on to their shares. Booth, *supra* n. 24, at p. 15.

[29] E.g., Booth, *supra* n. 21, at p. 147; Alexander, *supra* n. 22, at p. 1502; see also Fox, *supra* n. 16, at p. 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 and Gideon Parchomovsky, 'The Essential Role of Securities Regulation', 55 *Duke Law Journal* (2006) p. 711.

[31] But see Georg Eckert, 'Emittentenhaftung für fehlerhafte Kapitalmarktinformation und aktienrechtliche Kapitalerhaltung', *GesRZ* (2010) p. 88, at p. 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 internalise social cost, see, e.g., Shavell, *supra* n. 10, at p. 178. Robert Cooter and Thomas Ulen, *Law and Economics*, 3rd edn. (Addison

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 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

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Wesley Longman 2000), at pp. 300-302; Robert Cooter, 'Prices and Sanctions', 84 *Columbia Law Review* (1984) p. 1523, at p. 1532; A. Mitchell Polinsky and Steven Shavell, 'Punitive Damages: An Economic Analysis', 111 *Harvard Law Review* (1998) p. 869, at pp. 874 and 887-896. 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* (Jan Sramek Verlag 2013), ¶3/5. This is not persuasive because economic analysis does not even purport to strive for complete deterrence.

33 E.g., Hellgardt, *supra* n. 22, at p. 366; Amanda M. Rose, 'The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis', 158 *University of Pennsylvania Law Review* (2010) p. 2173, at pp. 2188-2189 (discussing the issue in the context of securities markets).

34 For a comparative overview, see Klaus J. Hopt and Hans-Christoph Voigt, 'Grundsatz- und Reformprobleme der Prospekt- und Kapitalmarktinformationshaftung', in Klaus J. Hopt and Hans-Christoph Voigt, eds., *Prospekt- und Kapitalmarktinformationshaftung* (Mohr Siebeck 2005) p. 9, at pp. 86-89.

35 E.g. Richard A. Posner, 'Law and the Theory of Finance: Some Intersections', 54 *George Washington Law Review* (1986) p. 159, at pp. 169-170; Paul G. Mahoney, 'Precaution Cost and the Law of Fraud in Impersonal Markets', 78 *Virginia Law Review* (1992) p. 623, at pp. 629-630; Fox, *supra* n. 16, at p. 302; Hopt and Voigt, *supra* n. 34, at p. 56; Thomas M.J. Möllers and Franz Clemens Leisch, in *Kölner Kommentar zum WpHG* (Carl Heymanns 2007) § 37b, c ¶274; Hellgardt, *supra* n. 22, at pp. 140-141 (all discussing the secondary market); Marcel Kahan, 'Securities Laws and the Social Costs of "Inaccurate" Stock Prices', 41 *Duke Law Journal* (1992) p. 977, at pp. 1006-1007.

36 Andreas Schönenberger, *Ökonomische Analyse der Notwendigkeit und Effizienz des börsengesetzlichen Haftungsregimes* (Nomos-Universitätsschriften 2000), at pp. 106-107. 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* n. 10, at p. 12 (discussing reduced incentives to invest in the absence of property rights); Dean Lueck and Thomas J. Miceli, 'Property Law', in A. Mitchell Polinsky and Steven Shavell, eds., *Handbook of Law and Economics*, Vol. 1 (Elsevier 2007) p. 184, at p. 229 (discussing the 'efficient theft' argument and the social cost of theft).

37 Posner, *supra* n. 35, at p. 170; Easterbrook and Fischel, *supra* n. 20, at p. 623; Mahoney, *supra* n. 35, at p. 631.

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 favourably than they should be by all markets in which they operate, including the managerial labour market,[43] the executive compensation market[44] and the takeover market.[45] Fifth, 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 favourable 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]

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[38] Posner, *supra* n. 35; Easterbrook and Fischel, *supra* n. 20; Mahoney, *supra* n. 35, at pp. 629-630; Hellgardt, *supra* n. 22, at p. 142; see also Rose, *supra* n. 33, at p. 2179 (discussing the possibility to get information from other sources); Evans, *supra* n. 26, at p. 231 (pointing out that institutional investors spend considerable time analysing financial information, which may not be completely rational given their high degree of diversification); Davis, *supra* n. 27.

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

[40] Posner, *supra* n. 35, at p. 170; see also Kahan, *supra* n. 35, at pp. 1026-1027; Hellgardt, *supra* n. 22, at p. 142.

[41] Rose, *supra* n. 33, at p. 2179.

[42] Mahoney, *supra* n. 35, at p. 634; Rose, *supra* n. 33, at p. 2179.

[43] See Cox, *supra* n. 13, at p. 510; Coffee, *supra* n. 16, at p. 1562; Jennifer H. Arlen and William J. Carney, 'Vicarious Liability for Fraud on Securities Market: Theory and Evidence', *University of Illinois Law Review* (1992) p. 691, at pp. 702-703 and 720-734 (lending empirical support to this thesis).

[44] Rose, *supra* n. 33, at p. 2182; see also Coffee, *supra* n. 16, at pp. 1572-1573 (pointing out managers' incentives to front-load profits in order to gain from high stock prices).

[45] Kahan, *supra* n. 35, at pp. 1035-1037; Mahoney, *supra* n. 35, at p. 634.

