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### The Role of Private Litigation

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## **Seminar Paper**

On the Topic of

### **The Role of Private Litigation**

As Part of the Course

### **Comparative Corporate Governance**

Held by

Prof. Dr. Brigitte Haar, LL.M. (Univ. Chicago) and Prof. Jill E. Fisch

Benjamin Lee and Benedict Heil

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## List of Abbreviations

AG .....	Die Aktiengesellschaft
AktG .....	Aktiengesetz
B.U. Int'l L. J. ....	Boston University International Law Journal
BaFin .....	Bank- und Finanzaufsicht
BAWe .....	Bundesaufsicht für den Wertpapierhandel
BB .....	Betriebsberater
Berkley J. Int'l L. ....	Berkley Journal of International Law
BGB .....	Bürgerliches Gesetzbuch
BGBI. ....	Bundesgesetzblatt
BGH .....	Bundesgerichtshof
Brook J. Int'l L. ....	Brooklyn Journal of International Law
BT-Drucks. ....	Drucksache des Bundestages
BVerfG .....	Bundesverfassungsgericht
cit. ....	cited
crit. ....	critical
e.g. ....	exempli gratia
Ed. ....	Edition
EU .....	European Union
EUR .....	Euro
FAZ .....	Frankfurter Allgemeine Zeitung
FS .....	Festschrift
GVG .....	Gerichtsverfassungsgesetz
GWR .....	Gesellschafts- und Wirtschaftsrecht
i.e. ....	id est
J.F.E.P. ....	Journal of Financial Economic Policy

IPO .....	Initial Public Offering
Iss .....	Issue
JZ .....	Juristenzeitung
KapMuG .....	Kapitalanleger-Musterverfahrensgesetz
LG .....	Landgericht
NJW .....	Neue Juristische Wochenschrift
NZG .....	Neue Zeitschrift für Gesellschaftsrecht
OLG .....	Oberlandesgericht
para. ....	Paragraph
R.J.F.A. ....	Research Journal of Finance and Accounting
RIW .....	Recht der Internationalen Wirtschaft
SEC .....	Securities and Exchange Commission
sent. ....	Sentence
SUNY B.L.S.R.P. ....	SUNY Buffalo Legal Studies Research Paper
US .....	United States
USD .....	United States Dollar
Vol. ....	Volume
VuR .....	Verbraucher und Recht
VwGO .....	Verwaltungsgerichtsordnung
WM .....	Wertpapier-Mitteilungen
WpHG .....	Wertpapierhandelsgesetz
ZG .....	Zeitschrift für Gesetzgebung
ZGR .....	Zeitschrift für Unternehmens- und Gesellschaftsrecht
ZIP .....	Zeitschrift für Wirtschaftsrecht
ZPO .....	Zivilprozessordnung

# **Part I - Germany**

## **A. Chapter Introduction**

*“Volkswagen faces shareholder claims over emissions scandal”<sup>1</sup>*

- *Reuters News, 01/28/2016*

*“With Optimum Pressure - Actions for Damages against VW”<sup>2</sup>*

- *F.A.Z., 09/25/2015*

The VW emissions scandal is still all over the news - and with it the pending shareholder actions against the corporation. *“Global civil litigation of all stripes is growing”<sup>3</sup>* and today, securities fraud actions are by far no longer a “US-only” issue.

This paper aims to show the role of private litigation in the corporate governance debate with a focus on German securities law and its litigation procedures. After a brief introduction to the topic (B.), there will be an extensive discussion of the present collective redress scheme for securities fraud actions in Germany and its implications on private enforcement (C.) and possible areas of conflict will be pointed out (D.). A brief summary of the most important points and an outlook will conclude (E.).

## **B. Private Litigation in Germany: An Overview**

The topic of this paper is the role of private litigation. This should in turn be understood in the broader context of corporate governance, thus it is vital to have a definition of what corporate governance is. One of the most common definitions is that of the Cadbury Report: “Corporate governance is the system by which companies are directed and controlled.”<sup>4</sup> This definition is also the shortest and therefore very handy.<sup>5</sup> Now how exactly are companies essentially controlled? There are two basic control mechanisms, namely internal control from within the company and external control from without. External control is achieved through regulation, which in turn has to be enforced to be effective.<sup>6</sup> Legal research is in agreement that there are

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<sup>1</sup> *Wissenbach*, Volkswagen Emissions Lawsuit.

<sup>2</sup> *Budras*, Schadensersatzklagen gegen VW.

<sup>3</sup> *Iwata*, Securities-fraud suits go global.

<sup>4</sup> *Cadbury*, Report of the Committee on the Financial Aspects of Corporate Governance, 15.

<sup>5</sup> See for a comparison of other definitions: *Clarke*, International Corporate Governance, 1-2.

<sup>6</sup> *Dharmastuti/Wahyudi*, 4:4 R.J.F.A., 132-134 (2013).

basically two types of regulation enforcement mechanisms namely public enforcement and private enforcement.<sup>7</sup>

Public enforcement is based on an ex-ante perspective. In order to create a working market infrastructure, statutory regulations are passed to deter company misconduct before it happens.<sup>8</sup> If violated, these regulations are enforced by state authorities through sanctions or even by means of criminal prosecution.<sup>9</sup>

Private enforcement on the other hand is characterized by an ex-post view. Civil liability of a corporation for past misbehavior has a deterring effect, thus preventing repeated violation of statutory regulations.<sup>10</sup> Through this deterrence effect, when suing a company, private individuals are in fact enforcing statutory regulations. This in turn means they promote a public interest, making them something that has become known in legal literature as “private attorney general”.<sup>11</sup>

Private enforcement mechanisms can be found in different areas of the law, most notably anti-trust law and capital markets / securities law. Private enforcement has traditionally not played a big role in German anti-trust law<sup>12</sup>, though in recent years, there was a lot of effort on EU level concerning collective redress and reforms have been passed aiming to promote private litigation in the area of competition law.<sup>13</sup>

The focus of this research however is not on anti-trust law but on securities law. Taking a closer look at the securities market, one will find that there is a natural asymmetry of information in the capital market. Only the capital seeker (issuer of securities) initially has all the relevant company information which the capital provider (investor) needs in order to make a sound investment decision.<sup>14</sup> Yet to prevent market failure, these information asymmetries have to be leveled out. This is achieved by creating a set of disclosure and publication obliga-

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<sup>7</sup> Arguably *market control* is a third mechanism inducing corporations to comply with legal requirements all on their own, e.g. because they rely on the trust of the market for ‘repeat transactions’. However the effectiveness of *market control* is heavily doubted, see *Brellocks*, *Publizität und Haftung von Aktiengesellschaften*, 174-176.

<sup>8</sup> *Porrini/Ramello*, 3:2 J.F.E.P., 143-144 (2011).

<sup>9</sup> Criminal prosecution can be seen as a form of public enforcement, even though it is sometimes listed as a separate enforcement mechanism, see e.g.: *Ramphal*, *The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States*, 10.

<sup>10</sup> *Porrini/Ramello*, 3:2 J.F.E.P., 142-143 (2011).

<sup>11</sup> *Baetge/Eichholtz*, *Die Class Action in den USA*, 315; *Reuschle*, *WM* 2004, 966 (970); *Hopt*, *WM* 2009, 1873 (1879-1880); Sometimes the term „private public attorney” is used, see *Hess*, *JZ* 2011, 66 (67).

<sup>12</sup> *Buxbaum*, 23:3 *Berkley J. Int’l L.*, 484 (2005).

<sup>13</sup> *KK KapMuG / Hess*, *Einl.*, RN 2, 54; The concept of private law enforcement in Germany was first explicitly taken up on in the “7<sup>th</sup> Cartel Law Novella” of 2005, see *Hess*, *JZ* 2011, 66 (67). Very recently 2014/104/EU directive has been passed by the European Parliament and the Council, aiming to promote private litigation. Its possible impact on private law enforcement in German competition law is however disputed, see *Keßler*, *VuR* 2015, 83 (83-84, 91); For a comprehensive overview of the development of collective redress in Europe in recent years, see *Haar*, *Investor protection through model case procedures (CFS Working Paper No. 2013/21)*, 4-17.

<sup>14</sup> *Brellocks*, *Publizität und Haftung von Aktiengesellschaften*, 166.



tions for corporations, providing the investor with the needed information.<sup>15</sup> Thus disclosure obligations play a key role in maintaining a functioning capital market.<sup>16</sup>

As with any regulation, these disclosure obligations may be publicly and/or privately enforced. Historically, public enforcement has always played the predominant role in the European Union.<sup>17</sup> The same holds true for Germany in particular.<sup>18</sup> Public corporate surveillance is achieved through a three-tier monitoring and enforcement system consisting of the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, short: *BaFin*), the States of Germany and the Stock Exchanges.<sup>19</sup>

However, German Law does also provide the vehicles for private enforcement. Similar to US law there are possibilities for bringing either a derivative suit (*Aktionärsklage*) or a direct suit against the corporation.<sup>20</sup> In general, derivative suits are seen as unattractive for individual investors.<sup>21</sup> The main reason is that while the shareholder bears the full cost risk of litigation - in German Law at least concerning the approval procedure (*Zulassungsverfahren*), pursuant to § 148 para. 6 sent. 1 of the German Stock Corporation Act (*Aktiengesetz - AktG*)<sup>22</sup> - only the corporation itself profits directly from a successful trial.<sup>23</sup> Thus the derivative suit has not been popularly used in Germany.<sup>24</sup> Up until today there are only three published court decisions concerning shareholder derivative suit.<sup>25</sup>

Now this leaves the direct suit of the investor against the corporation for enforcing liability because of violations of disclosure requirements. In most cases it is in practice too risky while at the same time too expensive for an individual investor to bring a case against a company.<sup>26</sup> This effect, known as “rational disinterest” or “rational apathy”, in turn impedes the enforcement of disclosure obligations through private individuals.<sup>27</sup>

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<sup>15</sup> *Brellochs*, *Publizität und Haftung von Aktiengesellschaften*, 167.

<sup>16</sup> *Brellochs*, *Publizität und Haftung von Aktiengesellschaften*, 1.

<sup>17</sup> *Russell*, 28:14 B. U. Int'l L. J., 142 (2010).

<sup>18</sup> *Hopt*, WM 2009, 1873 (1879).

<sup>19</sup> Hdb. Kapitalanlagerecht, 3rd Ed. / *von Rosen*, § 2 RN 224-267; *Claussen*, *Bank- und Börsenrecht / Bröcker*, § 6 RN 27.

<sup>20</sup> *Brellochs*, *Publizität und Haftung von Aktiengesellschaften*, 185.

<sup>21</sup> *Ramphal*, *The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States*, 12.

<sup>22</sup> *Aktiengesetz - AktG*, as of December 22 2015, BGBl. I 1965, p. 1089.

<sup>23</sup> *KK KapMuG / Hess*, Einl., RN 15.

<sup>24</sup> *Haar/Grechenig*, AG 2013, 653 (654-655, 662); *Habersack*, *Staatliche und halbstaatliche Eingriffe in die Unternehmensführung*, E92; It has been suggested to institute a „bounty“-system in order to create monetary incentives for the suing shareholder and this way encourage more derivative suits, see *Schmolke*, ZGR 2011, 398 (434-437). This approach however is not unquestioned, see (crit.) *Kahnert*, AG 2013, 663 (670).

<sup>25</sup> OLG Hamburg, AG 2007, 331; LG München I, NZG 2007, 477; OLG München, NZG 2010, 1392.

<sup>26</sup> *Hellgardt*, *Kapitalmarktdeliktsrecht*, 546-547.

<sup>27</sup> *Bergmeister*, *KapMuG*, S. 27; *Hellgardt*, *Kapitalmarktdeliktsrecht*, 546-547.

The most important way to counter this effect and encourage private litigation is for the legislation to provide a collective redress scheme.<sup>28</sup> Collective redress schemes enable a multitude of plaintiffs and/or a multitude of defendants to join together and collectively litigate in front of a court.<sup>29</sup> By this way minimizing the costs and risks for individual investors, a system for collective redress is a prerequisite for effective private litigation.<sup>30</sup> The following will explore what kind of collective redress scheme is implemented in Germany in securities and capital market disputes and whether or not or how it promotes private litigation.

### C. Collective Redress in Germany: KapMuG

Up until today, the *Zivilprozessordnung*<sup>31</sup> (ZPO) as the central code for German civil procedural law provides no possibility for bringing a collective suit to court.<sup>32</sup> This is largely due to the fact that German civil procedural law is traditionally based on the concept of a two-party-process<sup>33</sup> and since its first introduction in 1877 there was no aspiration to change the core principles on which the ZPO is based on.<sup>34</sup> Especially in recent years, there have been some major reforms;<sup>35</sup> however no collective redress scheme has been incorporated into the ZPO so far. Outside the provisions of the ZPO though, there are in certain areas of civil law possibilities for collective redress, most notably the German “Capital Markets Model Procedure Act” (*Kapitalanleger-Musterverfahrensgesetz*<sup>36</sup> or short: “KapMuG”), which applies to shareholder actions for damages (and certain fulfillment duties) in securities markets disputes.<sup>37</sup>

The following will give a brief overview over the development of the KapMuG (I.) before going into the details of its procedure (II.) and analyzing its actual impact (III.).

### I. Development

In 2000 and 2001, allegations were made against *Deutsche Telekom AG* concerning misrepresentation and failure to disclose material information. The two main (albeit not the only) alle-

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<sup>28</sup> *Russell*, 28:14 B. U. Int'l L. J., 144 (2010).

<sup>29</sup> KK KapMuG / *Hess*, Einl., RN 1.

<sup>30</sup> *Schäfer*, Anreizwirkungen bei der Class Action und der Verbandsklage, 70.

<sup>31</sup> *Zivilprozessordnung - ZPO*, as of November 20 2015, BGBl. 2005 I p. 3202; 2006 I p. 431; 2007 I p. 1781

<sup>32</sup> There is the possibility under § 79 para. 2 No. 3 ZPO for consumers association to collect consumers' claims and litigate in their own name those claims. This is however the only procedure that could be considered a collective redress scheme, see *Hess*, JZ 2011, 66 (66).

<sup>33</sup> *Langenbacher*, Aktien- und Kapitalmarktrecht, § 21 RN 3.

<sup>34</sup> *Hess*, JZ 2011, 66 (66).

<sup>35</sup> Notable changes include the reform of arbitration law in 1998 as well as the ZPO reforms of 2002, 2004 and 2009, see *Hess*, JZ 2011, 66 (66).

<sup>36</sup> Gesetz über Musterverfahren in kapitalmarktrechtlichen Streitigkeiten (Kapitalanleger-Musterverfahrensgesetz - KapMuG), as of November 20 2015, BGBl. 2009 I, p. 2182.

<sup>37</sup> KK KapMuG / *Hess*, Einl., RN 3.

gations made were misrepresentation concerning Telekom's real estate values and the failure to disclose the intended acquisition of the American telephone company *Voice Stream Wireless Corp.*<sup>38</sup> This led to a wave of shareholder actions against Deutsche Telekom in both Germany and the United States.<sup>39</sup> Over 17,000 shareholder claims were subsequently brought to court in Germany alone, represented by around 900 different law firms.<sup>40</sup>

All of them were filed with the regional court of Frankfurt (*Landgericht Frankfurt am Main*).<sup>41</sup> This mass of cases was equal to the courts workload of 10 years.<sup>42</sup> To get a measure of the extent of the case, let it be said that there were very literally *truckloads* of documents brought to the court building,<sup>43</sup> one judge died during the proceeding and one was routinely transferred<sup>44</sup> and a complaint was filed with the constitutional court of Germany (*Bundesverfassungsgericht*) for undue delay in the proceeding<sup>45</sup>.

Recognizing that having so many cases to deal with at the same time was too much for any one court to handle, on February 25<sup>th</sup> 2003 the German Government released a "Ten-Point" action program to promote investor protection.<sup>46</sup> This was the initial step towards the introduction of the first KapMuG<sup>47</sup> in November of 2005.<sup>48</sup> The original version of the act had an expiration date on November 1<sup>st</sup> 2010, giving it five years to prove its practicality.<sup>49</sup> Today, a new act is in effect, which is due to expire on November 1<sup>st</sup> 2020.<sup>50</sup>

## II. Proceeding

Getting a hold of the Telekom case certainly was the driving factor in the introduction of KapMuG. However the intended goal was to strengthen shareholders rights in a more general way, by promoting shareholder litigation. "Reestablishing the regulatory control function" of liability statutes by introducing a collective redress scheme was the declared intention in the

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<sup>38</sup> *Tilp*, FS Krämer, 331 (334-335).

<sup>39</sup> For a comprehensive overview over the events and timeline of the case both in Germany and the United States, see *Tilp*, FS Krämer, 331 (332-360).

<sup>40</sup> *Halberstam*, 021 SUNY B.L.S.R.P., 25 (2015).

<sup>41</sup> Today, § 32b ZPO provides that the exclusive venue for shareholder litigation is to be the competent court at the registered office of the issuer. This provision is criticized by some in legal literature to be impractical and problematic. See *Stackmann*, NJW 2010, 3185 (3188), who suggests as an alternative the distribution to specialized courts.

<sup>42</sup> PM LG Frankfurt am Main, 1.

<sup>43</sup> *Jahn*, ZIP 2008, 1314 (1314).

<sup>44</sup> *Jahn*, ZIP 2008, 1314 (1315); *Tilp*, FS Krämer, 331 (333).

<sup>45</sup> BVerfG NJW 2004, 3320.

<sup>46</sup> *Seibert*, BB 2003, 693 (693-698).

<sup>47</sup> Gesetz über Musterverfahren in kapitalmarktrechtlichen Streitigkeiten (Kapitalanleger-Musterverfahrensgesetz - KapMuG), as of August 16 2005, BGBl. 2005, I p. 2437.

<sup>48</sup> *Hess/Michailidou*, WM 2003, 2318 (2318).

<sup>49</sup> BT Drucks. 15/5091, 47.