[46] Urska Velikonja, 'The Cost of Securities Fraud', 54 *William and Mary Law Review* (2013) p. 1887, at pp. 1915-1929.

[47] Velikonja, *idem*, at pp. 1916-1923.

[48] Velikonja, *idem*, at p. 1919.

2.3 Insufficient incentives for deterrence

The bottom line from the mismatch between social cost and the plaintiffs' injury is that compensation as such sets 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 be 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 much 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.

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]

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

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

51 E.g., Arlen and Carney, *supra* n. 43, at pp. 692 and 718; Urska Velikonja, 'Leverage, Sanctions, and Deterrence of Accounting Fraud', 44 *UC Davis Law Review* (2011) p. 1281, at p. 1340 ('there is no social value in aggressive accounting').

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

53 Arlen and Carney, *supra* n. 43, at pp. 715 and 725; Cox, *supra* n. 13, at p. 510; Langevoort, *supra* n. 16, at p. 654.

54 Velikonja, *supra* n. 51, at p. 1340; but see Davies, *supra* n. 17, at pp. 301-304 (suggesting that liability may overdeter if a negligence standard applies, which may discourage voluntary disclosures).

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] Normally, 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 extinguishes not only 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 dispersed ownership.[61] However, empirical research by Baker and Griffith shows that securities claims in the US

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55 Langevoort, *supra* n. 16, at p. 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 liable, including managers and signatories of the registration statement); Securities Exchange Act § 20(a) (providing for 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 possible at all, have to be based on general civil law. See Wolfgang Gross, *Kapitalmarktrecht*, 5th edn. (C.H. Beck 2012) § 21 WpPG ¶35. For the very similar Austrian situation under § 11 KMG, see Friedrich Rüffler, 'Organaußenhaftung für Anlegerschäden', 133 *Juristische Blätter (JBl)* (2011) p. 69; for a comparative overview, see Hopt and Voigt, *supra* n. 34, at pp. 120-121.

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

57 Coffee, *supra* n. 16, at p. 1551; see also Alexander, *supra* n. 22, at p. 1498. But see Davies, *supra* n. 17, at p. 301 (suggesting that reputational effects of lawsuits may deter wrongdoing); Amanda M. Rose, 'Better Bounty Hunting: How the SEC's New Whistleblower Program Changes the Securities Fraud Class Action Debate', Vanderbilt University Law School Public Law and Legal Theory Working Paper 13-34 (2013), at p. 18 (suggesting that personal stock ownership and possible reputational losses may incentivise directors to avoid fraud).

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

59 Coffee, *supra* n. 16, at p. 1570 (suggesting that 90% of issuers were covered in 2002). See also Tom Baker and Sean J. Griffith, *Ensuring Corporate Misconduct* (University of Chicago Press 2010), at p. 46.

60 Baker and Griffith, *idem*, at pp. 60-61.

61 Cf. Arlen and Carney, *supra* n. 43, at p. 712.

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 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 incentivise management to avoid providing false information to the 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 investigate this possibility. Specifically, I argue that different financial structures make a difference for the effects of issuer liability and that the apparent 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

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[62] See Tom Baker and Sean J. Griffith, 'How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements', 157 *University of Pennsylvania Law Review* (2009) p. 755, at pp. 760-761. See also Fox, *supra* n. 16, at p. 305; Cox, *supra* n. 13, at p. 512 (finding that the settlement amount is covered by insurance in 96% of cases); Bratton and Wachter, *supra* n. 5, at p. 100; Baker and Griffith, *supra* n. 59, at p. 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).

[63] Baker and Griffith, *idem*, at pp. 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', *Wisconsin Law Review* (2009) p. 455, at p. 462.

[64] Arlen and Carney, *supra* n. 43, at p. 707; see also Sharon Oded, 'Inducing Corporate Compliance: A Compound Corporate Liability Regime', 31 *International Review of Law and Economics* (2011) p. 272, at pp. 273-275 (discussing the role of corporate liability for compliance; but see Reinier Kraakman, 'Corporate Liability Strategies and the Costs of Legal Control', 93 *Yale Law Journal* (1984) p. 857, at pp. 867-888 (discussing individual liability as a back-up making up for insufficiency of sanctions imposed on the firm).

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 whom 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 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 scepticism about the monitoring capabilities of corporate boards abounds today.[72] In the context of securities litiga-

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

66 Arlen and Carney, *supra* n. 43, at p. 710.

67 *Idem*, at pp. 711-712; see also Fox, *supra* n. 16, at p. 281 (favouring individual liability).

68 Jeffrey N. Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices', 59 *Stanford Law Review* (2007) p. 1465, at pp. 1472-1509.

69 Cox, *supra* n. 13, at pp. 511-512.

70 Gordon, *supra* n. 68, at pp. 1504-1505 (summarising empirical evidence).

71 Eric Helland, 'Reputational Penalties and the Merits of Class-Action Securities Litigation', 49 *Journal of Law and Economics* (2006) p. 365.

72 E.g., Donald C. Clarke, 'Three Concepts of the Independent Director', 32 *Delaware Journal of Corporate Law* (2007) p. 73, at p. 75 ('The overall weight of the findings is that there is no solid evidence suggesting that independent directors improve corporate performance'); Velikonja, *supra* n. 51, at p. 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 Law Review* (2011) p. 783, pp. 796-797; Stephen M. Bainbridge and M. Todd Henderson, 'Boards-R-Us: Reconceptualizing Corporate Boards', at pp. 20-26, available at: <http://ssrn.com/abstract=2291065> (discussing problems of the board); in the context of securities violations, Langevoort, *supra* n. 16, at pp. 654-655.

tion, the general view in the US is therefore that issuer liability does not create better deterrence than does individual liability.[73]

One could theorise 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 a 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 are 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 this is the case depends of course strongly on whether they have the appropriate incentives and on 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 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

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

[74] Posner, *supra* n. 35, at pp. 169-170.

[75] Arlen and Carney, *supra* n. 43, at p. 714.

[76] Cox, *supra* n. 13, at p. 511; Fox, *supra* n. 16, at p. 303, n. 6.

[77] Arlen and Carney, *supra* n. 43, at p. 693; see, generally, Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance', 52 *Journal of Finance* (1997) p. 737, at pp. 740-744.

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 apparent 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 shareholder 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 summarise, we can say that 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

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78 E.g., Armour, et al., *supra* n. 6, at p. 29 (noting the prevalence of dispersed ownership in the US); see also Rose and Squire, *supra* n. 21, at p. 1689 (noting that 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 *Review of Financial Studies* (2009) p. 1377 (controversially suggesting that dispersed ownership is a myth).

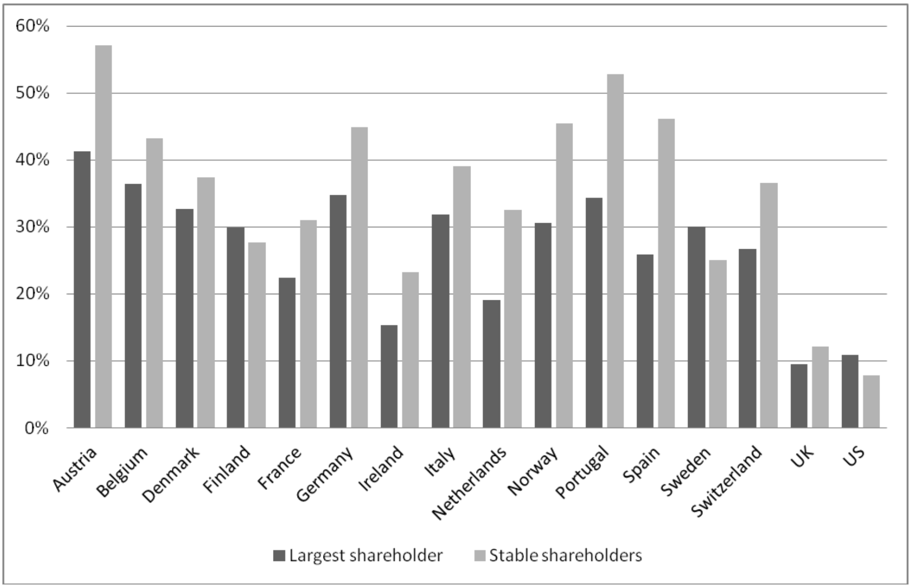
80 E.g., Ronald J. Gilson and Jeffrey N. Gordon, 'The Agency Cost of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', 113 *Columbia Law Review* (2013) p. 863, at pp. 886-888; Martin Gelter, 'The Pension System and the Rise of Shareholder Primacy', 43 *Seton Hall Law Review* (2013) p. 909, at p. 954.

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 *Delaware Journal of Corporate Law* (2005) p. 673, at p. 687 (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 *Journal of Corporation Law* (2009) p. 843.

82 E.g., Marco Becht and Alisa Roëll, 'Blockholdings in Europe: An International Comparison', 43 *European Economic Review* (1999) p. 1049; Raphael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Corporate Ownership Around the World', 54 *Journal of Finance* (1999) p. 471; Mara Faccio and Larry H.P. Lang, 'The Ultimate Ownership of Western European Corporations', 65 *Journal of Financial Economics* (2002) p. 365, at pp. 379-380; Peter A. Gourevitch and James Shinn, *Political Power and Corporate Control* (Princeton University Press 2005), at p. 18 (creating an index for concentration of stock ownership in different countries).

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.

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 its assets when the corporation has to make a large damages payment. The incentives to prevent mis-

[83] Data from Pepper D. Culpepper, *Quiet Politics and Business Power* (Cambridge University Press 2011), at pp. 31-32. The higher share of stable shareholders compared to the largest ones 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 data.

[84] E.g., Shleifer and Vishny, *supra* n. 77, at p. 754; Ronald J. Gilson and Jeffrey N. Gordon, 'Controlling Shareholders', 152 *University of Pennsylvania Law Review* (2004) p. 785, at pp. 785-786; Alex Edmans, 'Blockholders and Corporate Governance' (2013), at p. 3, available at: <http://ssrn.com/abstract=2285781>.

conduct 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 are in fact often capable of influencing the board and management. 'Core shareholders' are not only often informally consulted before important transactions, but are typically also represented on the board with one or more confidants.[85] In much of Continental Europe, a non-compliant director or officer would, for example, risk being removed and replaced by the firm's large shareholder.[86] If there is single controlling shareholder, the firm may even be characterised by a 'command and control' system, in which management has little power.[87]

Large shareholders thus not only monitor, but are 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 often 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 have both 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, it will suffer from the award or settlement and therefore have stronger incentives to either monitor or refrain from fraud.