<sup>50</sup> See § 28 KapMuG .

governments justification of the KapMuG.<sup>51</sup> In other words this meant more corporate control through private enforcement.

Still it was made clear that there was no intention of creating a US style class action. Rather a “model case” collective redress scheme was to be created.<sup>52</sup> The regional court in Frankfurt had already started off its immense task by trying to focus on ten “pilot-procedures” that covered most of the legal questions common to all cases - this way creating its own “model procedure”, albeit without statutory basis.<sup>53</sup>

By choosing a model case solution the legislator deviated from the proposal of the “Commission German Corporate Governance Codex” (*Regierungskommission Deutscher Corporate Governance Kodex*), which favored the solution of having a mutual representative for all (opt-in) shareholder plaintiffs.<sup>54</sup> The main criticism was that the shareholders who did not choose to opt-in could simultaneously litigate individually, which in turn could lead to different court decisions in the same matter and did not help in lowering the overall judiciary workload.<sup>55</sup>

The concept of a model case procedure is not totally unknown to German Law. The KapMuG had its role model in German administrative law. Pursuant to Sec. 93a, para. 1 of the Rules of the Administrative Courts (*Verwaltungsgerichtsordnung - VwGO*)<sup>56</sup> a model case procedure is possible for certain administrative actions brought to court by individual petitioners.<sup>57</sup>

The KapMuG procedure itself is divided into three basic stages, viz. application proceeding (*Antragsverfahren*), intermediate proceeding (*Zwischenverfahren*) and continuation of the individual proceeding (*Fortsetzung des Individualverfahrens*).<sup>58</sup>

## 1. Application Proceeding

The first step towards a KapMuG procedure is the application proceeding. The competent court for all shareholder claims on grounds of alleged misrepresentation is the regional court (*Landgericht*) at the place of the corporation’s registered office (§ 71 para. 2 No. 3 GVG<sup>59</sup>, § 32b ZPO). In the individual proceeding in front of this trial court, a motion has to be filed, requesting a model case procedure. The motion can be filed by either the plaintiff or the defendant (§ 2 para. 1 sent. 2 KapMuG). In practice it is usually the plaintiff who seeks to initi-

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<sup>51</sup> BT Drucks. 15/5091, 1, 16.

<sup>52</sup> *Seibert*, BB 2003, 693 (694-695).

<sup>53</sup> *Duve/Pfizner*, BB 2005, 673 (676).

<sup>54</sup> BT-Drucks. 14/7515, 88-90.

<sup>55</sup> BT Drucks. 15/5091, 50.

<sup>56</sup> *Verwaltungsgerichtsordnung - VwGO*, as of December 12 2015, BGBl. 1991 I p. 686.

<sup>57</sup> *Hess*, ZIP 2005, 1713 (1715).

<sup>58</sup> *Halfmeier/Rott/Feess*, *Kollektiver Rechtsschutz im Kapitalmarktrecht*, 19.

<sup>59</sup> *Gerichtsverfassungsgesetz - GVG*, as of December 21 2015, BGBl. 1975 I p. 1077.

ate a KapMuG procedure.<sup>60</sup> This seems odd, considering that usually the defendant too would benefit from such a procedure by getting rid of a multitude of cases simultaneously.<sup>61</sup> A possible explanation would be that corporations hope for tactical advantages by splitting the case and having multiple trials.<sup>62</sup> The motion may only be filed in first instance (§ 2 para. 1 sent. 1 KapMuG), so if a case has already gone on appeal, it can no longer be part of a KapMuG procedure. After the trial court verifies the motion's admissibility, it is made public on the electronic litigation register (*elektronisches Klageregister*) pursuant to § 3 para. 2 KapMuG. The publication is supposed to encourage other shareholders to file a similar motion in trial court.<sup>63</sup> This is very important because only if ten such commutated motions are filed within six months of the first motion, does the KapMuG procedure enter its main stage, the intermediate proceeding (§ 6 para. 1 sent. 1 KapMuG).

## 2. Intermediate Proceeding

If the quorum is met within the given time limit, the trial court issues an order for reference to the Higher Regional Court (*Oberlandesgericht*) pursuant to § 6 KapMuG. In its order, the court sets the original list of legal questions to be decided in the intermediate proceeding. Subject of the proceeding can be the legal clarification of questions that are fundamental to all individual cases (§ 2 para. 1 sent. 1 KapMuG). That means not the validity of the claims themselves is decided by the Higher Regional Court, but the underlying issues which are the same for all cases. The Higher Court may for examples decide on the question of whether a Sales Prospectus or an ad hoc announcement issued by the corporation was incorrect or misleading.<sup>64</sup> "Non-collectivizable" issues however will not be decided, e.g. the individual damage<sup>65</sup> or the limitation or forfeiture of a claim.<sup>66</sup> During the intermediate proceeding, all individual trials that are dependent on issues of the model procedure are suspended, regardless of whether the individual plaintiff opted in by filing a motion of request (§ 8 para. 1 KapMuG). That means as soon as the KapMuG procedure has reached the point of the intermediate proceeding, no other individual trial regarding the same case can be held anywhere in the Federal Republic of Germany. This has been described as the "suction" effect of the KapMuG.<sup>67</sup>

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<sup>60</sup> *Stackmann*, NJW 2010, 3185 (3186).

<sup>61</sup> *Stackmann*, NJW 2010, 3185 (3186).

<sup>62</sup> BT Drucks. 14/7515, 89.

<sup>63</sup> *Hess*, ZIP 2005, 1713 (1715).

<sup>64</sup> BT Drucks. 15/5091, 20.

<sup>65</sup> LG München I, BeckRS 2006, 18838.

<sup>66</sup> BGH, WM 2008, 1353 (1353).

<sup>67</sup> This is the official term used in the Government's Justification of the KapMuG, BT Drucks. 15/5091, 25; see also *Bergmeister*, KapMuG, 226.

Parties of the intermediate proceeding are the defendant and a “model plaintiff” (*Musterkläger*) as well as the “joined parties” (*Beigeladene*) consisting of all other individual plaintiffs who have “opted-in” (§ 9 para. 1 KapMuG). The model plaintiff is selected by the court. Before making the decision the court has to give consideration to the suitability of the plaintiff in question, the amount of this plaintiff’s claim and the will of the majority of the plaintiffs (§ 9 para. 2 KapMuG).

Now all injured shareholders who have not yet gone to court have two options. Either they take their claim to court, in which case their individual trial will immediately be suspended and the plaintiff will join the KapMuG procedure as a “joined party”, due to the suction effect described above. This joining can happen at any point of the intermediate proceeding so long as no final verdict has been reached (§ 8 para. 1 KapMuG). The other option is to *register* the claim with the Higher Regional Court within six months of the initiation of the intermediate procedure. In this case the court’s decision in the KapMuG procedure will not be legally binding for the shareholder but the limitation of the claim will still be suspended (§ 204 para. 1 No. 6a of the German Civil Code - *Bürgerliches Gesetzbuch (BGB)*<sup>68</sup>). The differentiation between these two options is very important, as it has far-reaching effects and sets unwanted incentives, as will be discussed in further detail below.<sup>69</sup>

The actual procedure follows the general rules of the ZPO if not otherwise provided for in the KapMuG (§ 11 para. 1 KapMuG). At the end of the intermediate proceeding, the Higher Regional Court will issue a legally binding decision on the questions of fact and law that were raised (§ 16 para 1 KapMuG).

### **3. Continuation of the Individual Proceeding**

The Higher Regional Courts decision can be brought on appeal to the Federal Court of Justice in Germany (*Bundesgerichtshof - BGH*) by any party of the intermediate proceeding pursuant to §§ 20 and 21 KapMuG. After a final verdict has been reached, the (suspended) individual proceedings are continued at trial court level (§ 22 para. 4 KapMuG). The decisions of the intermediate procedure are legally binding and the trial court will only have to decide on the (legal and factual) questions that are individual for each case, e.g. extent and causation of individual damages.<sup>70</sup>

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<sup>68</sup> Bürgerliches Gesetzbuch - BGB, as of November 20 2015, BGBl. 2002 I p. 42, 2909; 2003 I p. 738.

<sup>69</sup> D. II. 1..

<sup>70</sup> *Halfmeier/Rott/Feess*, Kollektiver Rechtsschutz im Kapitalmarktrecht, 34.

### III. Analysis

The question remains whether the introduction of the KapMuG can be thought of as a success. This section will try to give an answer to this by analyzing the actual impact the introduction of the KapMuG has had in terms of number of cases filed.

There were four declared goals that the legislative hoped to achieve.<sup>71</sup> The first and foremost aim was to create greater incentive for shareholders to sue, i.e. to promote private enforcement.<sup>72</sup> This goes hand in hand with the second declared goal, which was to make effective enforcement easier for private individuals.<sup>73</sup> The third aim was to lower the workload of the courts dealing with securities fraud actions.<sup>74</sup> Last but not least there was the growing fear that the Federal Republic of Germany would lose its attractiveness as “justice site” (*Jus-tizstandort*), considering that it was possible for shareholders to litigate claims in a foreign country by way of “forum shopping”. This could effectively lead to a loss of Germany’s judicial control over domestic securities markets, thus the fourth goal was to increase the attractiveness of Germany as justice site.<sup>75</sup>

#### 1. Shareholder Activity before and after KapMuG<sup>76</sup>

Starting off with the extent of shareholder action, the main question is how many such cases are actually brought to court each year. The focus here is on suits concerning misrepresentation on secondary market. In legal literature there has been talk about a “flood” of shareholder securities fraud actions ever since the stock market crash of 2001/2002.<sup>77</sup> However neither source nor actual numbers were provided. To be fair, before the dot-com collapse, there was hardly any shareholder action against stock corporations.<sup>78</sup> However from 2001 to 2013, there were only exactly 111 court decisions concerning misrepresentation suits brought forward by shareholders in all of Germany. That amounts to an average of 8-9 court decisions per year - talking of a “flood” here seems (mildly speaking) not exactly on point.

Now how has this number been influenced by the introduction of the KapMuG in 2005? From 2001 to 2004 there were 24 cases, resulting in an average of 6 cases per year. From 2005 to

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<sup>71</sup> All four topics had already been subject of a discussion in legal literature and were named as reasons for the importance of introducing a collective redress scheme, see *Reuschle*, WM 2004, 966 (972).

<sup>72</sup> BT Drucks. 15/5091, 16.

<sup>73</sup> BT Drucks. 15/5091, 16.

<sup>74</sup> BT Drucks. 15/5091, 17.

<sup>75</sup> BT Drucks. 15/5091, 17.

<sup>76</sup> The litigation data for this section comes from the comprehensive list of published and unpublished court decisions on the matter of misrepresentation on secondary market in Germany in: KK WpHG / *Möllers/Leisch*, Vor §§ 37b, c “Rechtsprechung”; see also: Hdb. Kapitalanlagerecht / *Fleischer*, § 6 RN 1 footnote 1.

<sup>77</sup> *Ertmann/Keul*, WM 2007, 482 (482).

<sup>78</sup> To be exact, there were six relevant court decisions in the time from 1982 to 2000.

2013 there were 87 cases, leading to an average of almost 10 cases per year. Seeing this increase of around 67% may seem impressive at first. Nevertheless the total number pales in international comparison, as the following section will show.

## 2. Effective Enforcement through KapMuG Procedures

Turning towards the second declared goal, effective enforcement through *collective* redress, the numbers grow even smaller. From 2005 until today there have been only 14 decisions in different model cases.<sup>79</sup> Even when excluding the starting phase<sup>80</sup> until the first KapMuG procedure was decided in 2007<sup>81</sup>, this only amounts to an average of 1.5 cases per year. By comparison, 1,607 class actions were decided in the same period of time in the US - amounting to a total average of 178 court decisions per year.<sup>82</sup> Now of course these numbers have to be seen in the light of each country's total stock market capitalization. As of 2014, stock market capitalization in the US was 26,330,589,190,000 USD while in Germany it was only 1,738,539,060,000 USD.<sup>83</sup> This leads to a ratio of 15.14 to 1. Yet even integrating this information there are eight class actions for every one KapMuG procedure.<sup>84</sup>

Considering this, measured on international standards, the KapMuG does not provide a collective redress scheme that is as widely accepted and used as the US securities class action. The comparison seems especially important when thinking about another declared goal of the KapMuG, increasing the attractiveness of Germany as justice site.

## 3. International Competition

As mentioned before, there was the general fear that Germany would gradually lose judicial control over the domestic securities market.<sup>85</sup> The most conclusive way to measure this effect is to look at how many US class actions were filed against German companies, i.e. corporations which have their headquarters in Germany.<sup>86</sup> An extensive search within the *Securities Class Actions Clearinghouse Filings Database* reveals that there has been a total of 15 class actions against Germany based corporations, the first one filed in 2000. During the period from 2007 until today there were eight such cases. For the period from 2000 to 2006 that makes an average of 1 case per year; for the period of 2007 to date, the average is 0.89 cases

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<sup>79</sup> This data is publicly available at the electronic litigation register at: <https://www.bundesanzeiger.de/>.

<sup>80</sup> As is suggested by *Erttmann/Keul*, WM 2007, 482 (482).

<sup>81</sup> This was the DaimlerChrysler case, OLG Stuttgart, WM 2007, 595.

<sup>82</sup> Stanford, *Federal Securities Class Action Litigation 1996 - YTD*.

<sup>83</sup> World Bank, *Market capitalization of listed domestic companies (current US\$)*.

<sup>84</sup>  $15.14 \text{ (factor)} * 14 \text{ (KapMuG procedures)} = 211.96 \parallel 1607 \text{ (Class actions)} / 211.96 = 7.59 \approx 8$ .

<sup>85</sup> BT Drucks. 15/5091, 17; see also *Hess/Michailidou*, WM 2003, 2318 (2325).

<sup>86</sup> This procedure was suggested by *Halfmeier/Rott/Feess*, *Kollektiver Rechtsschutz im Kapitalmarktrecht*, 82.



per year. This drop of 11% cannot be considered significant and it seems highly questionable if it can be attributed to the introduction of the KapMuG at all.

On a side note, the German legislator's fear of extensive forum shopping by investors on the domestic stock market has been incidentally eased by the US Supreme Court, which in *Morrison v. National Australia Bank* held that the anti-fraud provision of the SEC Rules<sup>87</sup> does not apply extraterritorially.<sup>88</sup> That means German investors will no longer be able to sue corporations in the United States using US securities class action in regard to stock they purchased on a German (or other Non-US) stock exchange.<sup>89</sup> This ultimately affirms Germany's judicial control over domestic stock markets.<sup>90</sup>

#### 4. Judicial Workload

Last of all the question remains whether the introduction of the KapMuG did in any way help in lowering the judicial workload.

In regard to the Telekom procedure, the final verdict by the Federal Court of Justice of Germany has only been spoken very recently, on October 21<sup>st</sup> 2014 and published in 2015.<sup>91</sup> Now that the model case has been finally decided, the individual proceedings will be continued in front of the trial court.<sup>92</sup> Up until today, no final court decision has been made public for any of the trial procedures.<sup>93</sup> That means over 15 years have passed since the first claims against Telekom have been filed with the Regional Court of Frankfurt. By comparison, the same case was brought to court in the US as a class action and settled in 2005 after only five years.<sup>94</sup> The fact that even after the introduction of the KapMuG the model procedure took almost ten years in total - twice as long as it took the case in the US to be settled - suggests that the judicial workload in Germany has at least not been lowered to the US' level in regard to collective redress procedures. But has it been lowered at all? The hope was that by factoring out the elements common to all individual cases and centrally deciding on them only once (i.e. in the model case procedure), the overall judiciary workload would be lowered.<sup>95</sup>

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<sup>87</sup> SEC Rule 10b-5, 17 C.F.R. §240.10b-5 (Sec. 10; 48 Stat. 891; 15 U.S.C. 78j) [13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951].

<sup>88</sup> *Morrison v. National Australia Bank*, 130 S.Ct. 2869, 2888 (2010).

<sup>89</sup> *Lehmann*, RIW 2010, 841 (847); see for the remaining possibilities of securities litigation (against Non-US corporations) *Mankowski*, NZG 2010, 961 (965).

<sup>90</sup> It is however doubted how effective that judicial control is in comparison to the previous US control, see *Lehmann*, RIW 2010, 841 (847) who pleads for more private enforcement in Europe.

<sup>91</sup> BGH NJW 2015, 236.

<sup>92</sup> See *supra*, C. II. 3..

<sup>93</sup> As of February 04 2016.

<sup>94</sup> Stanford, Case Summary Deutsche Telekom AG Securities Regulation.

<sup>95</sup> BT Drucks. 15/5091, 17.

However, commentators are in agreement that this goal has not been reached.<sup>96</sup> This is attributed to the fact that the KapMuG does not change anything about the necessity of individual trials.<sup>97</sup> In addition to this, a considerable amount of effort is necessary to just determine the “collectivizable” material common to all cases.<sup>98</sup> Furthermore, it is at least in theory possible for all parties to go on (individual) appeal and revision on grounds of alleged errors of fact or law concerning issues that could only be dealt with in the individual proceedings.<sup>99</sup> All in all the model case procedure provides no real remedy for the judicial overload generally caused by sheer number of cases.<sup>100</sup>

## 5. Conclusion

The introduction of the KapMuG as a means for collective redress was nearly uniformly welcomed by scholars.<sup>101</sup> During the course of the KapMuG reform in 2012<sup>102</sup>, the legislator even mentioned the possibility of integrating a similar collective redress scheme into the ZPO, if it proved itself until “sunset” in 2020.<sup>103</sup> The hope is to have a wider scope of application for collective redress, especially in the area of product, pharmaceutical and environmental liability.<sup>104</sup>

However the analysis above shows that the self-set goals have not entirely been met and there is room for improvement. Private enforcement in Germany has increased in recent years but there is still a lot of room for more, especially when looking at collective redress and in comparison with the United States. After the Supreme Court’s decision in *Morrison*, the matter of extensive forum shopping by German investors does not seem as pressing as before. Still, the courts’ problem with handling a large number of similar cases at the same time has not effectively been eliminated by the KapMuG as there still has to be an individual trial for each claimant.