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[85] E.g., Johannes Semler, 'The Practice of the German Aufsichtsrat', in Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch and Stefan Prigge, eds., *Comparative Corporate Governance. The State of the Art and Emerging Research* (Oxford University Press 1998) p. 267, at p. 269 (describing how supervisory board members are often nominated by shareholders); Claus Luttermann and Jean J. du Plessis, 'Banking on Trust: The German Financial Sector, Global Capital Markets and Corporate Finance and Governance', in Jean J. du Plessis, et al., *German Corporate Governance in International and European Context*, 2nd edn. (Springer 2012) p. 329, at pp. 335-336 (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 *Harvard International Law Journal* (2009) p. 129, at pp. 156-161, and Sofie Cools, 'Europe's Ius Commune on Director Revocability', 8 *European Company and Financial Law Review* (2011) p. 199, at pp. 204-205 (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 *Oxford Review of Economic Policy* (2005) p. 198, at p. 204.

[88] E.g., Ronald J. Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy', 119 *Harvard Law Review* (2006) p. 1641, at p. 1651.

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

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 favour 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 and to a large extent borne by the original 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

[90] E.g., Easterbrook and Fischel, *supra* n. 20, at pp. 638-639; see also Coffee, *supra* n. 16, at p. 1556; Booth, *supra* n. 24, at p. 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 of the remedy himself if he remains a shareholder of the issuer.

between controlling shareholders and outside investors. A controlling shareholder might not favour a strong disclosure regime that reduces opportunities to obtain private benefits of control through tunnelling.[92] Consequently, it may not be interested in insurance that actually improves monitoring in the firm, since it 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 do not. 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 its 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]

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[92] Allen Ferrell, 'The Case for Mandatory Disclosure in Securities Regulation Around the World', 2 *Brooklyn Journal of Business Law* (2007) p. 81, at pp. 87-92.

[93] Tom Baker and Sean J. Griffith, 'Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market', 74 *University Of Chicago Law Review* (2007) p. 487, at p. 522.

[94] E.g., Lucian Arye Bebchuk, Reinier Kraakman and George Triantis, 'Stock Pyramids, Cross-Ownership, and Dual-Class Equity', in Randall K. Morck, ed., *Concentrated Corporate Ownership* (University of Chicago Press 2000) p. 295, at pp. 297-301; Luca Enriques and Paolo Volpin, 'Corporate Governance Reforms in Continental Europe', 117 *Journal of Economic Perspectives* (2007) p. 117, at pp. 119-121 (discussing examples of pyramids).

[95] See, e.g., La Porta, et al, *supra* n. 82, at pp. 498-500 and 511 (concluding that, while pyramids are common, the magnitude of deviations from the one-share-one-vote ideal tends to be small); Julian Franks and Colin Mayer, 'Ownership and Control of German Corporations', 14 *Review of Financial Studies* (2001) p. 943, at pp. 950-951 (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* (2001) p. 257, at pp. 280-281 (reporting that in only 10% of a sample of 5788 German manufacturing firms with a pyramidal structure the ratio of cash flow rights to voting rights was less than 75%); Faccio and Lang, *supra* n. 82, at p. 392 (reporting mean ratios of cash flow to

Second, if firm A is at the bottom of a pyramid, a large damages 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. This might also affect the reputation and personal wealth of B's managers, 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 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 publicised (when the shareholder possibly benefits from it) is still the same at the time when a liability payment is made (and thus 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, the remedy will set no incentive effects for the seller if the falsity of the information is not yet known and thus does not affect the sales price. Moreover, the threat of liability could conceivably create an incentive to sell all shares as quickly as possible before the inaccuracy of the publicised information has been revealed.

Most likely, these cases reduce the social utility of issuer liability but do not eliminate it completely. First, a 'departing' large shareholder can be expected to 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 it does not, the selling blockholder might still be exposed to a contractual remedy if vital information was not made available to the buyer.

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control rights between .740 and .941 for 13 Western European countries); Roberto Barontini and Lorenzo Caprio, 'The Effect of Family Control on Firm Value and Performance. Evidence from Continental Europe', 12 *European Financial Management* (2006) p. 689, at p. 698 (reporting an average wedge of 6.8% between voting and control rights).

[96] For a similar argument in the context of actions harming employees, see Gelter, *supra* n. 86, at p. 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.

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 if not, a large volume of sales during a short period will normally reduce prices and alert investors. Moreover, a large shareholder will partly internalise the fraud risk through the insurance premia paid by the corporation long before a securities lawsuit materialises.[99] A large shareholder will want this risk to be low in order to minimise 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 mechanism and the persistence of concentrated ownership; we 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 for large shareholders to monitor. 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

98 Coffee, *supra* n. 87, at pp. 204-205.

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

'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 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 which the SEC 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 their 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]

In recent years, US law has to some extent moved away from the policy of deprioritising defrauded investors. § 308(a) of the Sarbanes-Oxley Act of 2002[106] created a 'Fair Funds for Investors' provision 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

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[100] E.g., Jessica Ansell Hauser, 'Nonconsensual Repeal of Third-Party Beneficiary Contract Rights: Senior Creditors under Subordination Agreements', 8 *Cardozo Law Review* (1987) p. 1227. Until the 1984 amendments, claims arising from the acquisition of stock were even subordinated to the stock itself. See, e.g., *Collier on Bankruptcy*, 16th edn. (LexisNexis 2012) P.510.LH (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 and Homer Kripke, 'The Interface Between Securities Regulation and Bankruptcy – Allocating the Risk between Securityholders and the Issuer's Creditors', 48 *NYU Law Review* (1973) p. 261, at pp. 283-284; Kenneth B. Davis Jr, 'The Status of Defrauded Securityholders in Corporate Bankruptcy', *Duke Law Journal* (1983) p. 1, at p. 8. Prior cases of appellate courts had subordinated investors' claims. See Slain and Kripke, *idem*, at pp. 272-279; Davis, *idem*, at pp. 4-7.

[102] Slain and Kripke, *supra* n. 101, at p. 261. Regarding the article's influence on the legislation, see H.R. 595-95 (1977) 194-196 (citing the article); Davis, *supra* n. 101, at pp. 10-11; Hauser, *supra* n. 100, at p. 1244.

[103] Slain and Kripke, *supra* n. 101, at pp. 286-287.

[104] *Idem*, at pp. 288-291; *contra* Davis, *supra* n. 101, at pp. 19-24.

[105] Daniel C. Cohn, 'Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code', 56 *American Bankruptcy Law Journal* (1982) p. 293, at pp. 299-300; Davis, *supra* n. 101, at pp. 34-43; Nicholas L. Georgakopoulos, 'Strange Subordinations: Correcting Bankruptcy's § 510(b)', 6 *Bankruptcy Developments Journal* (1999) p. 91, at p. 95.

[106] Public Law 107-204, 30 July 2002.

have recognised 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 criticised that the provision undermines the purposes of subordination under bankruptcy law.[109]

4.2 Distribution of risk among shareholders and creditors

There are parallel discussions in several European countries. Interestingly, the question is not framed as one of subordination of investors' claims, but as one 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, in recent years, the courts have allowed issuer liability to go forward in spite of these objections,[111] as well as in Denmark,[112] Norway[113] and Sweden.[114] In the Nordic

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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 and Michael E. Wiles, 'At the Crossroads: The Intersection of the Federal Securities Laws and the Bankruptcy Code', 63 *Business Lawyer* (2007) p. 125, at pp. 141-145.

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* n. 107, at pp. 141 and 145; Zack Christensen, 'The Fair Funds for Investors Provision of Sarbanes-Oxley: Is It Unfair to Creditors of a Bankrupt Debtor?', *University of Illinois Law Review* (2005) p. 339, at pp. 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 Bankruptcy Developments Journal* (2004) p. 259, at pp. 293-300 (apparently favouring subordination).

110 A comparative overview is provided by Hopt and Voigt, *supra* n. 34, at pp. 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 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', 13 *European Business Law Review* (2002) p. 323, at pp. 329-330; *idem*, 'From Caveat Emptor to Caveat Venditor – The Winding Road to Prospectus Liability in Scandinavian Countries', *Journal of Business Law* (2003) p. 91, at pp. 97-98; Paul Krüger Andersen, 'Denmark', in Hopt and Voigt, eds., *supra* n. 34, at pp. 401 and 411.

113 Sandeberg, 'Prospectus Liability', *idem*, at p. 330; Sandeberg, 'Caveat Emptor', *idem*, at pp. 97-98.

114 Sandeberg, 'Prospectus Liability', *idem*, at p. 329; Sandeberg, 'Caveat Emptor', *idem*, at p. 98; Rolf Skog, 'Sweden', in Hopt and Voigt, eds., *supra* n. 34, p. 935, at pp. 939-940; see also Fabian Walla, 'The Swedish Capital Markets Law from a European Perspective', 22 *European Business Law Review* (2012) p. 211, at p. 220.

countries, creditor interests have traditionally been given preference,[115] and in Sweden it was still not clear in 2012 whether the issuer can be liable at all.[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 often pointed out as well, particularly in the German-speaking countries, that corporate law is also characterised 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 Article 12 of the recodified First Directive,[120] at least to some extent, as it restricts 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 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 favoured issuer liability,[122] some scholars seem to prefer 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

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115 Sandeberg, 'Prospectus Liability', *supra* n. 112, at pp. 323 and 333-334; Sandeberg, 'Caveat Emptor', *idem*, at pp. 92-93 and 101.

116 Walla, *supra* n. 114, at p. 220.

117 E.g., Walter Bayer, 'Emittentenhaftung versus Kapitalerhaltung', 67 *Wertpapier-Mitteilungen* (2013) p. 961, at p. 961.

118 In the context of issuer liability, see Carsten Schäfer, 'Kapitalmarktinformationshaftung und die Lehre vom fehlerhaften Verband', 33 *Zeitschrift für Wirtschaftsrecht (ZIP)* (2012) p. 2421.

119 Christoph Andreas Weber, 'Kapitalmarktinformationshaftung und gesellschaftsrechtliche Kapitalbindung – ein einheitliches Problem mit rechtsformübergreifender Lösung?', 176 *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht (ZHR)* (2012) p. 184, at p. 193.