Notwithstanding this, some of the weaknesses of the KapMuG (especially the last one mentioned) might be attributed to more fundamental and opposing principles in German civil procedure, as the following section will try to show.

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<sup>96</sup> *Bergmeister*, KapMuG, 315-317; Hdb. Kapitalmarktinformation / *Schmitz*, § 33 RN 403; Hdb. Managerhaftung / *Hess*, § 14 RN 15; *Platzmeier*, NZG 2005, 609 (614).

<sup>97</sup> *Bergmeister*, KapMuG, 316.

<sup>98</sup> Hdb. Kapitalmarktinformation / *Schmitz*, § 33 RN 403, for a detailed description of all the factors that cause delays during the proceeding, see *Ertmann/Keul*, WM 2007, 482 (485).

<sup>99</sup> *Tilp*, FS Krämer, 331 (349).

<sup>100</sup> *Bergmeister*, KapMuG, 317.

<sup>101</sup> See Hdb. Kapitalmarktinformation / *Schmitz*, § 33 RN 397 with further proof.

<sup>102</sup> To be exact it was not a reform but by definition a new Act in itself, see *supra*, C. I..

<sup>103</sup> BT Drucks. 17/8799, 14.

<sup>104</sup> *Keul/Ertmann*, WM 2007, 482 (482).

## D. Areas of Conflict

It has already been pointed out that German Civil Procedure is based on the concept of a two-party system with little room for a scheme of collective redress. As such, the KapMuG marks a break with fundamental principles of German law.<sup>105</sup>

The problem has to be seen in the broader perspective of the conflicting policy objectives underlying the concept of private enforcement. Private Enforcement as part of a corporate governance system is driven by two policy objectives. These are (1.) to incentivize private action and (2.) to efficiently handle these actions.<sup>106</sup>

## I. Incentivizing Shareholder Action

As has already been explained, the main barrier for shareholder action is rational apathy because of dispersed damages. The German answer to this problem has typically been the “loser pays rule”, which ultimately relieves the plaintiff of court and attorney fees in case his claim is meritorious and the trial successful.<sup>107</sup> Is this fee shifting enough though? Looking at the numbers above, the answer seems to be no. Fee shifting is only possible up to the amount of the (statutory) fixed fees and most of the times there will be significantly higher contractual fee agreements (e.g. hourly rates) between the plaintiff and his lawyer.<sup>108</sup> There is also still the plaintiff’s risk of losing and then himself having to pay double.<sup>109</sup> So how then can the large number of plaintiffs in the Telekom litigation be explained? The Telekom case was an exception because there was no rational apathy involved.<sup>110</sup> Even though no institutional investors were part of the trial, the average individual claim was about 5,900 EUR - an amount high enough to overcome the barriers of rational apathy.<sup>111</sup> This was due to the fact that before its IPO, Telekom launched a huge public promotional campaign for its share, which led a lot of private investors to invest in Telekom shares as part of their pension scheme - many of them purchasing stocks for the first time in their lives.<sup>112</sup>

In addition to that there was a decision by the Federal High Court of Germany<sup>113</sup>, holding that an action for damages in regard to prospectus liability in general and the Telekom case in par-

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<sup>105</sup> KK KapMuG / Hess, Einl. RN 4.

<sup>106</sup> Bergmeister, KapMuG, 42.

<sup>107</sup> Bergmeister, KapMuG, 24-25.

<sup>108</sup> Bergmeister, KapMuG, 25.

<sup>109</sup> Bergmeister, KapMuG, 36.

<sup>110</sup> Hess, JZ 2011, 66 (72).

<sup>111</sup> Tilp, FS Krämer, 331 (332-333); Hess, JZ 2011, 66 (72).

<sup>112</sup> Jahn, ZIP 2008, 1314 (1314).

<sup>113</sup> BGH NJW 2003, 2384.

ticular was covered by standard legal protection insurance.<sup>114</sup> This aspect (as a further incentive to sue) however is reduced today, because most insurance companies have promptly reacted to the court decision by adapting modified terms and conditions.<sup>115</sup>

Further incentives for shareholder action could in theory be achieved through US-style contingency fees.<sup>116</sup> A Contingency fee is a success-based remuneration of the attorney combined with his proportional participation in the monetary damages awarded by the court.<sup>117</sup> This would entail the risk of abuse through the attorney.<sup>118</sup> For fear of a “complaint industry” Germany has traditionally been very conservative with contingent fees.<sup>119</sup>

## II. Efficient Litigation

Efficiency is the second key element for private enforcement.<sup>120</sup> Here lies the second obstacle posed by German legislation: the constitutionally guaranteed importance of the individual protection rights (*Individualrechtsschutz*). Concerning collective redress, there are two main areas of conflict, namely (1.) pooling of claims vs. individual assertion and (2.) slender procedure vs. participation rights.

### 1. Pooling of Claims vs. Individual Assertion

One of the more fundamental German constitutional rights is the right to judicial access (*Justizgewährleistungsanspruch*), which encompasses the right to an effective legal protection in civil law disputes, including access to court, a generally comprehensive assessment of facts and law relevant to the case through the judge and a binding verdict.<sup>121</sup> The original version of the KapMuG (2005) did not include the possibility to “register” a claim and thereby suspend its limitation.<sup>122</sup> This led to a factual compulsion to join the model procedure, because of the suction effect described above and the relatively short period of limitation on the claims.<sup>123</sup> It was heavily debated whether this was a constitutional breach of the right to judi-

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<sup>114</sup> *Tilp*, FS Krämer, 331 (344); *Bergmeister*, KapMuG, 8-9.

<sup>115</sup> *Halfmeier/Rott/Feess*, Kollektiver Rechtsschutz im Kapitalmarktrecht, 39; *Bergmeister*, KapMuG, 306; see for example § 3 (2) a) HUK-Coburg ARB 2015, or section 9.3.6.2., D.A.S. Rechtsschutz.

<sup>116</sup> *Bergmeister*, KapMuG, 333.

<sup>117</sup> *Bergmeister*, KapMuG, 32, 162-170.

<sup>118</sup> *Bergmeister*, KapMuG, 33.

<sup>119</sup> *Warren III*, 37:3 *Brook Int'l L.* 1075, 1085 (2011-2012).

<sup>120</sup> *Bergmeister*, KapMuG, 41.

<sup>121</sup> BVerfGE 80, 103 (107); 85 337 (345); 97, 169 (185).

<sup>122</sup> See *supra*, C. II. 2.

<sup>123</sup> *Bergmeister*, KapMuG, 228; In the Telekom procedure this was avoided by registering the claims with the ÖRA, a kind of public mediation services institution, which had a suspension effect on the limitation pursuant to § 204 para. 1 No. 4 BGB, see *Tilp*, FS Krämer, 331 (344).

cial access.<sup>124</sup> The legislator responded to this by introducing the option to register a claim - thus suspending this claim's limitation while not being affected by the binding effect of the court's decision in the model proceeding.<sup>125</sup> By consequently weakening the "pooling" of claims, the German legislator responded to constitutional concerns to the detriment of efficiency in shareholder litigation.

The simplest solution to create an effective pooling of claims would probably be to just create a US-style "opt-out" model. Considering the constitutional concerns just mentioned however, this seems utterly out of question in Germany.<sup>126</sup>

## 2. Slender Procedure vs. Participation Rights

Other principles in German law are the constitutional right to a fair hearing (*rechtliches Gehör*) and the principle of party control (*Dispositionsmaxime*).<sup>127</sup> These rights establish that the parties can determine themselves what is to be decided by the judge, i.e. they can *dispose* over the matter in question,<sup>128</sup> and that they have to be heard by the judge.<sup>129</sup> In consequence, all joined parties (basically<sup>130</sup>) have the same rights (e.g. to plea or present evidence) as the model plaintiff, pursuant to § 14 KapMuG. This goes fundamentally to the detriment of a slender and ultimately efficient proceeding. How could the Telekom case then be decided at all, albeit after almost 10 years? The simple answer is that almost none of the joined parties had made use of their participation rights.<sup>131</sup> Out of the 900 law firms involved on the plaintiffs' side, only 24 initially showed up personally in court and later only a handful remained.<sup>132</sup> If every one of the 900 law firms submitted just one pleading (not even one for every one of the 17,000 claimants) and only Telekom replied to each of them, the proceeding would have still dragged on until today.<sup>133</sup>

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<sup>124</sup> For the voices alleging a constitutional breach, see e.g. *Scholz*, ZG 2003, 248 (260); *Meyer*, WM 2003, 1349 (1352-1353). For the other side, see e.g. *Hess*, ZIP 2005, 1713 (1715); *Reuschle*, WM 2004, 966 (977).

<sup>125</sup> *Wardenbach*, GWR 2013, 35 (36). For the resulting further problems and possible solutions (concerning D&O insurance), see *von Bernuth/Kremer*, NZG 2012, 890 (892); *Wardenbach*, GWR 2013, 35 (37); *Wigand*, WM 2013, 1884 (1887).

<sup>126</sup> *Bergmeister*, KapMuG, 45.

<sup>127</sup> See for the constitutional roots *Rau*, KapMuG und Dispositionsgrundsatz, 32, 165.

<sup>128</sup> As the judge of the trial court generates the brief of questions presented to the higher court, this right is somewhat constrained, see *Haar*, Investor protection through model case procedures (CFS Working Paper No. 2013/21), 22.

<sup>129</sup> *Halberstam*, 021 SUNY B.L.S.R.P.,30 (2015); *Rau*, KapMuG und Dispositionsgrundsatz, 167-168.

<sup>130</sup> As long as their pleading does not contradict that of the model plaintiff, § 14 sent. 2 KapMuG.

<sup>131</sup> *Tilp*, FS Krämer, 331 (359-360).

<sup>132</sup> *Jahn*, ZIP 2008, 1314 (1316).

<sup>133</sup> *Tilp*, FS Krämer, 331 (360, FN 105).

Ultimately there is an unsolvable conflict between fundamental constitutional and procedural principles in German law on one side and the goal of having a slender procedure resulting in efficient litigation.<sup>134</sup>

## **E. Conclusion**

In short summary, there is a general trend in Europe and Germany in particular towards more private enforcement, designated as a second track parallel to public enforcement of securities laws. Because of dispersed damages and rational apathy, a collective redress scheme is a prerequisite for effective private enforcement. In the form of the KapMuG, the German legislator has tried to create one such with mixed success. Even though the amount of shareholder actions have somewhat increased, the current legal framework does not provide the judiciary with means to deal with them in a timely fashion. The main deficiencies of the KapMuG however are rooted in constitutionally guaranteed procedural rights. These rights and principles are not easily abandoned.

The current spirit in Germany is definitely in favor of shareholder litigation. Private law enforcement is increasingly seen as positive and US-style class actions are more and more quoted as positive rather than negative examples.<sup>135</sup> Even creating a definite opt-out model is openly favored by some.<sup>136</sup> History has shown that Germany has always been slow to adapt in securities supervision and enforcement.<sup>137</sup> It might be that in the field of private enforcement too, Germany just needs more time to adapt and maybe just another push. After over 15 years of judicial work with the Telekom case, the current VW emissions scandal might just be that push, as it could become the next severe test for German collective redress in securities litigation. In four years the sun will set on the current version of the KapMuG and at the moment it seems more than questionable whether it will be deemed ripe for integration into the ZPO.

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<sup>134</sup> *Halberstam*, 021 SUNY B.L.S.R.P., 30-31 (2015).

<sup>135</sup> KK KapMuG / *Hess*, Einl., RN 2.

<sup>136</sup> *Jahn*, ZIP 2008, 1314 (1317).

<sup>137</sup> For example, the BAWe (now: BaFin) was only created in 1994, long after the US (1933), Belgium (1935) and France (1967) had created corresponding institutions, see *Hopt*, WM 2009, 1873 (1879).

## **Part II – United States of America**

### **A. Chapter introduction**

This paper will give an overview of the securities class action (B), go on to show the process of securities class action (C), and introduce the discussions about the strengths and weaknesses of some of the rationales of the current private enforcement system (D). A brief conclusion will follow (E).

### **B. Rule 10b-5 Class Actions in the U.S.: An Overview**

In the U.S., average of 189 securities class action claims were filed from 1997 to 2013, and 170 class actions were filed in 2014, according to Cornerstone Research, an economic and financial consulting firm which tracks securities class action filings.<sup>138</sup> Less than 200 cases each year may not look significant compared to the total civil cases filed each year. But confined to federal class actions, securities class actions take up nearly 50% of cases pending in the Federal Court of the U.S..<sup>139</sup> And 170 class actions in 2014 means that about one in 28 corporations listed on U.S. exchanges was subject to a class action.<sup>140</sup> During the period of 1997 and 2007, plaintiffs' attorneys earned nearly 17 billion dollars in fees from securities litigation.<sup>141</sup> In 2014, when total settlement dollars in securities litigation was the lowest in 16 years, the total amount was still above 1 billion dollars.<sup>142</sup> And among those cases, many actions were based on Securities and Exchange Commission ("SEC") Rule 10b-5.<sup>143</sup>

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<sup>138</sup> See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2014 YEAR IN REVIEW 1 (2015), <http://securities.stanford.edu/research-reports/1996-2014/Cornerstone-Research-Securities-Class-Action-Filings-2014-YIR.pdf>.

<sup>139</sup> John C. Coffee, Jr, *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1539 (2006) (finding that percentage of securities class actions pending in federal courts as of September 30, 2002, 2003, and 2004 to be 47.5%, 47%, and 47.9%).

<sup>140</sup> CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2014 YEAR IN REVIEW 9 (2015), <http://securities.stanford.edu/research-reports/1996-2014/Cornerstone-Research-Securities-Class-Action-Filings-2014-YIR.pdf>.

<sup>141</sup> Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 69 Business Lawyer 307, 308-09 (Feb. 2014).

<sup>142</sup> CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS 2014 REVIEW AND Analysis 1 (2015), <https://www.cornerstone.com/GetAttachment/701f936e-ab1d-425b-8304-8a3e063abae8/Securities-Class-Action-Settlements-2014-Review-and-Analysis.pdf>.

<sup>143</sup> CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2014 YEAR IN REVIEW 8 (2015), <http://securities.stanford.edu/research-reports/1996-2014/Cornerstone-Research-Securities-Class-Action-Filings-2014-YIR.pdf> (finding that the percentage of filings with Rule 10b-5 claims remained essentially unchanged in 2014 at 85 percent for the third year in a row).

The private right of action based on SEC Rule 10b-5 (“Rule 10b-5”) was not created by the legislators of the U.S..<sup>144</sup> The Congress only rendered conduct unlawful if it was prohibited by an SEC rule in Section 10(b) of the Security Exchange Act of 1934 (“Section 10(b)”).<sup>145</sup> The SEC promulgated Rule 10b-5 which is the catch-all antifraud provision proscribing fraudulent conduct in connection with the purchase or sale of any security.<sup>146</sup> But Rule 10b-5 also did not explicitly adopt a private right of action, either. Instead, the judiciary, when deciding on defendant’s motion to dismiss on lack of jurisdiction grounds, ruled that there is an implied right of action under Section 10(b) and Rule 10b-5.<sup>147</sup> Since then Rule 10b-5 actions has eventually become a dominant cause of action by use of class action procedure as shown below.

**Percentage of complaints of securities class actions cases filed each year which includes Rule 10b-5 actions<sup>148</sup>**

Year	Percentage
2011	71
2012	85
2013	84
2014	85

**Settlements by nature of claims 1996-2014<sup>149</sup>**

Nature of Claim	Number of cases
Section 11 or Section 12 only	83
Both Rule 10b-5 and Section 11 and/or 12(a)(2)	253
Rule 10b-5 only	1,102
All cases since 1996	1,438

<sup>144</sup> Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 69 Business Lawyer 307, 324 (Feb. 2014) (“Because the private right of action under section 10(b) is implied, it is entirely a creature of the judicial imagination.”).

<sup>145</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, *RULE 10B-5 SECURITIES-FRAUD LITIGATION* 18 (2015).

<sup>146</sup> Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements*, 157 U. Pa. L. Rev. 755, 764-65 (2009).

<sup>147</sup> *Kardon v. National Gypsum Co.*, 69 F.Supp. 512, 514 (E.D. Pa. 1946).

<sup>148</sup> CORNERSTONE RESEARCH, *SECURITIES CLASS ACTION FILINGS 2014 YEAR IN REVIEW* 8 (2015), <http://securities.stanford.edu/research-reports/1996-2014/Cornerstone-Research-Securities-Class-Action-Filings-2014-YIR.pdf>.

<sup>149</sup> CORNERSTONE RESEARCH, *SECURITIES CLASS ACTION SETTLEMENTS 2014 REVIEW AND ANALYSIS* 13 (2015), <https://www.cornerstone.com/GetAttachment/701f936e-ab1d-425b-8304-8a3e063abae8/Securities-Class-Action-Settlements-2014-Review-and-Analysis.pdf>



The Supreme Court's decision in *Basic v. Levinson* is recognized to have allowed the investor lawsuits alleging open market fraud for Rule 10b-5 cause of action to be widely used in securities fraud litigation by not rejecting the presumption of reliance, that is the presumption which most courts of appeals have adopted by the time of the decision.<sup>150</sup> The traditional, and most direct, way a plaintiff may show reliance is by showing that the plaintiff knew about the company's statement and bought or sold stock based on that misrepresentation.<sup>151</sup> In *Basic*, however, the Supreme Court recognized that requiring investors to show direct reliance would place an unnecessarily unrealistic burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.<sup>152</sup> The Supreme Court observed that requiring individualized reliance would prevent investors from proceeding with a class action in Rule 10b-5 suits because if every investor had to prove direct reliance on the defendant's misrepresentation then individual issues would overwhelm the common ones making class certification inappropriate.<sup>153</sup> And the Supreme Court held that it is not inappropriate to apply a rebuttable presumption of reliance supported by the fraud on the market theory.<sup>154</sup>

### **C. Rule 10b-5 Class Action Process**

When there is an announcement of correction of a prior representation which follows with a drastic stock price change, plaintiffs with counsels will typically sue multiple defendants including but not limited to the issuer, CEO and CFO in a class action alleging Rule 10b-5 claim. Under the Private Securities Litigation Reform Act ("PSLRA"), the plaintiff who files a securities class action complaint must publish notice to other potential class members to encourage them to step forward within 20 days.<sup>155</sup> Within 60 days after the date of the publication, any member of the purported class may move to serve as lead plaintiffs.<sup>156</sup> The court must appoint a lead plaintiff not later than 90 days after the publication of notice.<sup>157</sup>

When choosing the lead plaintiff, the court should appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be the most capable of

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<sup>150</sup> Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. 151, 153 (2009) ("In that sense, the Supreme Court simply endorsed what was by then a solid line of precedent.")