120 Directive 2009/101/EC of the European Parliament and of 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 *OJ* 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* n. 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* (De Gruyter 2003) p. 817, at pp. 826-827; Carsten Schäfer, 'Effektivere Vorstandshaftung für Fehlinformation des Kapitalmarkts?', *Neue Zeitschrift für Gesellschaftsrecht* (2005) p. 985; Michael Gruber, 'Prospekthaftung der AG versus Kapitalerhaltung', *GesRZ* (2010) p. 73, at p. 75; Eckert, *supra* n. 31, at p. 98.

other words, only funds that would otherwise be available for a dividend could be awarded to plaintiffs.[124] Some authors have favoured subordination of investor claims (following US law).[125] The question arises not only on the level of national corporate laws, but also on that of EU law, which enshrines the prohibition against distributions to shareholders outside dividends in Article 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 German[128] and Austrian courts[129] 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-shareholder 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 prioritise issuer liability sometimes argue that creditors cannot expect capital

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124 E.g., Susanne Kalss, *Anlegerinteressen* (Springer 2001), at p. 221; Rüdiger Veil, 'Die Ad-hoc-Publizitätshaftung im System kapitalmarktrechtlicher Informationshaftung', 167 *ZHR* (2003) p. 365, at p. 395; Peter Doralt and Martin Winner, *Münchener Kommentar zum Aktiengesetz*, Vol. 1, 3rd edn. (C.H. Beck 2008) § 57 ¶261.

125 E.g., Baums, *supra* n. 15, at p. 170; Katja Langenbucher, 'Kapitalerhaltung und Kapitalmarkthaftung', *ZIP* (2005) p. 239, at pp. 244-245.

126 Günter H. Roth, 'Kapitalerhaltung versus Prospekthaftung: Die europäischen Richtlinien', 134 *Juristische Blätter (JBl)* (2012) p. 73, at p. 74; Weber, *supra* n. 119, at p. 188.

127 *Supra* n. 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 which the *lex posterior*. E.g., Walter Bayer, in Doralt and Winner, *supra* n. 124, § 57 ¶20. 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* n. 117, at pp. 966-967.

132 Hopt and Voigt, *supra* n. 34, at p. 63. See also Möllers and Leisch, *supra* n. 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 makes taking out credit marginally easier. See Weber, *supra* n. 119, at p. 201 (pointing out that creditors, like shareholders, are capable of adjusting on the market).

133 E.g., Luca Enriques and Jonathan R. Macey, 'Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules', 86 *Cornell Law Review* (2001) p. 1165, at p. 1186.

not to be dissipated by issuer liability claims, as they cannot rely on its protection from any other managerial actions.[134] As we shall see shortly, applying the capital maintenance principle to issuer liability clearly would have a redistributive effect that changes 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 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 the risk that investors are defrauded if only the issuer is available as a defendant, namely either creditors or those 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 of equity and should therefore 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]

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134 Baums, *supra* n. 15, at p. 169; Holger Fleischer, 'Konturen der kapitalmarktrechtlichen Informationsdeliktshaftung', 26 *ZIP* (2005) p. 1805, at p. 1811; Matthias Casper, 'Haftung für fehlerhafte Information des Kapitalmarktes', *Der Konzern* (2006) p. 32, at p. 37.

135 E.g., Enriques and Macey, *supra* n. 133, at pp. 1188-1195; John Armour, 'Legal Capital: An Outdated Concept?', 7 *European Business Organization Law Review (EBOR)* (2006) p. 5, at pp. 16-17. 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* (Nomos 2007), at pp. 170-171. 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. Mülbert and Max Birke, 'Legal Capital – Is There a Case Against the European Legal Capital Rules', 3 *EBOR* (2002) p. 695, at pp. 705-706; Luca Enriques and Martin Gelter, 'Regulatory Competition in European Company Law and Creditor Protection', 7 *EBOR* (2006) p. 417, at pp. 426-427; Thomas Bachner, *Creditor Protection in Private Companies* (Cambridge University Press 2009), at pp. 122-138.

136 *Supra* section 2.1.

137 Weber, *supra* n. 119, at p. 202.

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

139 Langenbucher, *supra* n. 125; Peter Kindler, 'Gesellschaftsrechtliche Grenzen der Emittentenhaftung am Kapitalmarkt – Eine Nachlese zum Fall "EM.TV" vor dem Hintergrund zwischenzeitlicher Entwicklungen', in Peter Kindler, Jens Koch, Peter Ulmer and Martin Winter, eds., *Festschrift für Uwe Hüffer zum 70. Geburtstag* (C.H. Beck 2010) p. 417, at p. 424.

140 E.g., Hartwig Henze, in Klaus Hopt and Herbert Wiedemann, eds., *Großkommentar Aktiengesetz*, Vol. 2, 4th edn. (De Gruyter 2000/2012), § 57 ¶20.

Including US law and the various possible interpretations of capital maintenance, there are at least four possible options (Table 1 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 for 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 usually 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' claims, 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).

Table 1: Allocation of fraud risk through issuer liability

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

In Table 1, 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 Incentivising creditors to monitor

Slain and Kripke argued that creditors should be able to rely on a certain cushion of equity and saw subordination of shareholder claims as a means to that end.[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 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 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 compensating 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 debate 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 favour 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 over the

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141 Slain and Kripke, *supra* n. 101, at pp. 288-291.