<sup>151</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, *RULE 10B-5 SECURITIES-FRAUD LITIGATION* 67 (2015).

<sup>152</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 245 (1988).

<sup>153</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 242 (1988).

<sup>154</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988).

<sup>155</sup> 15 U.S.C.A. Section 78u-4(a)(3)(A).

<sup>156</sup> 15 U.S.C.A. Section 78u-4(a)(3)(A)(i)(II).

<sup>157</sup> 15 U.S.C.A. Section 78u-4(a)(3)(B)(i).

adequately representing the interest of class members.<sup>158</sup> It is the chosen lead plaintiff who select and retain counsel to represent the class subject to the approval of the court.<sup>159</sup> Although the PSLRA imposes only the duty to select and retain counsel to the lead plaintiff, the courts have generally recognized the power of the lead plaintiff to control the overall litigation including discovery, the assertion of legal theories and settlement negotiations.<sup>160</sup> Once the lead plaintiff is appointed, the courts generally allow plaintiffs to file an amended, consolidated class action complaint.<sup>161</sup>

The Summons and complaint must be served on the defendant within 90 days after the filing of the complaint under Federal Rule of Civil Procedures (“FRCP”) rule 4.<sup>162</sup> When the defendants are served, they may opt for moving to dismiss the cases.<sup>163</sup> PSLRA stays discovery pending any motion to dismiss.<sup>164</sup>

After the motion to dismiss, the next pivotal moment where the parties collide is the class certification stage.<sup>165</sup> FRCP rule 23(a) allows one or members of a class to sue or be sued as representative parties on behalf only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.<sup>166</sup> These requirements for a federal class action apply to Rule 10b-5 class actions seeking monetary relief.<sup>167</sup> However, to seek monetary relief the plaintiff also has to meet the requirement of FRCP rule 23(b)(3). That is, the plaintiffs have to show that (1) questions of law or fact common to class members predominate over any questions affecting only individual members, and that (2) a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.<sup>168</sup> The party who moves for class certification bears the burden

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<sup>158</sup> 15 U.S.C.A. Section 78u-4(a)(3)(B)(i).

<sup>159</sup> 15 U.S.C.A. Section 78u-4(a)(3)(B)(v).

<sup>160</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 189 (2015).

<sup>161</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 189-190 (2015).

<sup>162</sup> Fed. R. Civ. P. 4(m).

<sup>163</sup> Fed. R. Civ. P. 12.

<sup>164</sup> 15 U.S.C.A. Section 78u-4(b)(3).

<sup>165</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 353 (2015).

<sup>166</sup> Fed. R. Civ. P. 23(a).

<sup>167</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 357 (2015).

<sup>168</sup> Fed. R. Civ. P. 23(b)(3).

to show that each of the FRCP rule 23 prerequisites are satisfied.<sup>169</sup> Of these requirements, the predominance requirement allows the courts to exercise considerable discretion when determining what causes of action are suitable on their facts for class-wide determination.<sup>170</sup>

In a Rule 10b-5 cause of actions context, elements of FRCP rule 23(a) and superiority requirement of FRCP rule 23(b)(3) are not much of an issue.<sup>171</sup> However, much controversy centered around the predominance requirement.

The Supreme Court has recognized that for cause of action under Rule 10b-5 the plaintiff must allege and prove 6 elements, that is (1) a material misrepresentation (or omission), (2) scienter, i.e., a wrongful state of mind, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation.<sup>172</sup> And there are two pivotal stages, that is class certification stage and the trial stage, where the elements could potentially be proven. So there are potentially 12 number of cases where each element could be proven.

Of the 6 elements, the Supreme Court decided that reliance requirement is need to be inquired at the class certification stage in *Basic*.<sup>173</sup> But the debate over the adequacy of the Supreme Court decision went on until the Supreme Court once again upheld the decision in 2014.<sup>174</sup> In 2011, the Supreme Court decided that loss causation need not be proven at class certification stage.<sup>175</sup> And the Supreme Court ruled that materiality requirement need not be proven at class certification stage in 2013.<sup>176</sup> The decision on class certification may be appealed subject to the discretion of the court.<sup>177</sup>

Not many securities class action cases actually go to trial. Only 21 have gone to trial and only 15 have reached a verdict or judgment out of 4,435 securities class actions that were filed between the enactment of PSLRA and December 31th, 2014.<sup>178</sup> Another study found that out of securities claim cases seeking damages from 1980 to 2005, only 37 cases that were tried to

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<sup>169</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 357 (2015).

<sup>170</sup> John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 Colum. L. Rev. 288, 299 (2010).

<sup>171</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 358-360 (2015).

<sup>172</sup> *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-342 (2005).

<sup>173</sup> Jill E. Fisch, *The Trouble with Basic: Price Distortion After Halliburton*, 90 Wash. U. L. Rev. 895, 910-911 (2013) (“*Basic* reaffirmed the need for an inquiry into reliance and, importantly, preserved this inquiry for a threshold stage of the litigation—the class certification decision.”) (emphasis in original).

<sup>174</sup> *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398 (2014).

<sup>175</sup> *Erica P. John Fund, Inc v. Halliburton*, 131 S.Ct. 2179, 2183 (2011).

<sup>176</sup> *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S.Ct. 1184, 1191 (2013).

<sup>177</sup> Fed. R. Civ. P. 23(f).

<sup>178</sup> RENZO COMOLLI & SVETLANA STARYKH, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2014 FULL-YEAR REVIEW 36 (2015)  
[http://www.nera.com/content/dam/nera/publications/2015/PUB\\_2014\\_Trends\\_0115.pdf](http://www.nera.com/content/dam/nera/publications/2015/PUB_2014_Trends_0115.pdf).

judgment against public companies, their officers and directors, or both.<sup>179</sup> Most cases that are not dismissed are settled. The cases may settle any time during the procedure. About 40% of the securities class actions including Rule 10b-5 class action are settled while there is still a possibility of dismissal.<sup>180</sup> Because settlements made as a class binds other class members who are absent, FRCP 23(e) requires court approval as a safeguard against abuse.<sup>181</sup> Settlement procedure consists of three phases: (1) the preliminary approval hearing; (2) the notice period; and (3) the final approval and fairness hearing.<sup>182</sup> When the parties have agreed to the terms of the settlement, they must move the court for preliminary approval.<sup>183</sup> The court reviews whether (1) the proposed class is suitable for final certification under the Federal Rules; and (2) the substantive and procedural terms of the settlement are fair, reasonable, and adequate.<sup>184</sup> When the court gives a preliminary approval, the parties should then notify proposed class members of the settlement.<sup>185</sup> After the notice is served, the court will conduct a final approval hearing and determine whether to finally approve the settlement.<sup>186</sup> It is possible to opt out of a class action in class actions seeking money damages.<sup>187</sup> If a party opts out of a securities class action, the party is not bound by the class action.<sup>188</sup> Study shows that in cases where there were parties who opted out to sue individually, the opted out parties have done better than they would have if they have not opted out and settled as a class.<sup>189</sup> Opting out is possible even at the class action settlement stage by the court's discretion.<sup>190</sup>

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<sup>179</sup> Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 Stan. L. Rev. 1055, 1064 (2006).

<sup>180</sup> Michael Klausner, Jason Hegland & Matthew Goforth, *When Are Securities Class Actions Dismissed, When Do They Settle, and for How Much? An Update*, 23 PLUS 1, 4 (April, 2013) ("Forty-three percent of settlements occur in the Early or Late Pleading Phase—that is, while there is still a possibility of dismissal.")

<sup>181</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 582 (2015).

<sup>182</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 604 (2015).

<sup>183</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 604 (2015).

<sup>184</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 604 (2015).

<sup>185</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 605 (2015).

<sup>186</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 606 (2015).

<sup>187</sup> Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 Vand. L. Rev. 1529, 1538 (2004).

<sup>188</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 636 (2015).

<sup>189</sup> John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better Than "Voice"*, 30 Cardozo L. Rev. 407, 409 (2008).

<sup>190</sup> Fed. R. Civ. P. 23(e)(4).

In Rule 10b-5 action, the plaintiff commonly name both the company and the potentially responsible executives and directors as defendants.<sup>191</sup> However, the Supreme Court of United States have been criticized as narrowing the scope of defendants over the years.<sup>192</sup> In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court concluded that there is no private aiding and abetting liability under Section 10(b), which means that there is no cause of action for aider and abettors in a Rule 10b(5) action.<sup>193</sup> And in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Supreme Court when addressing whether two third-party participants in a fraudulent scheme, engineered by a corporate issuer, faced liability in a private securities lawsuit for harm caused by the issuer's false and misleading corporate disclosures, decided that there is no reliance, and hence no liability, when the link between the third party's actions and the resulting misrepresentation by the issuer is too remote or attenuated.<sup>194</sup> Then again, In *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court held that a mutual fund investment advisor can not be held liable for Rule 10b-5 private action for misrepresentation in the prospectuses of the mutual fund because it did not make a misrepresentation within the meaning of Rule 10b-5.<sup>195</sup>

#### **D. Analysis**

Rule 10b-5 class action may serve multiple purposes. It may (1) serve to compensate fraud victims, (2) operate as a deterrent against future fraud, or/and (3) work as a corporate governance mechanism. But there are different views on whether the class action is working effectively to serve these purposes which we will look into below.

#### **I. Compensation Rationale**

Rule 10b-5 class action is criticized for not being an adequate tool to compensate the victims for various reasons. First of all, it is criticized that the private litigation is performing poorly

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<sup>191</sup> Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, 631-632, (2007).

<sup>192</sup> Donald C. Langevoort, *Reading Stoneridge Carefully: A Duty-based Approach to Reliance and Third-party Liability Under Rule 10b-5*, 158 U. Pa. L. Rev. 2125, 2126-2127 (2010).

<sup>193</sup> *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* 511 U.S. 164, 191 (1994).

<sup>194</sup> Donald C. Langevoort, *Reading Stoneridge Carefully: A Duty-based Approach to Reliance and Third-party Liability Under Rule 10b-5*, 158 U. Pa. L. Rev. 2125, 2126 (2010).

<sup>195</sup> *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S.Ct. 2296, 2299 (2011).

to compensate the victims.<sup>196</sup> Study shows that the median recovery rate for class actions does not exceed 7.2% of the estimated investor loss.<sup>197</sup> Although it is hard to calculate the damages caused by the revelation of the misrepresentation which can be connected to the misrepresentation itself,<sup>198</sup> the difference between the estimated investor loss and the median recovery rate does seem substantial. Another study shows that approximately 96% of securities class action settlements fell within the insurance coverage.<sup>199</sup> The finding that the settlement amounts are almost always covered by whatever insurance coverage that a corporation may have at the moment could show that the settlement amount may not be an adequate compensation for investor loss.

Moreover, the fact that most of the Rule 10b-5 class actions settle in the U.S. has further implications. When securities class actions settle, most of the cases are settled with the insurance companies paying all or most of the settlement.<sup>200</sup> And even for the cases where insurance companies not paying all the settlement payments, corporations seem to pay the settlement payments mostly.<sup>201</sup> This practice undermines the rationale for compensating the plaintiffs in Rule 10b-5 class actions for reasons below.

Many shareholders who is a class of plaintiff in a Rule 10b-5 class action may hold shares of the corporation named defendant.<sup>202</sup> That is because the shareholder may have bought and sold the share at different times.<sup>203</sup> Moreover, many modern investors hold stocks in portfolios.<sup>204</sup> Because these investors can be expected to sometimes benefit when the misrepresentation distorts the price by selling in a high price, while sometimes be harmed when the misrepresentation distorts the price by selling in a low price, thus their gain and losses will net out

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<sup>196</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1545 (2006).

<sup>197</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1545 (2006).

<sup>198</sup> Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 Iowa L. Rev. 811, 849-850 (2009).

<sup>199</sup> James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 Ariz. L. Rev. 497, 512 (1997).

<sup>200</sup> Michael Klausner, et al., *How Protective is D&O Insurance in Securities Class Actions? An Update*, 26 PLUS 1, 1-2 (May, 2013) (finding that out of the 253 securities class actions which were filed between 2006 and 2010 of which 81% of the 253 securities class action settlement data obtained, 57% of the settlement payments were all paid by the insurer and 28% of the settlement payment was paid at least in part by the insurer).

<sup>201</sup> Michael Klausner, et al., *How Protective is D&O Insurance in Securities Class Actions? An Update*, 26 PLUS 1, 2 (May, 2013) (finding that of the data obtained for securities class actions cases which were filed between 2006 and 2010, officers paying settlement payment in only 2% of the cases and no directors paying settlement payment).

<sup>202</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1558 (2006).

<sup>203</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1558 (2006).

<sup>204</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 94 (2011).

over time as their diversified status.<sup>205</sup> Assuming that investors are repeat players, the benefits and harms will mostly cancel each other out.<sup>206</sup> This may also be true to uninformed traders who buy and sell stocks randomly without informational basis.<sup>207</sup> In these instances, the litigation fee including those paid to the attorneys will be extra cost suffered for a benefit which has been already accomplished by diversification.<sup>208</sup>

However, this may not be the case for retail investors who buy and hold the stocks for a long time.<sup>209</sup> Since in the U.S., Rule 10b-5 class action is actionable to those who have bought or sold the stocks, someone who holds on to the stock without trading for a long time will not have standing to sue.<sup>210</sup> They will be systematically compensating for the plaintiffs in the class action unless they may be compensated in other ways.<sup>211</sup> As we will see below, they will not be compensated because of the settlement practice.

Another group of people who are not holding their stocks in portfolio are informed investors.<sup>212</sup> The informed trader who instead of diversifying incur cost of research to profit from acting on the information by trading are more likely to suffer net losses from securities fraud precisely because they trade on information, including fraudulent information.<sup>213</sup> For these kind of traders, compensation is both desirable and noncircular.<sup>214</sup>

This problem mainly occurs because the defendant contributing for the damages of the plaintiffs are the corporation by paying the premium to the insurance company and actually paying the damages out of corporate assets.<sup>215</sup> If the directors and/or officers who actually made the misrepresentation or the aiders and abettors of the misrepresentation such as lawyers are the ones who are paying for the damages to the plaintiffs, then there will be no pocket shifting to

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<sup>205</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 94 (2011).

<sup>206</sup> See Donald C. Langevoort, *Capping Damages for Open-market Securities Fraud*, 38 Ariz. L. Rev. 639, 646-47 (1996).

<sup>207</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 96 (2011).

<sup>208</sup> Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do not Trade?*, 2009 Wis. L. Rev. 297, 309 (2009).

<sup>209</sup> John C. Coffee, Jr, *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1560 (2006).

<sup>210</sup> *Blue Chip Stamps v. Manor Drug Stores*, 95 S.Ct. 1917, 1934-1935 (1975).

<sup>211</sup> John C. Coffee, Jr, *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1560 (2006).

<sup>212</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 346 (2009).

<sup>213</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 345-346 (2009).

<sup>214</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 347 (2009).

<sup>215</sup> See John C. Coffee, Jr, *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1557-58 (2006).

the portfolio holders and no systemic loss to the long term holders.<sup>216</sup> However, as the rule and practice stands in the U.S., the criticisms that Rule 10b-5 class actions is not adequately compensating the victims are not entirely without merits.<sup>217</sup>

## II. Deterrence Rationale

It is further argued that private litigation also has a role in deterring misrepresentation.<sup>218</sup> This rationale is independent from the compensation rationale in the sense that the success or failure of one does not depend upon the other.<sup>219</sup> Corporate fraud may cause reduced management accountability, a loss of liquidity in the stock market and distorted capital allocation.<sup>220</sup> Private litigation serves as a deterrence mechanism in which the plaintiff or plaintiff's lawyer works as a private attorney general who punishes corporations for its prohibited behavior.<sup>221</sup>

Deterrence works when a prospective wrongdoer decides not to do the wrongful act knowing that he or she will be forced to pay the full cost of any harm he or she causes.<sup>222</sup> Number of offenses one would commit would be a function of probability of conviction per offense, punishment per offense and other variables.<sup>223</sup> An increase in probability of conviction or punishment per offense would tend to reduce the number of offenses because in either case the probability of paying the higher price or the price itself would increase.<sup>224</sup> In securities class action context, it may work as an mechanism which could increase both the probability of finding the misrepresentation or increasing the price to pay for making such a misrepresentation.<sup>225</sup> However, it is criticized as not being an efficient mechanism for reasons below.

According to a study about who detects fraud consisting of 216 cases of alleged corporate frauds which include all of the high-profile cases such as Enron, HealthSouth, and Worldcom,

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<sup>216</sup> This may not be true if the director, officer, or aider and abettor can use mechanisms such as indemnification, insurance, executive compensations or contractual arrangement to deflect the effect from themselves to the corporation. See Donald C. Langevoort, *Capping Damages for Open-market Securities Fraud*, 38 Ariz. L. Rev. 639, 653 (1996).

<sup>217</sup> See, e.g., William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 100 (2011).

<sup>218</sup> John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is not Working*, 42 Md. L. Rev. 215, 218 (1983).

<sup>219</sup> TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 6 (2010).

<sup>220</sup> A.C. Pritchard, *Market as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925, 945 (1999).