142 E.g., Kindler, *supra* n. 139, at p. 422 (arguing that shareholders collectively committed capital to current and future creditors); Schäfer, *supra* n. 118, at p. 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* n. 134, at p. 1810; Langenbucher, *supra* n. 125, at p. 242 (both noting that an unlawful action preceded the acquisition of shares); Casper, *supra* n. 134, at p. 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.

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

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

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

past twenty 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 in both the UK and Continental Europe.[147]

Large banks should normally be capable of protecting themselves against credit risk posed by 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 will often enable a financial institution to reduce the probability of false information provided by management to the capital markets. Even if the role of large, voluntary lenders seems to have decreased in Europe in the past twenty years, they

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146 European Central Bank, 'Corporate Finance in the Euro Area', Occasional Paper No. 63/2007, at p. 13, available at: <http://www.ecb.int/pub/pdf/scpops/ecbocp63.pdf> (showing that bank loans amounted to 29.1% of firms' capital in 2005, compared to 3.5% for debt securities excluding derivatives); European Central Bank, *idem*, at p. 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 and David A. Skeel Jr, 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom', 55 *Vanderbilt Law Review* (2002) p. 1699, at pp. 1763-1777 (describing the development of debt structure in evolutionary terms).

148 On monitoring by creditors, see, generally, Douglas G. Baird and Robert K. Rasmussen, 'Private Debt and the Missing Lever in Corporate Governance', 154 *University of Pennsylvania Law Review* (2006) p. 1209, at pp. 1242-1250; Joanna M. Shepherd, Frederick Tung and Albert H. Yoon, 'What Else Matters for Corporate Governance? The Case of Bank Monitoring', 88 *Boston University Law Review* (2008) p. 991; Frederick Tung, 'Leverage in the Boardroom: The Unsung Influence of Private Lenders in Corporate Governance', 57 *UCLA Law Review* (2009) p. 115; Charles K. Whitehead, 'Creditors and Corporate Governance', in Claire A. Hill and Brett H. McDonnell, eds., *Research Handbook on the Economics of Corporate Law* (2012) p. 68, at p. 73.

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 *American Journal of Comparative Law* (1992) p. 503; David Charny, 'The German Corporate Governance System', *Columbia Business Law Review* (1998) p. 145, at pp. 151-157; Brian R. Cheffins, 'The Metamorphosis of "Germany Inc.": The Case of Executive Pay', 49 *American Journal of Comparative Law* (2001) p. 497, at pp. 500-501. However, German banks seem to have reduced their industrial shareholdings in recent years, partly because of the 2000 elimination of a capital gains tax on equity sales and some changes to corporate law. Cheffins, *idem*, at pp. 502-503; Dariusz Wojzik, 'Change in the German Model of Corporate Governance: Evidence from Blockholdings 1997-2001', 35 *Environment and Planning A* (2003) p. 1431; Sigurt Vitols, 'Das "neue" deutsche Corporate Governance-System: Ein zukunftsfähiges Modell?', in Ulrich Jürgens, Dieter Sadowski, Gunnar Folke Schuppert and Manfred Weiss, eds., *Perspektiven der Corporate Governance* (Nomos 2007) p. 76, at pp. 82-83 (tracing the decline of ownership concentration); Luttermann and du Plessis, *supra* n. 85, at pp. 332-333.

are likely still 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 are, in fact, sometimes involved in capital market fraud. It is particularly important for large shareholders to retain an incentive to monitor. If capital maintenance took precedence, incentives for both large shareholders and creditors to prevent misinformation would be reduced. From a doctrinal perspective, it seems absurd how prioritising 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 benefits large shareholders to the detriment of outside investors. Rules (2) and (3) increase the risk for lenders, and hence the incentive to monitor, to some extent, but not as much as rule (4), which completely prioritises 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 creditors' 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

150 Weber, *supra* n. 119, at pp. 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* n. 31, at p. 95 (suggesting that it would be absurd to expect creditors to monitor the issuer's information policies).

152 Johannes Reich-Rohrwig, *Grundsatzfragen der Kapitalerhaltung* (Manz 2004), at pp. 365-366 (proposing a relatively low limit of €40,000 under Austrian law, based on an analogy).

153 Susanne Kalss, 'Kapitalmarktinformationshaftung – Runde wie viel?', *GesRZ* (2012) p. 150.

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, in terms of both creating incentives and the danger of such creditors getting into financial difficulty themselves.

A possible objection could be that financial institutions, given their centrality to 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 materialise if the borrower is subject to 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 possibility of issuer liability claims in different firms in the portfolio typically does not create correlated risks. 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 publication of false or misleading information to the capital markets.

5. SHOULD EUROPE STRENGTHEN PRIVATE ENFORCEMENT OF SECURITIES LAW?

As shown by the discussion of the cost of securities fraud in section 2.2, the objective of securities litigation cannot be to serve the private interests of misled investors, but must be the broader goal of a better functioning capital market. One could therefore argue that enforcement should be in the hands of a public regulator, such as the SEC, whose goal should clearly be to eliminate frictions in the market caused by opportunistic behaviour. 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 enforcement[154] 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

[154] Jackson and Roe, *supra* n. 2.

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

[156] See James D. Cox, Randell S. Thomas and Dana Kiku, 'SEC Enforcement Heuristics: An Empirical Inquiry', 53 *Duke Law Journal* (2003) p. 737, at pp. 763-77 (finding that firms targeted by SEC enforcement actions tend to be smaller than defendant firms in securities class actions).

motivated by monetary gains may ensure enforcement where, for example, regulators shy away from it for fear of antagonising 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 US, 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 private actions might be a relatively easy way of incentivising 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 must first muster the strength to pick it up. Private enforcement of securities law still faces more hurdles than in the US, 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 settlement.[159] In combination with the American system of having each party 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

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157 E.g., Manning Gilbert Warren III, 'The U.S. Securities Class Action: An Unlikely Export to the European Union', 37 *Brooklyn Journal of International Law* (2012) p. 1075, at p. 1082.

158 E.g., Möllers, *supra* n. 22, at p. 261; Fox, *supra* n. 16, at pp. 318-319; Gerard Hertig, Reinier Kraakman and Edward Rock, 'Issuers and Investor Protection', in Kraakman, et al., *The Anatomy of Corporate Law*, *supra* n. 6, p. 275, at pp. 295-296.

159 E.g., Park, *supra* n. 16, at p. 348.

160 E.g., Möllers, *supra* n. 22, at p. 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 *Brooklyn Journal of International Law* (2012) p. 843, at pp. 863-864 (discussing Germany, France and Italy). Regarding the incentives set by damages awards, including punitive damages, see also Warren, *supra* n. 157, at p. 1082.

161 Federal Rules of Civil Procedure, Rule 26. See, e.g., Guido Ferrarini and Paolo Giudici, 'Financial Scandals and the Role of Private Enforcement', ECGI Working Paper No. 40 (2005), at pp. 50-51, available at: <http://ssrn.com/abstract=730403>; Möllers, *supra* n. 22, at p. 267; Nathan M. Crystal and 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* (2011) p. 1, at pp. 23-24; Warren, *supra* n. 157, at p. 1082.

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 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.

Notably, there have been steps in several jurisdictions, notably Germany,[165] the UK[166] and Italy,[167] 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 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,

162 Warren, *idem*, at p. 1082.

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

164 Section 2.2 above.

165 In 2005, Germany introduced the *Kapitalanleger-Musterverfahrensgesetz – KapMuG* (Act on Model Investor Litigation), BGBl I S. 2437. 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 and Heiko Heppner, 'KapMuG Reloaded – Das neue Kapitalanleger-Musterverfahrensgesetz', *Betriebs-Berater (BB)* (2012) p. 2703, at p. 2705.

166 See Eilís Ferran, 'Are US-Style Investor Suits Coming to the UK?', 9 *Journal of Corporate Law Studies* (2009) p. 315, at pp. 321-322 (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 *European Company and Financial Law Review* (2009) p. 246, at pp. 258-264.

168 Art. 3:305a *Burgerlijk Wetboek*; see Deborah R. Henssler, 'The Future of Mass Litigation: Global Class Actions and Third-Party Litigation Funding', 79 *George Washington Law Review* (2011) p. 306, at pp. 310-320.

plaintiffs assigned their claims to the Consumer Protection Association, which then enforced them in joint lawsuits.[169] Given that the features of these European procedural laws 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 scepticism 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] to develop other litigation models which are primarily publicly funded and which could be based on existing models in the area of consumer protection, where consumer associations are sometimes 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] they perhaps have been allowed to develop over the decades because they did not particularly hurt those groups dominating business interests while at the same time they created 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

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169 Susanne Kalss, 'Civil Law Protection of Investors in Austria – A Situation Report from Amidst a Wave of Investor Lawsuits', 13 *EBOR* (2012) p. 211, at pp. 215-217.

170 See Public Consultation: Towards A Coherent Approach on Collective Redress, available 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 *OJ* L 201/60.

172 Commission Recommendation, *idem*, Arts. 13, 21, 29-31; see also Warren, *supra* n. 157, at p. 1112 (summarising 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 Daphne Aichberger-Beig, et al., eds., *Jahrbuch Junger Zivilrechtswissenschaftler 2010* (Boorberg 2011) p. 103, at pp. 114-115 (suggesting that a toned-down European action incorporating the critique of US class actions would have been ineffective).

173 *Supra* nn. 106-109 and accompanying text; Warren, *supra* n. 157, at pp. 1109-1110.

174 Arts. 4-7.

175 See Gerhard Wagner, 'Collective Redress – Categories of Loss and Legislative Options', 127 *Law Quarterly Review* (2011) p. 55, at p. 57.

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

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 actual governance effects of these lawsuits were negligible, the existence of a shareholder remedy might have created the perception of a functioning system and thus pre-empted more intrusive regulation.[178] In comparative perspective, in much of Europe, share ownership does not have the political salience 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 more 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 centre 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 incentivised 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 Germany,[180] structures where large shareholders or coalitions of shareholders dominate firms persist to a significant degree across the Continent. Even in the UK, where in recent years steps to facilitate investor suits have been taken, share ownership is less dispersed than in the US, which might create some potential for socially valuable litigation.

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177 Bratton and Wachter, *supra* n. 5, at pp. 136-142.
178 *Idem*, at p. 147.
179 Gelter, *supra* n. 80, at pp. 963-968.
180 *Supra* n. 149 and accompanying text.

If issuer liability's function is public rather 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.

[181] Cf. Fox, *supra* n. 16, at pp. 319-320 (expressing scepticism from the perspective of a cost-benefit analysis).

[182] Bratton and Wachter, *supra* n. 5, at pp. 115-117.