<sup>221</sup> John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 Md. L. Rev. 215, 218 (1983).

<sup>222</sup> TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 9 (2010).

<sup>223</sup> Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169, 177 (1968).

<sup>224</sup> Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169, 177 (1968).

<sup>225</sup> James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 ECFLR 164, 173 (2009).



there were only 3% of the cases where the detection of the fraud was attributable to private litigation.<sup>226</sup> This contrasts with the finding in the study where the key role in fraud detection is made by employees who is the detector in 17% of the cases and the media which can be accountable for 13% of the cases.<sup>227</sup> While the study may not show whether or not we need private litigation to detect the 3% of cases to reach the optimal level of detection, it does show that private litigation does not take up the bulk of the work in detecting corporate fraud.<sup>228</sup>

Another mechanism where private litigation may have a role in detecting fraud is by enhancing transparency. That is, if private litigation adds more transparency to corporate information, it may help deter fraud. But there are mixed findings on whether private litigation adds more transparency to corporate conducts or not, especially regards to voluntary disclosures.<sup>229</sup>

Private enforcement could increase the price of payment of the misrepresentation after the fraud was detected. But this mechanism is undermined by the usage of director and officer (“D&O”) insurance. When a payment is made by the corporation, it would mean that the the stockholders of the corporation as a residual owner is making the ultimate payment.<sup>230</sup> And because the corporation usually pays the premium for the D&O insurance, the payment made by the D&O insurance is also born by the shareholder of the corporation as a premium paid by the corporation.<sup>231</sup>

D&O insurance as commonly provided consist of 3 distinct insurance arrangement.<sup>232</sup> They are (1) coverage to protect individual managers from the risk of shareholder litigation in the event that the corporation is unable to indemnify them, (2) coverage to reimburse the corporation for its indemnification obligations, and (3) coverage to protect the corporation from the

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<sup>226</sup> Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. Fin. 2213, 2213-2214 (Dec. 2010).

<sup>227</sup> Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. Fin. 2213, 2214 (Dec. 2010).

<sup>228</sup> Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. Fin. 2213, 2251 (Dec. 2010).

<sup>229</sup> Compare Stephen P. Baginski et al., *The effect of Legal Environment on Voluntary Disclosure: Evidence from Management Earnings Forecasts Issued in U.S. and Canadian Markets*, 77 Acct. Rev. 25, 27 (2002) (finding that Canada firms with less litigious environment than the U.S. during the time period from 1993 to 1996 were more likely to issue forecast disclosures more frequently compared to the U.S. firms in the same period), and James P. Naughton et al., *Private Litigation Costs and Voluntary Disclosure: Evidence for the Morrison Ruling* 28 (Oct. 7, 2015), SSRN: <http://ssrn.com/abstract=2432371> (“We find consistent evidence that a reduction in expected private litigation costs leads to a reduction in voluntary disclosure across all three sets of analyses.”).

<sup>230</sup> Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: *Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, 629 (2007).

<sup>231</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 95 (2011).

<sup>232</sup> Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market*, 74 U. Chi. L. Rev. 487, 499 (2007).

risk of shareholder litigation to which the corporate entity itself is a party.<sup>233</sup> The part of coverage which insures individual directors and officers usually include compensatory damages, settlement amounts, and defense costs incurred by the individual director or officer in his or her official capacity.<sup>234</sup> When corporation incurs an obligation to indemnify its officers or directors which most policies deem to be required in every case in which a corporation is legally permitted to do so, the insurer will reimburse the company pursuant to the terms of the indemnification obligation.<sup>235</sup> For the cases where the liabilities arising directly against the corporation as a defendant in shareholder litigation, D&O insurance also included coverage to protect the corporation itself as a party.<sup>236</sup> While most D&O insurance payment is made under coverage (2), (3) which is technically a coverage for the corporation, the insurance package as a whole works for the benefit of the directors and officers.<sup>237</sup>

This doesn't mean that the managers will always settle for their own good at the expense of the corporation. The managers may have incentive to settle for the benefit of the corporation. Considering American rule where prevailing party are not entitled to get reimbursement of the incurred legal fees and expense from the opposing party combined with the cost of discovery, the defendants will generally find settlement cheaper than litigation.<sup>238</sup> Litigation costs for the defendants can be high because in a discovery process the plaintiff can control the discovery agenda which the defendants are obliged to respond unless they can persuade the court that the request is improper.<sup>239</sup> The plaintiff's attorney, knowing that the American rule prevents fee shifting will impose costs on the adversary while economizing its own cost.<sup>240</sup>

One could argue that as long as the D&O insurers companies work to prevent and manage the corporation, the usage of D&O insurance works as a deterrence.<sup>241</sup> However, study suggests that insurance companies do not provide loss prevention services regarding corporate fraud.<sup>242</sup> As long as the actual wrong doers are not actually paying for the settlement amount of the securities class action, enforcement by private litigation may not have the asserted deterrence

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<sup>233</sup> Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. Chi. L. Rev. 487, 499 (2007).

<sup>234</sup> Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 Geo. L. J. 1795, 1804 (2007).

<sup>235</sup> TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 47 (2010).

<sup>236</sup> TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 47-48 (2010).

<sup>237</sup> TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 48 (2010).

<sup>238</sup> A.C. Pritchard, *Market as Monitors: A Proposal to Replace Class Action with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925, 952-953 (1999).

<sup>239</sup> Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Action*, 43 Stan. L. Rev. 497, 549 (1991).

<sup>240</sup> JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION 165 (2015).

<sup>241</sup> Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, Int'l Rev. L. & Econ. 115, 118 (1990).

<sup>242</sup> Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 Geo. L. J. 1795, 1808 (2007).

effect of increasing the price of misrepresentation.<sup>243</sup> On the other hand, increasing the cost of making representation could potentially cause excessive precaution cost.<sup>244</sup>

The deterrence effect may still function indirectly if the outside professionals functioning as gatekeepers of corporate frauds are affected by the securities litigation.<sup>245</sup> When a corporation makes a public statement, outside professionals could be efficient gatekeepers because they can access the corporation's inside information when providing necessary service for making such a statement.<sup>246</sup> These professionals may not have the proper incentive to perform the gatekeeping function because they have incentives to maintain a relationship with the corporation.<sup>247</sup> But because the supreme court of the U.S. have kept on removing the liability of the outside professionals as seen above, gatekeepers may not have sufficient incentives to deter corporate fraud.<sup>248</sup>

### III. Corporate Governance Rationale

The justification of private litigation may not only be grounded on investor protection but also on enhancement of corporate governance.<sup>249</sup> One rationale is that by making the shareholders pay for the corporate fraud of the managers, the securities class action creates responsibility and incentives to monitor the acts of the managers.<sup>250</sup> This rationale is not without merits. However, considering the given power of the shareholders in U.S. corporate governance system, shareholders may not have the power to monitor the acts of the managers.<sup>251</sup> That is, shareholders may not be innocent, but they may be helpless.<sup>252</sup>

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<sup>243</sup> See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1585-86 (2006).

<sup>244</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 Colum. L. Rev. 1534, 1548 (2006).

<sup>245</sup> Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 Colum. L. Rev. 1293, 1314 (1999).

<sup>246</sup> Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 Colum. L. Rev. 1293, 1314-1315 (1999).

<sup>247</sup> Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 Colum. L. Rev. 1293, 1315 (1999).

<sup>248</sup> See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 318-20 (2004).

<sup>249</sup> Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 Wis. L. Rev. 298,301 (2009).

<sup>250</sup> Lawrence E. Mitchell, *The "Innocent Shareholders": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 Wis. L. Rev. 243, 294 (2009).

<sup>251</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 341 (2009).

<sup>252</sup> See Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 340-41 (2009).

Another rationale for shareholder litigation is that it may enhance the quality of the disclosure which plays a role in corporate governance.<sup>253</sup> Not only will better informed shareholder monitor the managers better, but the allows the market mechanism like market for corporate control to work more efficiently.<sup>254</sup> But whether securities class action as currently practiced has sufficient deterrence effect on managers to improve their quality of disclosure is debatable for the reasons seen above. Moreover, although the corporation will have to disclose information that are mandatory, risk of liability could increase incentives to reduce the amount of voluntary disclosure.<sup>255</sup> So the over all effect of the securities class action on the disclosure system seems unclear.

But shareholder litigation as a compensation mechanism may add more justification to the shareholder litigation as a corporate governance mechanism.<sup>256</sup> This rationale involves the role of informed traders. Informed traders make costly investments to research for firm-specific information which could include fraudulent information.<sup>257</sup> Because informed traders are trading based on information, their gains and losses from securities fraud are unlikely to cancel each other out.<sup>258</sup> As these informed traders promote capital market efficiency which will enhance corporate governance, allowing informed traders to recover their damages from fraudulent information could be justified.<sup>259</sup> This compensation rationale, while persuasive as a justification for allowing private enforcement, could also lead to a possible demand for modification in U.S. securities class action.<sup>260</sup> Because fraud on the market theory as decided by the U.S. Supreme court allows not only who relied on the information to recover but also allows those who only relied on the market price to recover as well.<sup>261</sup>

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<sup>253</sup> Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 Wis. L. Rev. 298,310 (2009).

<sup>254</sup> Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 Wis. L. Rev. 298, 311 (2009).

<sup>255</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 114 (2011).

<sup>256</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 345 (2009).

<sup>257</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 347 (2009).

<sup>258</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 347 (2009).

<sup>259</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 350 (2009).

<sup>260</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 348-394 (2009).

<sup>261</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 Wis. L. Rev. 333, 348 (2009).

## **E. Conclusion**

Securities class action is supposed to do a lot of work in the U.S. It is expected to compensate, effectively deter misrepresentations, or/and work as a mechanism to enhance corporate governance. However, private litigation as currently practiced in the U.S. are subject to much criticism. Whether it should be reformed to better serve its objectives or be eliminated will have to be considered not just by itself, but also with public enforcement mechanism which tries to address similar objectives by different approach.<sup>262</sup>

Even up against much criticism, it is true that private enforcement of the U.S. is unique in the sense that it is not something that is left in the book, but something that is in operation.<sup>263</sup> So when searching for optimal enforcement mechanism to meet the objectives of securities law, whether they are compensation, deterrence, or/and enhancing corporate governance, the rich experience of the U.S. private enforcement history should be taken into consideration.

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<sup>262</sup> See JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION 233-34 (2015) (suggesting mechanism to make public enforcers and private enforcer in to partners in enforcement).

<sup>263</sup> See John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 245 (2007).

## **Part III - Comparison**

### **A. Chapter Introduction**

As has been shown, private litigation and collective redress is an issue both in the U. S. and in Germany. On the basis of Part I and Part II, the following will try to draw some comparisons between the legal frameworks followed by considering possible obstacles of importing U.S. style class action to Germany. Then, we will consider some German legal framework which may be used in the U.S. to improve the U.S. securities class action system. Finally, we will consider the impact that securities law and D&O insurance practice in Germany might have on addressing deterrence objectives in Germany under the assumption of active enforcement, which will be followed by a brief conclusion.

### **B. Comparison between US and Germany**

The comparison will focus first on a more general level (I.). Next, the incentives of the parties to use collective redress will be addressed (II.). Following this, the possibility of importing U.S. style class action to Germany and potential obstacles hereto will be discussed (III.), which will follow with a conclusion (IV.).

### **I. General Observations**

Taking a broad look at Part I and Part II above, one cannot help but notice some more general differences between Germany and the U.S. Main differences exist in the areas of enforcement mechanisms, the extent of shareholder actions and the topics of legal discussion.

#### **1. Private vs. Public Enforcement**

Corporate behavior can be externally controlled by enforcing disclosure duties.<sup>264</sup> This enforcement can happen in two distinct ways, i.e. by public or private means.<sup>265</sup>

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<sup>264</sup> *Dharmastuti/Wahyudi*, 4:4 R.J.F.A., 132-134 (2013).

<sup>265</sup> *See supra*, Part I, B..

Germany has historically been favoring public enforcement, through the BaFin, the States and the Public Exchanges.<sup>266</sup> Private enforcement is only recently becoming more popular and being adopted on a statutory basis.<sup>267</sup>

This marks a contrast to the situation in the U.S., where the U.S. Supreme Court has recognized the supplementary role of private enforcement to public enforcement as early as 1964.<sup>268</sup> U.S. procedural law allows class action lawsuits for most areas of substantial law, including (but in no way limited to) securities fraud disputes.<sup>269</sup>

These different approaches to the enforcement of regulations can be explicitly seen in the field of securities law, when contrasting the extent of private litigation in both countries.

## **2. Extent of Private Litigation in Securities Markets**

When looking at the actual numbers of private shareholder actions for securities fraud there is a stark contrast between Germany and the U.S. In Germany there was a total of only 111 court decisions concerning securities fraud action based on §§ 37b, c WpHG (the predominant statutory basis for misrepresentation suits) from 2001 to 2013.<sup>270</sup> This is less than the yearly average of securities class action lawsuits being filed in the U.S. - a number that does not even come close to the total number of securities disputes.<sup>271</sup>

These differences in factual circumstances are an explanation for the third area of contrast between Germany and the U.S. - the focus of legal discussion.

## **3. Topics of Legal Discussion**

As we have seen, many securities class actions are being filed in the U.S. every year, and most of them are filed with Rule 10b-5 cause of action.<sup>272</sup> But because Rule 10b-5 cause of action is implied not explicit, lots of issues regarding both substantive law and procedural law had to be cleared up by the judiciary as the Congress did not design the overall elements and

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<sup>266</sup> *Hopt*, WM 2009, 1873 (1879).

<sup>267</sup> *See supra*, Part I..

<sup>268</sup> *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

<sup>269</sup> Fed. R. Civ. P. 23.

<sup>270</sup> *See supra*, Part I, C. III. 1..

<sup>271</sup> *See supra*, Part II, B..

<sup>272</sup> *See supra*, Part II, B..

procedures.<sup>273</sup> And because of the volume of filings, the U.S. Supreme Court had many chances to frame the structure of the implied cause of action.<sup>274</sup>

Germany on the other hand is - provocatively speaking - still “a step behind” concerning matters of private enforcement and substantial law. A system of collective redress in the form of the KapMuG has only recently been established for securities market disputes.<sup>275</sup> The KapMuG and its underlying aspects of procedural law are still hotly debated and the focus is not as much on substantial law.<sup>276</sup> The most relevant topic of legal discussion is how a collective redress scheme in Germany should look like. One possibility - importing US-style securities class action - will be discussed in further detail below.

## II. Incentives to Use Collective Redress

One question that deserves further elaboration is: What are the incentives to use collective redress in both countries? For a system of collective redress in securities disputes to work and be actually used, it should address the incentive of the party expected to use the procedure.

### 1. General Observations

The mechanism of collective redress can be designed in various ways. It can be structured either as an opt-in system (as which the German KapMuG is basically designed) or as an opt-out system as in the case of U.S. class action pursuant to Federal Rule of Civil Procedures (FRCP) Rule 23.

Another basic differentiation can be made concerning the scope of the court’s decision. In a German KapMuG procedure the court only decides on certain elements, while in the U.S. the court decides on the claim in its entirety.<sup>277</sup>

However, it is interesting to note that although much focus is on the U.S. class action with opt-out system and monetary claims, the U.S. has other kinds of class actions, too. For instance, FRCP Rule 23(d) allows opt-out class certification on partial issues, although this pro-

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<sup>273</sup> Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 69 Business Lawyer 307, 324 (Feb. 2014).

<sup>274</sup> Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 69 Business Lawyer 307, 325-26 (Feb. 2014) (listing 28 cases visited by the Supreme Court regarding Rule 10b-5 cause of action until the time of the publication).

<sup>275</sup> The first version of the KapMuG was only introduced in 2005. For details on its development, see supra, Part I, C. I..

<sup>276</sup> See supra, Part I, D..

<sup>277</sup> Bergmeister, KapMuG, 232.



cedure is only used infrequently.<sup>278</sup> Moreover, U.S. statutes like Fair Labor Standards Act (FLSA), Age Discrimination in Employment Act (ADEA) and the Equal Pay Act (EPA) also have opt-in class actions for certain kinds of actions.<sup>279</sup>

## 2. Incentives on Plaintiffs' Side

In the case of FRCP Rule 23 securities class action in the U.S., the incentive to make use of class action procedure seems to be mainly on the plaintiffs' side. One reason is the existence of mandatory court awarded fees for the plaintiffs' counsel.<sup>280</sup> This is more of an incentive for the attorney or attorneys who represent the filing plaintiff rather than the individual plaintiffs.<sup>281</sup> If the counsel succeeds in obtaining a certification of a class (of which the aggregated amount of all claims is sufficiently high), the counsel can expect to be awarded a considerable sum when the case settle.<sup>282</sup>

The American Rule regarding litigation fee could also be considered to favor the plaintiff.<sup>283</sup> In the U.S., each side pays for its own litigation fees regardless of the outcome in a securities class action.<sup>284</sup> Consequently the plaintiff does not have to take the possibility of paying for the inevitably incurred legal fees of the defendant in the event of losing the case into account when considering whether to file a claim or not.<sup>285</sup> In practice, the plaintiff's counsel will agree to represent the plaintiff in a class action, expecting court awarded remuneration when the case concludes.<sup>286</sup>

This is not the case for Germany. The KapMuG is designed in a way that resembles an opt-in system (although it technically is something unique that cannot be classified as purely opt-in).<sup>287</sup> The aggregation effect of an opt-in system is far weaker than the opt-out system.<sup>288</sup>

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<sup>278</sup> JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION: ITS RISE FALL AND FUTURE 225 (2015).

<sup>279</sup> JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION: ITS RISE FALL AND FUTURE 207 (2015).

<sup>280</sup> John C. Coffee, Jr., *Accountability and Competition in Securities Class Action: Why "Exit" Works Better Than "Voice"*, 30 *Cardozo L. Rev.* 407 (2008).

<sup>281</sup> See John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implication of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 *Colum. L. Rev.* 669, 677-78 (1986).

<sup>282</sup> See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implication*, 106 *Colum. L. Rev.* 1534, 1546 (2006).

<sup>283</sup> John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implication of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 *Colum. L. Rev.* 669, 670 (1986).

<sup>284</sup> James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 *Ariz. L. Rev.* 497 (1997).

<sup>285</sup> See Theodore Eisenberg & Geoffrey P. Miller, *The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts*, 98 *Cornell L. Rev.* 327, 335 (2013).

<sup>286</sup> Janet Cooper Alexander, *Contingent Fees and Class Actions*, 47 *DePaul L. Rev.* 347, 348 (1998).

<sup>287</sup> See supra, Part I, C. II. 2.; *Haar*, Investor protection through model case procedures (CFS Working Paper No. 2013/21), 22.

Moreover, not only does the KapMuG not allow court-awarded fees contingent on the amount of the plaintiffs' recovery, but contingent fee contracts are (generally) not allowed in Germany.<sup>289</sup> So there is not much incentive for the plaintiffs' attorneys to file for a KapMuG intermediate proceeding.

However, there may still be some incentive for the plaintiff to file for a KapMuG proceeding. In a KapMuG action, the court fee for each individual trial has to be paid when initially filing a claim and there is no extra fee when the case progresses to the model case procedure.<sup>290</sup> The additional costs incurred during the model case procedure (e.g. expert expenses) are added to the total costs in the individual trials in proportion to the amount of each plaintiff's claim in the end.<sup>291</sup> The plaintiffs do not have to pay the advance in costs for the expert expenses in the model case proceeding.<sup>292</sup> This is quite different from the usual procedure, where the party making the motion is required to pay the advance in costs for the expenses of gathering evidence, including the expenses of the expert appointed by the court.<sup>293</sup> That means in a case where the expert expenses are high, the party with the burden to prove an element requiring high expenses (which will usually be the plaintiff) has an incentive to request a model procedure. The loser of the case has to reimburse these costs at the end of the individual proceeding.<sup>294</sup> Because the litigation costs incurred during the model case procedure (including expert expenses) would have incurred even if the case was brought individually, the overall expected cost of litigation may be lower compared to the expected cost of an individual proceeding. In a KapMuG procedure, the expert expenses are distributed between all plaintiffs and each plaintiff has the duty to reimburse only when one loses.<sup>295</sup>

When we look deeper in the KapMuG procedure, we should note that there are two decisions to be made by all injured shareholders. The first decision is whether to file a securities fraud action at all or not, and the second decision is whether to request a KapMuG procedure or not. The first decision may be crucially influenced by the existence of the KapMuG for a plaintiff who does not have the money for the advance in costs for expert fees. This plaintiff will have more incentive to request a KapMuG procedure because such a plaintiff would probably be judg-

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<sup>288</sup> Andrew C. Brunnsden, *Hybrid Class Actions, Dual Certification and Wage Law Enforcement in the Federal Courts*, 29 Berkeley J. Em. & Lab. L. 269, 294 (2008) (finding average opt-in rate of 15.71% out of 21 FLSA cases in the U.S.).

<sup>289</sup> *Wagner*, 16 Theoretical Inq. L. 69, 99 (2015).

<sup>290</sup> *Bergmeister*, KapMuG, 222.

<sup>291</sup> See § 24 para. 1 KapMuG

<sup>292</sup> See § 17 para. 4 sent. 1 of the German Court Fees Act [Gerichtskostengesetz (GKG), as of 12/21/2015, BGBl. I 2014, 154].

<sup>293</sup> See § 17 para. 1 sent. 1 GKG

<sup>294</sup> *Bergmeister*, KapMuG, 223

<sup>295</sup> *Bergmeister*, KapMuG, 223

ment proof anyway if the party loses in the final outcome.<sup>296</sup> However, a party who has the resources to pay for the procedure, even if the outcome is a loss, only has the money value of the time for expert fee which has not been prepaid in the KapMuG procedure. This in turn should be weighed against the resources spent by the extra time the KapMuG procedure may have incurred.

The other mechanism, which allows proportionate distribution of the expense among the losers, will be an advantage which can be exploited indifferently by all parties. However, this is an incentive which is modest at best, as it only lowers the legal cost of the party, not the legal attorney. So this mechanism will not be likely to bring about the entrepreneurship mindset of a plaintiff or plaintiff's counsel in Germany, unlike the U.S. securities class action does in the U.S..<sup>297</sup>

Some attention should also be brought to the incentives on the side of plaintiffs' counsels. Usually, there is no extra payment for the plaintiff's counsel when a case goes on to KapMuG intermediate proceeding in principle.<sup>298</sup> So requesting the use of KapMuG procedure may not be welcome to the plaintiff's counsel unless the counsel happens to be representing many plaintiffs with similar claims which cannot be joined together by other procedure.<sup>299</sup>

### 3. Incentives on Defendants' Side

Will there be an incentive on the defendant's side? Because settling an opt-out class action in the U.S. will make the dispute be settled for good (except for some individual plaintiffs who choose to opt out) without risking the cost of high litigation, there may be an incentive for the defendant to use an opt-out class action in theory.<sup>300</sup> However, defendants will generally move to dismiss the case because PSLRA stays discovery pending any motion to dismiss.<sup>301</sup>

It could be said that there is also some incentive to the defendant of Germany to opt for class action in KapMuG, because in a KapMuG procedure the issue is only a certain element of a claim which is fatal for the plaintiffs' case, while the defendant may still go on disputing

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<sup>296</sup> See John C. Coffee, Jr., "Loser Pays": *The Latest Installment in the Battle-Scarred, Cliff-Hanging Survival of the Rule 10b-5 Class Action*, 68 S.M.U.L. 689, 699 (2015) (asserting that only judgment proof plaintiff with no assets will rationally serve as lead plaintiff for Rule 10b-5 class action in a loser pays rule).

<sup>297</sup> John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is not Working*, 42 Md. L. Rev. 215, 235-36 (1983) (noting that the entrepreneurial private attorneys generally predominate in some areas of litigation including the securities class action).

<sup>298</sup> Bergmeister, KapMuG, 272.

<sup>299</sup> Bergmeister, KapMuG, 273.

<sup>300</sup> See JOHN C. COFFEE, JR., *ENTREPRENEURIAL LITIGATION* 209 (2015).

<sup>301</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, *RULE 10B-5 SECURITIES-FRAUD LITIGATION* 286-287 (2015).

plaintiffs' claims in other grounds.<sup>302</sup> However, usually it is the plaintiff who moves for KapMuG procedure in practice.<sup>303</sup> A possible explanation for this phenomenon could be that the defendants are seeking tactical advantages by trying each case individually.<sup>304</sup>

#### 4. Incentives on Courts' Side

Lastly, the incentives on the courts' side should be considered. In the U.S., because the petition for certifying class action is filed with the filing of the complaint.<sup>305</sup> So, it is hard for the court to voice their opinion about the petition of class certification before the petition has been filed in an individual case. However, the Supreme Court has been narrowing the scope of Rule 10b-5 private right of action which could in theory deter those kind of actions from being filed.<sup>306</sup> But statistics show that securities class actions filings have been quite steady over the years.<sup>307</sup>

In Germany, if the court has decided that there will be a KapMuG intermediate proceeding, then all individual trials that are dependent on issues of the model procedure are suspended, regardless of whether the individual plaintiff opted in by filing a motion of request.<sup>308</sup> Even those cases that are filed after the decision to proceed by the KapMuG procedure will be immediately suspended.<sup>309</sup> This effect will lower the workload of the court very much which is one of the reasons the KapMuG has been legislated in the first place.<sup>310</sup> It may even be that the court could be willing to advise the plaintiff to file a request to use a KapMuG procedure, when the court estimates that there will be too many individual filings of action. This is an empirical question which the answer could be partially found by seeing at what point the request is filed by the plaintiff. KapMuG procedure goes into intermediate proceeding only if ten or more plaintiffs make a request for KapMuG procedure within six months of the first motion. If the plaintiffs start to file requests for KapMuG procedure only after 10 or more plaintiffs have individually filed a securities fraud action, this may be an indication that the court has urged the plaintiff to do so.

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<sup>302</sup> See JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION 163 (2015).

<sup>303</sup> *Stackmann*, NJW 2010, 3185 (3186).

<sup>304</sup> BT Drucks. 14/7515, 89.

<sup>305</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 179 (2015).

<sup>306</sup> See supra, Part II..

<sup>307</sup> See supra, Part II..

<sup>308</sup> See supra, Part I, C. II. 2..

<sup>309</sup> § 8 para. 1 KapMuG.

<sup>310</sup> BT Drucks. 15/5091, 17.

Opt-in class actions may be filed when the stakes are high enough. In the U.S., FLSA wage claims often generate an amount in controversy in excess of five million dollars which could attract the plaintiffs or plaintiffs' attorneys to file for opt-in class action.<sup>311</sup> In the Telekom-case in Germany, there was a flood of securities fraud actions being filed even before the introduction of the KapMuG. The average individual claim was about 5,900 EUR, which is an amount that is high enough to overcome the effects of "rational apathy" and move shareholders to sue even without a class action procedure in Germany.<sup>312</sup>

### C. Importing US Class Action to Germany?

Assuming that U.S. opt-out class action system is needed for Germany, what are the obstacles for its implementation? There may be obstacles of political, legal and practical nature.

#### I. Political Obstacles

First of all, some consideration should be given to the political obstacles which would likely be encountered. As has been discussed, most securities class actions settle in the U.S. with the insurance companies paying all or most of the settlement payments because of D&O insurance.<sup>313</sup> In the cases where for some reason D&O insurances are not enough to cover the cost, the corporations mostly pay the settlement payments themselves.<sup>314</sup> When corporations make payments to plaintiffs, the shareholders - who are the residual owners of the corporation - are essentially paying the price.<sup>315</sup> Moreover, in the U.S. corporation buy the D&O insurance for their officers and directors,<sup>316</sup> so the D&O insurance premiums are also in essence paid by the shareholders.<sup>317</sup> Because of this mechanism, certain players of the capital market could actively resist any legal change that might result in more active private enforcement. These players

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<sup>311</sup> Andrew C. Brunsten, *Hybrid Class Actions, Dual Certification and Wage Law Enforcement in the Federal Courts*, 29 Berkeley J. Em. & Lab. L. 269, 283-284 (2008).

<sup>312</sup> *Tilp*, FS Krämer, 331 (332-333); *Hess*, JZ 2011, 66 (72).

<sup>313</sup> TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 10 (2010) ("D&O insurance transfers shareholder litigation risk away from individual directors and officers and the corporations they manage to third-party insurers.").

<sup>314</sup> Michael Klausner, et al., *How Protective is D&O Insurance in Securities Class Actions? An Update*, 26 PLUS 1, 2 (May, 2013).

<sup>315</sup> Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 Fla. L. Rev. 1103, 1128 (2008) ("When a corporation pays compensation, the current shareholders indirectly bear the costs;...").

<sup>316</sup> Bernald Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 Stan. L. Rev. 1055, 1085 (2006) ("Virtually all public companies purchase D&O insurance for their officers and directors.") (footnote omitted).

<sup>317</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 95 (2011).

could namely be (1) institutional investors, (2) long term investors, (3) controlling shareholders and even (4) the German government.

## 1. Institutional Investors

Many institutional investors who hold stocks in portfolios could object to class actions because they will potentially lose money due to the circularity problem.<sup>318</sup> These investors who are not looking for private benefit or control may on the one hand be rationally reticent to engage in firm specific corporate issues for various reasons.<sup>319</sup> Implementation of U.S. type class action system to Germany however may affect all listed corporation. For this reason, institutional investors as a whole may become more proactive and object to the implementation of U.S. style securities class action.

## 2. Long-Term Investors

More clear losers of the active enforcement through class actions could be the long term shareholders who do not hold stock in portfolios. For instance, there are employees, managers, or other small investors who buy and hold stocks for a long time for retirement.<sup>320</sup>

In the U.S., only the party who has bought or sold the stock have standing to sue.<sup>321</sup> In Germany too, there has to be some kind of transaction during the time period of misinformation.<sup>322</sup> Because of this reason, long term shareholders will most often be the ones who in the end will pay the price, as they will not have traded during the period at issue.<sup>323</sup>

With the above in mind, the long term shareholders in Germany will most likely resist change to the current low private enforcement levels and some may have enough political influences to succeed in blocking any attempt to incorporate the U.S. style opt-out class action.

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<sup>318</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 95 (2011) (“To summarize, diversified portfolio investors emerge undamaged but for the litigation costs.”).

<sup>319</sup> See generally, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Colum. L. Rev. 863, 889-95 (2015) (explaining that the desire of the institutional investors to deliver competitively superior performance for their beneficiaries or shareholders while minimizing costs will make institutional investors rationally reticent in performance activism for specific companies).

<sup>320</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1560 (2006).

<sup>321</sup> *Blue Chip Stamps v. Manor Drug Stores*, 95 S.Ct. 1917, 1934-1935 (1975).

<sup>322</sup> *Stübinger*, *Teilnehmerhaftung bei fehlerhafter Kapitalmarktinformation in Deutschland und den USA*, 78.

<sup>323</sup> William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. Pa. L. Rev. 69, 97 (2011) (“[T]hose who bought before the class date will be entirely on the defending side and will receive nothing from any settlement.”).

### 3. Controlling Shareholders

Specific types of long term shareholders are the controlling shareholders. Controlling shareholders will typically be holding on to shares for a long time, neither buying nor selling.<sup>324</sup> Considering the above, controlling shareholders who have large stakes as direct shareholders of a corporation, will pay the highest price. Moreover, because controlling shareholders hold a lot of stock in specific corporations, they will not be rationally apathetic. Although controlling stockholders may hold other corporations' stocks in an attempt to diversify, it will be difficult to fully diversify away all firm specific risks, while holding controlling blocks of publicly traded corporations. So at least some of them may not want the U.S. class action type enforcement.<sup>325</sup>

In the U.S., it may no longer be accurate to say that investors are dispersed.<sup>326</sup> However, the percentage of public corporations with controlling shareholders is quite low, approximately less than 10 percent.<sup>327</sup>

There are more corporations with controlling shareholders in Germany.<sup>328</sup> The general influence of dispersed-ownership stockholders is relatively low and is only slowly increasing.<sup>329</sup> As of 2008, only 7% of the Germans hold shares as private individuals, while in comparison, 50% of all households in the U.S. do.<sup>330</sup> There is a trend from more concentration to less concerning shareholder compositions, with less and less interdependencies.<sup>331</sup> It is however still safe to assume that due to the still existing entanglements in ownership, a powerfully large

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<sup>324</sup> INV'R RESPONSIBILITY RESEARCH CTR. INST., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 7 (2012) (finding that the average number of years since the current control mechanism of U.S. public held corporations with controlling shareholder is approximately 24 years).

<sup>325</sup> John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 246 (2007) (asserting that the deterrent threat generated by the U.S. commitment to enforcement will disproportionately repel some issuers with controlling shareholders who find it more advantageous to consume the private benefits of control themselves than to maximize their firm's share price).

<sup>326</sup> Ronald J. Gilson & Jeffrey N. Goldon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Colum. L. Rev. 863, 874 (noting statistics that institutional investors held 50.6% of all U.S. public equities by 2009).

<sup>327</sup> INV'R RESPONSIBILITY RESEARCH CTR. INST., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 3 (2012), <http://irrcinstitute.org/wp-content/uploads/2015/09/FINAL-Controlled-Company-ISS-Report1.pdf> (finding that 114 firms out of Standard & Poor 1,500 composite are controlled corporations in 2012).

<sup>328</sup> see the Report of the Monopoly Commission 2012/2013, *Monopolkommission*, Hauptgutachten XX, Kapitel II: Stand und Entwicklung der Konzentration und Verflechtung von Großunternehmen, 208-214, for an overview over the Top 100 companies in Germany and their ownership structure.

<sup>329</sup> Höpner, *Wer beherrscht die Unternehmen?*, 25.

<sup>330</sup> Möllers, *Effizienz als Maßstab des Kapitalmarktrechts*, 208 AcP 1, 3 (2008).

<sup>331</sup> *Max-Planck-Institut für Gesellschaftsforschung*, *Deutschland AG in Auflösung*, 1; *Max-Planck-Institut für Gesellschaftsforschung*, *Kapitalverflechtungen in Deutschland 1996-2010*.

part of the business world would heavily oppose an introduction of U.S. securities class actions due to the fear of falling prey to the mechanism described above.

#### 4. Government as controlling shareholder

Another possible influential player with economic interest in the public stock market is the government. In the U.S., there was no government controlled corporation incorporated under state law which traded in the public market before 2008.<sup>332</sup> This does not mean that there were no government controlled corporations in the U.S. history. The U.S. government have frequently chartered wholly owned corporation in the past, and some public traded business entities have special provisions in the charter giving some kind of control to the U.S. government.<sup>333</sup> It just means that there is not much history of U.S. government ownership of publicly trading corporation in private industry.<sup>334</sup>

This is not the case in Germany. Although there are not too many government involvements in publicly traded companies, German public authorities do hold stock in a few major ones, for example: Fraport AG (51.35%),<sup>335</sup> Deutsche Telekom AG (31.7%),<sup>336</sup> Deutsche Post AG (21%),<sup>337</sup> Volkswagen AG (20%),<sup>338</sup> and Commerzbank AG (17.15%).<sup>339</sup> As these participations are all long term, the Government could potentially be negatively affected by the mechanism described above.<sup>340</sup>

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<sup>332</sup> J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 Yale J. on Reg. 283, 293 (2010).

<sup>333</sup> J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 Yale J. on Reg. 283, 286 (2010).

<sup>334</sup> Marcel Kahan & Edward B. Rock, *When the Government is the Controlling Shareholder*, 89 Tex. L. Rev. 1293, 1297 (2011).

<sup>335</sup> 20.01% are held by the City of Frankfurt am Main through its (100% directly owned) company “Stadtwerke Frankfurt am Main Holding GmbH”, see the City’s Report on Financial Involvements: *Stadt Frankfurt am Main*, Graphische Gesamtdarstellung der Beteiligungen 2014; the other 31.34% are directly held by the State of Hesse, see the State’s Report on Financial Involvements: *Land Hessen*, Unmittelbare Beteiligungen des Landes Hessen an privatrechtlichen und öffentlich-rechtlichen Unternehmen, 1.

<sup>336</sup> The Federal Republic of Germany holds 14.26% of the shares directly and 17.44% through the KfW (which is 80% owned by the Federal Republic and 20% owned by the States of Germany), see the Federal Report on Financial Involvements, *Germany*, Beteiligungsbericht des Bundes, 31.

<sup>337</sup> The Federal Republic of Germany holds 21% of the shares through the KfW, see the Federal Report on Financial Involvements, *Germany*, Beteiligungsbericht des Bundes, 33.

<sup>338</sup> The State of Lower Saxony holds these shares through its company Hannoverschen Beteiligungsgesellschaft Niedersachsen, see the State’s Report on Financial Involvements, *Land Niedersachsen*, Beteiligungsbericht 2015, 30.

<sup>339</sup> The shares are held through the federal FMS (Financial Markets Stability Fund) - a fund that was created in 2008 in the wake of the financial crisis. It was mainly used to buy 100% of the shares of Hypo Real Estate Holding AG, which went bankrupt, see the Federal Report on Financial Involvements of Germany, *Bundesrepublik Deutschland*, Beteiligungsbericht des Bundes 2015, 46.

<sup>340</sup> See supra, Part III, II. 3. 1. a).



Yet even though the German Government may stand on the defendants' side systematically, consequently losing more due to a higher level of private enforcement through securities class actions, it would be a long shot to assert that this would be an (official) reason as to why the government resists the introduction of a U.S. style class action. After all, it was the German government's declared goal to increase the level of private enforcement.<sup>341</sup>

## II. Legal Obstacles

In addition to the possible political obstacles described above, there are a few potential legal obstacles too.

### 1. Filing Fee

In the U.S., the filing fee for a class action in federal court is flat, currently at 350 dollars.<sup>342</sup> Relative to the amount at stake in a class action, the filing fee that the plaintiff or the plaintiff's counsel has to bear is nominal.<sup>343</sup>

In contrast, the filing fee for a claim in Germany is calculated by a formula that is a function of the amount at stake and the calculated fee has to be filed up front.<sup>344</sup> If the amount at stake is calculated by not only the amount at stake for the plaintiff but the amount as a class, then it will not be economically feasible for a plaintiff to pay the filing fee of a class action.<sup>345</sup>

However, this effect could be circumvented by introducing a flat filing fee for securities class actions in Germany. Although it is the norm in Germany that the filing fee is calculated based on the amount of the claim,<sup>346</sup> there are already exceptions to this rule, i.e. flat fees for certain procedures.<sup>347</sup> So it may be possible to make another exception to the rule. Another possibility would be capping the filing fee to the alleged damages of the lead plaintiff.<sup>348</sup> Lastly, a system

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<sup>341</sup> see the German government's Memorandum of Explanation for the KapMuG, BT Drucks. 15/5091, 16.

<sup>342</sup> Deborah R Hensler, *The United States of America*, in THE COSTS AND FUNDING OF CIVIL LITIGATION 535, 539 (Christopher Hodges, Stefan Vogenauer & Magdalena Tulibacka eds., 2010).

<sup>343</sup> We thank Professor Fisch for pointing out this point to us.

<sup>344</sup> See § 3 para. 1, 2 GKG and § 6 para. 1 no. 1 GKG.

<sup>345</sup> Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 Law and Contemp. Probs. 167, 171 (1997) (noting that filing fees and amount-in-controversy requirement may serve as entry barriers which prevent the litigation of some claims).

<sup>346</sup> See § 3 para. 1 GKG.

<sup>347</sup> For example, for having a court decision about the acceptance of an order of (civil) execution from a foreign court, the flat filing fee is 240.- EUR, regardless of the actual amount in question, see GKG Anl. 1 (zu § 3 Abs. 2) Kostenverzeichnis, 1510.

<sup>348</sup> See Talia Fisher & Issi Rosen-Zvi, *It's for the Judges to Decide: Allocation of Trial Costs in Israel Report on Israel*, in COST AND FEE ALLOCATION IN CIVIL PROCEDURE 177, 183 (Mathias Reimann ed., 2012)

could be introduced where a plaintiff files a claim first with the normal fees subsequently allowing request class certification with an additional flat fee. Each of these mechanism may allow the plaintiff or the plaintiff's counsel to file a class action without having to carry the filing fees of other plaintiffs.

## 2. Fee Shifting Rule

Each party pays for its own legal fees regardless of the outcome in the U.S. in contrast to Germany, where the loser pays for the winners cost in principle.<sup>349</sup> Although the German fee shifting or “loser pays” rule may seem like an obstacle, it is not a high hurdle. When cases settle, each party pays for its own fees incurred until the time of the settlement unless party agree to a different arrangement.<sup>350</sup> In addition to this, there is a cap on how much legal fees can be charged to the other party, i.e. only the “standard statutory fees” for attorneys can be shifted.<sup>351</sup> The standard statutory fees are calculated with the help of the German Lawyer's Remuneration Act (RVG) and are also (as a general rule) based on the amount at stake.<sup>352</sup> In most cases however the lawyer will insist on working not on a static fee basis, but on hourly rates. Such agreements are possible pursuant to § 3a RVG and will most of the times exceed the statutory fees. The excess however will not be reimbursed under the loser pays rule.<sup>353</sup> It means a plaintiff (or plaintiff's counsel) that loses does not have to bear all of defendants' legal fees. Moreover, the plaintiff can roughly estimate the amount of lawyer fees the plaintiff will have to reimburse to the defendant in case of a loss when deciding whether to sue.<sup>354</sup>

However, it should be noted that there has to be some kind of a rule on calculating the amount at stake in a class action as it will be very difficult to make a calculation for the amount at

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(explaining that although there is a possibility of change in regulation, courts usually required class action plaintiffs to pay court fees only with respect to their personal claim in Israel as of 2012).

<sup>349</sup> Compare Theodore Eisenberg & Geoffrey P. Miller, *The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts*, 98 Cornell L. Rev. 327, 328-29 (2013) (“The American rule on attorney fees ordinarily requires parties litigating disputes to compensate their own attorneys regardless of the outcome.”) (footnote omitted), and Burkhard Hess & Rudolf Huebner, *Cost and Fee Allocation in German Civil Procedure*, in COST AND FEE ALLOCATION IN CIVIL PROCEDURE 151 (Mathias Reimann ed., 2012) (“In German, the losing party must bear all statutory costs of the litigation in civil and commercial matters, including the costs incurred by the opponent and the costs for the taking of evidence.”).

<sup>350</sup> Burkhard Hess & Rudolf Huebner, *Cost and Fee Allocation in German Civil Procedure*, in COST AND FEE ALLOCATION IN CIVIL PROCEDURE 151, 154 (Mathias Reimann ed., 2012) (“If the parties of a settlement do not agree on the allocation of costs, each party bears its own costs and court costs are equally divided.”).

<sup>351</sup> See § 91 para. 2 sent. 1 ZPO.

<sup>352</sup> § 2 para. 1 RVG.

<sup>353</sup> See § 3a para. 1 sent. 3 RVG.

<sup>354</sup> Theodore Eisenberg & Geoffrey P. Miller, *The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts*, 98 Cornell L. Rev. 327, 328 (2013) (noting the predictability of lawyer fees in Germany).

stake for the whole class. If the amount at stake is calculated by the amount at stake for the lead plaintiff, which will be very small compared to the amount at stake as a class, then the fee shifting rule will not make much difference because the actual amount to be reimbursed will not be high.

### 3. Contingent fee

As we have seen, judge awarded fees to the plaintiffs' counsel allow the counsel to represent plaintiffs on a contingent fee basis.<sup>355</sup> This works as a factor for the plaintiff's counsel to be an entrepreneur in the U.S..<sup>356</sup> However, this is not the case in Germany. In Germany, contingent fees are generally not allowed.<sup>357</sup> The total ban has been somewhat alleviated in 2006 by the Federal Constitutional Court of Germany, which held that a flat-out ban on contingent fees is unconstitutional.<sup>358</sup> Today, contingent fees are allowed in Germany, but only in a very limited scope, namely if no other funding is available for the plaintiff.<sup>359</sup> This may potentially be a starting point for further reform. Germany could decide to allow contingent fee contracts (up to a limited amount) in the specific case of securities fraud actions.

### 4. Lack of Discovery Process

In the U.S., discovery is a major part of civil litigation which allows private enforcement.<sup>360</sup> But because Germany does not have a discovery system, it may be harder for the plaintiff to prove certain elements like scienter. However, this obstacle may be overcome by either (1) creating procedural rules to shift the burden of proof for certain elements like scienter to the defendant, or (2) getting rid of certain elements like scienter. This could leave elements that may be proven by evidence that is not closely guarded by the defendant.

The German answer to the lack of a discovery stage in procedural law is mostly shifting the

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<sup>355</sup> Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 *Law and Contemp. Probs.* 167, 172 (1997).

<sup>356</sup> Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 *Law and Contemp. Probs.* 167, 173 (1997).

<sup>357</sup> see § 49b para. 2 sent. 1 of the German Federal Lawyers' Act [Bundesrechtsanwaltsordnung (BRAO), as of 12/21/2015, BGBl. III 1959; 303-8].

<sup>358</sup> BVerfG, NJW 2007, 797.

<sup>359</sup> See § 4a para. 1 of the German Lawyer's Remuneration Act [Rechtsanwaltsvergütungsgesetz (RVG), as of 12/21/2015, BGBl. I 2004, 718]; see also *Wagner*, 16 *Theoretical Inq. L.* 69, 99 (2015).

<sup>360</sup> Erica Gorga & Michael Halberstam, *Litigation Discovery and Corporate Governance: The Missing Story About the "Genius of American Corporate Law"*, 63 *Emory L.J.* 1383, 1394 (2014) ("[P]rivate enforcement in the United States depends on the power that *litigation discovery* affords private attorney general to investigate, uncover, and reconstruct the facts and circumstances of corporate management in great detail.") (footnote omitted) (emphasis in original).

burden of proof in favor of the party that would have difficulties proving a certain element in front of the court. However, it should be kept in mind that shifting the burden of proof might not have the same effectiveness as a discovery system. The defendant can in turn shift back by producing only evidence that is favorable for his position.<sup>361</sup> This again leaves the plaintiff blindsided, because in Germany there is no sanction for failing to reveal information (other than potentially losing the case).<sup>362</sup> However, in the U.S., a party that refuses to disclose information during the discovery phase may be heavily sanctioned, including the plaintiff's attorney or even the entire law firm.<sup>363</sup> Lack of a discovery procedure thus can be a crucial obstacle against effective securities litigation in Germany.

## 5. Lack of Civil Juries

Fact finding decisions made by civil juries are generally more unpredictable compared to the decisions of professional judges.<sup>364</sup> Moreover, juries may be more favorable to investors alleging loss than to public corporation.<sup>365</sup> So there could be more incentives to initiate a securities class action when civil juries are provided.<sup>366</sup> While there are civil juries in the U.S., there are no civil juries in Germany.

Yet because civil juries may make decisions that are generally more in favor of investors, this might incentivize meritless suits and open up securities fraud actions for abuse.<sup>367</sup> Considering this, the lack of civil juries should not be considered an obstacle for introducing class action in Germany in general, but rather as deterrence for meritless suits.

## 6. Constitutional constraints

As has been shown in full detail in Part I of this paper, the general idea of collective redress systems such as the class action face major constitutional constraints. A real bundling of cases through a class action can only be achieved to the detriment of the fundamental principles of

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<sup>361</sup> See § 292 sent. 1 ZPO.

<sup>362</sup> Halberstam, 021 SUNY B.L.S.R.P., 48 (2015).

<sup>363</sup> Halberstam, 021 SUNY B.L.S.R.P., 48 (2015).

<sup>364</sup> JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION 200 (2015) (“The availability of juries in civil cases implies greater unpredictability of outcomes—and thereby increases the plaintiff’s attorney’s leverage”).

<sup>365</sup> Manning Gilbert Warren III, *The U.S. Securities Fraud Class Action: An Unlikely Export to the European Union*, 37 Brook. J. Int’l L. 1075, 1087 (2012).

<sup>366</sup> Manning Gilbert Warren III, *The U.S. Securities Fraud Class Action: An Unlikely Export to the European Union*, 37 Brook. J. Int’l L. 1075, 1086-87 (2012).

<sup>367</sup> Bergmeister, KapMuG, 295.

party control and the right to judicial access in German procedural law.<sup>368</sup> As long as there is no movement away from these principles, this is perhaps the most relevant obstacle against an import of US class action to Germany.<sup>369</sup>

### III. Practical Obstacles - Proving Elements Using Expert Opinion

Generally, a plaintiff should allege and prove certain elements which could include reliance, loss causation and damages to the plaintiff for the plaintiff to prevail in a misrepresentation action. In a securities litigation context, the plaintiff would resort to expert witness to prove these elements.<sup>370</sup>

In the U.S., it is the practice that each party hires its own experts.<sup>371</sup> Although there is a rule which allows the court to hire its own expert, most judges are reluctant to use that power.<sup>372</sup> So in the U.S., each party knows that there will be at least some experts who are willing to testify for its cause as long as there is some credibility to the expert and the case has some merits. On the other hand, each party knows that there will probably be two differing opinions of experts which is itself a risk. This risk may be a factor which incentivizes the parties to settle.

However, this is not the case for Germany. Usually, German Courts appoint their own expert who will submit a written report of its findings with relevant opinions.<sup>373</sup> The court will choose the expert from lists kept by the professional bodies, or a person known from the court's past experience to be a reliable expert in the case where there is no such list.<sup>374</sup> So the

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<sup>368</sup> Bergmeister, KapMuG, 45.

<sup>369</sup> Halberstam, 021 SUNY B.L.S.R.P., 31 (2015).

<sup>370</sup> Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487,1488 (1996) ("Expert testimony is required to calculate damages, ..."); Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 Am. L. Econ. Rev. 380, 397-400 (2002) (explaining expert's use of event study in securities litigation to prove elements such as reliance and materiality).

<sup>371</sup> Faust F Rossi, *The Law of Expert Witnesses in the United States: Past, Present and Future*, in THE EXPERT IN LITIGATION AND ARBITRATION 215 (D. Mark Cato ed., 1999) ("Any time a litigant believes his case will be aided by presenting an expert, he is likely to seek one out if it is economically feasible. If one side in litigation uses an expert on an issue, the other party is likely to reciprocate by finding an opposing expert").

<sup>372</sup> Faust F Rossi, *The Law of Expert Witnesses in the United States: Past, Present and Future*, in THE EXPERT IN LITIGATION AND ARBITRATION 215 (D. Mark Cato ed., 1999) ("Although trial judges have the power to appoint neutral experts, most judges are reluctant to substitute their choice for that of the parties.").

<sup>373</sup> Volker Triebel & Heiko Plassmeier, *The Use of Experts in Litigation and Arbitration in Germany*, in THE EXPERT IN LITIGATION AND ARBITRATION 155, 157 (D. Mark Cato ed., 1999).

<sup>374</sup> Volker Triebel & Heiko Plassmeier, *The Use of Experts in Litigation and Arbitration in Germany*, in THE EXPERT IN LITIGATION AND ARBITRATION 155, 158 (D. Mark Cato ed., 1999).

parties have far less control over the expert who is appointed. Even if the party appoints an expert for itself, the expert will not be taken as impartial.<sup>375</sup>

Although the cost of an expert hired by the party is also subject to the loser pays rule if the hiring of the expert is necessary,<sup>376</sup> this is generally not the case.<sup>377</sup>

For the reasons above, the plaintiff in Germany cannot provide a favorable expert witness with a reasonable certainty compared to the plaintiff in the U.S., so it is riskier for the plaintiff or plaintiff's counsel to sue as a class action in Germany. This practice might also deter the plaintiff or the plaintiff's counsel from deciding to sue for class action.

It should be further noted that because of the current practice of using financial technics as event studies is very important in the U.S. style class action,<sup>378</sup> and because experts have some discretion over choices such as defining announcement date or considering the length of the announcement period,<sup>379</sup> loss of control over experts is also a risk to the parties because each party may not know how the expert chosen by the court will decide on such factors.

However, it could be argued that the German practice in expert evidence would just work as deterrence to meritless suits, because a favorable decision for a party cannot be "bought" by hiring a specific expert. The court appointed experts will be far more independent and thus be committed to the truth.

It should be noted that the German system allows for the parties to ask opinions of the expert chosen by the court, so the parties do have access to the expert (although limited compared to the U.S.) even if the expert is chosen by the court.<sup>380</sup>

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<sup>375</sup> Volker Triebel & Heiko Plassmeier, *The Use of Experts in Litigation and Arbitration in Germany*, in THE EXPERT IN LITIGATION AND ARBITRATION 155, 157 (D. Mark Cato ed., 1999) ("Where the parties appoint an expert, he will not normally be taken as impartial in German proceedings.").

<sup>376</sup> Burkhard Hess & Rudolf Huebner, *Cost and Fee Allocation in German Civil Procedure*, in COST AND FEE ALLOCATION IN CIVIL PROCEDURE 151 (Mathias Reimann ed., 2012) ("The reimbursable costs for the taking of evidence include not only court appointed expert witnesses, but also expert witnesses hired by the prevailing party as long as the hiring of the expert was necessary as provided by sec. 91 (1) ZPO.").

<sup>377</sup> Volker Triebel & Heiko Plassmeier, *The Use of Experts in Litigation and Arbitration in Germany*, in THE EXPERT IN LITIGATION AND ARBITRATION 155, 157 (D. Mark Cato ed., 1999) ("The costs of appointing a party expert will not normally be reimbursed to the appointing party even though it wins the case entirely.").

<sup>378</sup> Jill E. Fisch, *The Trouble with Basic: Price Distortion After Halliburton*, 90 Wash. U. L. Rev. 895, 918 (2013) ("Indeed, courts have frequently required an event study or similar empirical analysis.") (footnote omitted).

<sup>379</sup> Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part I: Technique and Corporate Litigation*, 4 Am. L. Econ. Rev. 141, 144-45 (2002) (explaining the difficulty of defining announcement date and announcement period in an event study).

<sup>380</sup> Volker Triebel & Heiko Plassmeier, *The Use of Experts in Litigation and Arbitration in Germany*, in THE EXPERT IN LITIGATION AND ARBITRATION 155, 157 (D. Mark Cato ed., 1999) ("The expert gives his opinion on the issues identified in one party's application for appointment of an expert and/or the court order of appointment.").

## IV. Conclusion

There are many differences between Germany and the U.S. which would not allow U.S. style class actions to be incorporated to function as in the U.S. However, it is hard to know how much each of these differences affects the likelihood of a successful implementation. Some or all of the factors may work together as an obstacle, or certain difference in system may be the crucial hurdle. Finding the optimal mechanism may be an empirical question to which an answer could be found by comparing the situation in other and different legal regimes. Different countries may have different sets of mechanisms with different results.<sup>381</sup> However, by identifying those differences, one could find solutions which may be different as to the form but similar as to the function.

### D. Enhancing the US Securities Class Action System

Some mechanisms found in Germany may serve to reform the current class action system in the U.S. In this part, we will discuss some mechanisms of Germany, which could be considered in the U.S. context.

### I. Civil Juries

As have seen above, civil juries may incentivize meritless suits and open up opportunities to abuse securities fraud actions.<sup>382</sup> Because defendants may predict decisions made by judges somewhat more accurately compared to decisions made by civil juries, the defendants may have less pressure to settle without civil juries.<sup>383</sup> Moreover, jurors may be less capable at understanding statistical evidences.<sup>384</sup> As we have seen above not many securities class action actually go to trial,<sup>385</sup> so the chance of an individual juror to actually experience statistical evidence is very low. Judges, on the other hand, are more likely to be more comfortable with

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<sup>381</sup> For instance, only 12 securities class action cases have been filed in Korean courts as of February 2016 since the enactment of Securities-related Class Action Act in 2005 which is an opt-out type class action regime like the U.S. Korea allows contingency fee arrangement like the U.S., but has a loser pay rule system like Germany. *See generally*, Benjamin Lee, *The not (yet) perfect implementation of securities class action in Korea* (unpublished Working Paper, 2016).

<sup>382</sup> *Bergmeister*, KapMuG, 295.

<sup>383</sup> JOHN C. COFFEE, JR., *ENTREPRENEURIAL LITIGATION* 200 (2015).

<sup>384</sup> DENNIS J. DEVINE, *JURY DECISION MAKING* 145 (2012) (“Third, most jurors do not use statistical information in an optimal fashion, tending to underweight it relative to the impact it should have according to the Bayesian model, and fail to combine probabilities in an ideal manner.”)

<sup>385</sup> RENZO COMOLLI & SVETLANA STARYKH, *RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2014 FULL-YEAR REVIEW* 36 (2015) [http://www.nera.com/content/dam/nera/publications/2015/PUB\\_2014\\_Trends\\_0115.pdf](http://www.nera.com/content/dam/nera/publications/2015/PUB_2014_Trends_0115.pdf).

statistical evidence, not only because judges are more likely to be a repeat players of securities class action but also because statistical evidence such as event study is used at the early stage of the litigation process.<sup>386</sup> For these reasons, the U.S. securities class action might improve if civil juries are replaced with professional judges.<sup>387</sup>

## II. Fee Shifting Rule

As we have seen, the loser pays in Germany.<sup>388</sup> While this rule may work as a hurdle for the plaintiff to aggressively file a class action, it also may have certain merits when compared to the American rule. For instance, the plaintiff may try to impose cost on the defendant while economizing its own cost, thus forcing the defendant to settle even though there is not enough merit in the U.S. system.<sup>389</sup> Although whether the loser pays rule deters frivolous suits more or not compared to the American rule is still debatable,<sup>390</sup> it would be safe to assume that the incentive to make the other party incur litigation cost will generally be lower in a loser pays system.<sup>391</sup>

Moreover, as we have seen, there is a cap in the German fee shifting rule which can be calculated ex ante.<sup>392</sup> If there is no cap on fee shifting, there will be a chilling effect on the plaintiff who will likely spend less on litigation compared to the defendant in a securities class action.<sup>393</sup> The cap allows to mitigate the chilling effect.<sup>394</sup> Also, the plaintiff can roughly esti-

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<sup>386</sup> MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 SECURITIES-FRAUD LITIGATION 355 (2015) (“An expert may be able to perform the necessary event study at class certification and demonstrate common issues, such as reliance and loss causation”).

<sup>387</sup> The means to achieve this end will have to be discussed elsewhere. We only note here that the possibility of the court enforcing mandatory arbitration clauses in the bylaws of U.S. corporations is recently being discussed. See Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 Del. J. Corp. L. 751, 769-88 (2015) (discussing legal issues that could be raised about mandatory arbitration clause in bylaws). The right to jury trial may be alienated by consenting to the arbitration contract. See Stephen J. Ware, *Arbitration Clauses, Jury-Waiver Clauses, and Other Contractual Waiver of Constitutional Rights*, 67 Law & Contemp. Probs. 167, 169 (2004). Interestingly, the standard for a legally acceptable consent to arbitration in the case law of the U.S. seems to be lower than the standard for legally acceptable consent to a waiver of jury rights. See Stephen J. Ware, *Arbitration Clauses, Jury-Waiver Clauses, and Other Contractual Waiver of Constitutional Rights*, 67 Law & Contemp. Probs. 167, 170 (2004). The possibility of using bylaws with a clause involving waiver of investor’s civil jury, which could be subject to a higher standard compared to bylaws mandating arbitration, will have to be examined in full at a later date.

<sup>388</sup> Burkhard Hess & Rudolf Huebner, *Cost and Fee Allocation in German Civil Procedure*, in COST AND FEE ALLOCATION IN CIVIL PROCEDURE 151 (Mathias Reimann ed., 2012).

<sup>389</sup> JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION 165 (2015).

<sup>390</sup> Theodore Eisenberg & Geoffrey P. Miller, *The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contract*, 98 Cornell L. Rev. 327, 334-39 (2013) (introducing conflicting theories about the effects of fee shifting rule).

<sup>391</sup> See JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION 165 (2015).

<sup>392</sup> See § 91 para. 2 sent. 1 ZPO.

<sup>393</sup> See JOHN C. COFFEE, JR., ENTREPRENEURIAL LITIGATION 165 (2015).



mate the amount he will have to pay to defendant in case of a loss before deciding to go forward.<sup>395</sup> However, for this system to work in the U.S., there should be a rule with a formula to calculate the cap on fees allowed to be shifted. This may or may not be a function of the amount at stake for the plaintiff, or the class as a whole.<sup>396</sup>

### **III. Conclusion**

There is much active discussion to reform the U.S. securities class action as we have seen in Part II. While the German civil procedure system has some merits which could be considered to improve U.S. securities class action, it cannot address the core issue being debated in the U.S., since each system has its distinct characteristics. With this in mind, we will address the role of opt-out class action on deterring fraud in the German context.

### **E. Deterring Corporate Fraud in Germany**

As we have seen in Part II, it is the practice in the U.S. when a securities class actions settles, D&O insurance companies covers the costs with the corporation indemnifying the individual directors and officers. The process is quite different in Germany. In Germany, the individual person who is responsible for the misrepresentation is typically not a party of the securities action. When executive bodies of a corporation breach their duties by violating disclosure obligations on the primary or secondary market, they are liable.<sup>397</sup> In Germany (as well as Switzerland and Austria), this liability however generally exists only towards the corporation itself and only in very rare exceptions directly towards shareholders or third parties.<sup>398</sup>

### **I. Managerial Liability of Securities Litigation in Germany: Law in Book**

Because this practice has to do with the German substantive law, a brief explanation is in order. In Germany, there is a very strong differentiation between liability for failure to disclose

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<sup>394</sup> JOHN C. COFFEE, JR., *ENTREPRENEURIAL LITIGATION* 165 (2015).

<sup>395</sup> Theodore Eisenberg & Geoffrey P. Miller, *The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts*, 98 *Cornell L. Rev.* 327, 328 (2013).

<sup>396</sup> For instance, Korean Securities-related Class Action Act has a formula with a function of amount at stake for the whole class with a fixed cap of 50,000,000 won. See Benjamin Lee, *The not (yet) perfect implementation of securities class action in Korea* (unpublished Working Paper, 2016).

<sup>397</sup> *Hopt*, WM 2013, 101 (108).

<sup>398</sup> *Hopt*, WM 2013, 101 (108).

material information on primary and on secondary market.<sup>399</sup> For liability on the primary market there is a multitude of statutory bases, namely (1) prospectus liability pursuant to the German Securities Prospectus Act (*Wertpapierprospektgesetz - WpPG*<sup>400</sup>) with a total of five statutory bases, (2) prospectus liability pursuant to the German Asset Investment Act (*Vermögensanlagegesetz - VermAnlG*<sup>401</sup>) with a total of three statutory bases, (3) prospectus liability pursuant to § 306 of the German Capital Investment Act (*Kapitalanlagegesetzbuch - KAGB*<sup>402</sup>), (4) prospectus liability pursuant to general civil law and (5) liability for faulty offer documents pursuant to § 12 of the German Securities Purchase and Acquisition Act (*Wertpapiererwerbs- und Übernahmegesetz - WpÜG*<sup>403</sup>).<sup>404</sup>

The secondary market for securities is mainly governed by the German Securities Trading Act (*Wertpapierhandelsgesetz - WpHG*<sup>405</sup>).<sup>406</sup> The most relevant liability norms are §§ 37b, 37c WpHG, which provide a basis for claims against (only) the corporation because of failure to disclose or faulty disclosure of material information by means of ad-hoc publicity.<sup>407</sup>

Managerial liability on the other hand is divided into internal and external liability.<sup>408</sup> In this context, internal liability means liability towards the corporation as a legal entity and external liability means - *direct* - liability towards shareholders or third parties.<sup>409</sup> External liability is very uncommon in Germany.<sup>410</sup> This is caused by a lack of statutory basis for such claims. There are only very limited possibilities to bring an action against a manager pursuant to general civil contract or tort law statutes of the German Civil Code and they generally only apply if the manager acted willfully.<sup>411</sup> In 2004, there was an initiative to institute a more severe managerial liability through the introduction of a “Capital Market Information Liability Act” (*Kapitalmarktinformationshaftungsgesetz - KapInHaG*<sup>412</sup>), which would enable shareholders

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<sup>399</sup> *Stübinger*, Teilnehmerhaftung bei fehlerhafter Kapitalmarktinformation in Deutschland und den USA, 16, 71.

<sup>400</sup> Wertpapierprospektgesetz (WpPG), as of 11/20/2015, BGBl. I 2005, 1698.

<sup>401</sup> Vermögensanlagegesetz (VermAnlG), as of 11/22/2015, BGBl. I 2011, 2481.

<sup>402</sup> Kapitalanlagegesetzbuch (KAGB), as of 12/21/2015, BGBl. I 2013, 1981.

<sup>403</sup> Wertpapiererwerbs- und Übernahmegesetz (WpÜG), as of 11/20/2015, BGBl. I 2001, 3822.

<sup>404</sup> see *Stübinger*, Teilnehmerhaftung bei fehlerhafter Kapitalmarktinformation in Deutschland und den USA, 17-19 for a comprehensive overview.

<sup>405</sup> Wertpapierhandelsgesetz (WpHG), as of 11/20/2015, BGBl. I 1998, 2708.

<sup>406</sup> *Stübinger*, Teilnehmerhaftung bei fehlerhafter Kapitalmarktinformation in Deutschland und den USA, 71.

<sup>407</sup> *Stübinger*, Teilnehmerhaftung bei fehlerhafter Kapitalmarktinformation in Deutschland und den USA, 75.

<sup>408</sup> *Ciota*, Die deliktische Außenhaftung des Vorstandes einer Aktiengesellschaft, 58.

<sup>409</sup> *Stübinger*, Teilnehmerhaftung bei fehlerhafter Kapitalmarktinformation in Deutschland und den USA, 50.

<sup>410</sup> see *Pregler*, Der Selbstbehalt des Vorstands, 50, asserting that external liability (towards shareholders and third parties) made up only 20-32% of the total liability risk of the manager.

<sup>411</sup> *Pregler*, Der Selbstbehalt des Vorstands, 64-78.

<sup>412</sup> see the “Discussion Proposal” of the Act, *BMI*, Diskussionsentwurf eines Gesetzes zur Verbesserung der Haftung für falsche Kapitalmarktinformationen (Kapitalmarktinformationshaftungsgesetz - KapInHaG), NZG 2004, 1042 (1042-1051).

to sue the manager directly more easily.<sup>413</sup> The initiative however was heavily opposed by scholars and the business world, so it was eventually dropped.<sup>414</sup>

Other possible enforcers are the general assembly (with a simple majority vote) or a minority of shareholders (holding at least 1% or 100,000 EUR in shares) through a derivative suit.<sup>415</sup> However, derivative suits are quite uncommon in Germany.<sup>416</sup> This leaves the corporation to claim liability to its managers. And claims that the corporation has against its managers are as a general rule to be brought by the supervisory board.<sup>417</sup> As to this liability, the substantive law of Germany is quite strict as the standard for managers to be liable for violating duty of care to the corporation is negligence.<sup>418</sup> Although Germany has adopted its own version of the Business Judgment Rule, it gives less protection to German managers compared to the U.S. counterparts.<sup>419</sup> Moreover, when a director is found to be personally liable to the corporation for violating duty of care, then the directors are liable to compensate the corporation fully.<sup>420</sup>

## II. D&O Insurance and Managerial Liability in Germany

However, German managers are not without protection. In Germany, D&O insurance (which was first introduced in Germany in 1986<sup>421</sup>), is the norm (at least for publicly traded corporations) although it is not mandatory.<sup>422</sup> The corporation pays for the insurance coverage for its managers as a group, so the policy is priced by the D&O insurance corporation considering the risks of all board members and executives as an aggregate.<sup>423</sup> But in order to prevent the existence of D&O insurances from incentivizing managerial misbehavior, § 93 para. 2 sent. 3 AktG asserts that at least 10% (at least 1.5 times the fixed annual salary) of the claim have to

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<sup>413</sup> Pregler, *Der Selbstbehalt des Vorstands*, 205.

<sup>414</sup> Stübinger, *Teilnehmerhaftung bei fehlerhafter Kapitalmarktinformation in Deutschland und den USA*, 68.

<sup>415</sup> Pregler, *Der Selbstbehalt des Vorstands*, 59-60.

<sup>416</sup> Martin Gelter, *Why do Shareholder Derivative Suits Remain Rare in Continental Europe?*, 37 *Brook J. Int'l L.* 843, 849 (2012) (noting that 2 cases have used derivative suits in a self dealing by controlling shareholder cases between 2000 and 2007); Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 87 (2015) (noting that only 3 cases of shareholder action which is a variant of American derivative suit have been filed in Germany since the introduction in 2005).

<sup>417</sup> See §§ 93 para. 2 sent. 1, 112 AktG and Pregler, *Der Selbstbehalt des Vorstands*, 58.

<sup>418</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 73-74 (2015).

<sup>419</sup> See Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 74-76 (2015) (explaining the similarity and difference between U.S. business judgment rule and German business judgment rule).

<sup>420</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 76 (2015).

<sup>421</sup> Pregler, *Der Selbstbehalt des Vorstands*, 92.

<sup>422</sup> see Pregler, *Der Selbstbehalt des Vorstands*, 100, 234, who asserts that 90% of all AG's have D&O insurance.

<sup>423</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 80 (2015).

be borne by the manager personally.<sup>424</sup> Managers may privately insure for the remaining 10%.<sup>425</sup>

Does the supervisory board enforce actively on the managers? It is difficult to answer this question. There is not much publicly available data on how many claims are brought against managers. Corporations do not have a duty to disclose such information under German law and have no interest in doing so because of the negative publicity.<sup>426</sup>

Studies assert that supervisory boards are reluctant to sue the managers.<sup>427</sup> The reason for this may be the fact that the supervisory board fears that their own breach of duty of care may surface during the process of enforcement against managers.<sup>428</sup> Even if the supervisory board is not legally liable, because it is the supervisory board who appoints the managers, the supervisory board would still not want to risk being shown to be responsible for the misconduct of the managers.<sup>429</sup> However, other studies suggest differently. For example, studies show that 16.67% of all D&O insurance contracts were at least once relied on during a time period of 10 years.<sup>430</sup> Another one estimates that German courts hold approximately 6,000 manager liability actions with 2 or 3 defendants on average.<sup>431</sup> The study also estimates that about 60% of the payout by the insurance company is used to pay the fees for the lawyers.<sup>432</sup>

Although, it is hard to find conclusive empirical evidence on this point, it is possible that today the supervisory boards are more aggressively filing suits against the managers.<sup>433</sup> In Germany, the Federal Supreme Court held that the decision whether to bring a damages claim against members of the executive board is not subject to the business judgment of the supervi-

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<sup>424</sup> Wagner, 16 *Theoretical Inq. L.* 69, 80-81 (2015).

<sup>425</sup> Wagner, 16 *Theoretical Inq. L.* 69, 80-81 (2015).

<sup>426</sup> Pregler, *Der Selbstbehalt des Vorstands*, 103.

<sup>427</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 77 (2015) (explaining that German managers do not face unlimited personal liability because claims for compensation are never enforced in Germany).

<sup>428</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 85 (2015)

<sup>429</sup> Martin Gelter, *Why do Shareholder Derivative Suits Remain Rare in Continental Europe?*, 37 *Brook J. Int'l L.* 843, 850 (2012).

<sup>430</sup> *Lier*, VW 2008, 277.

<sup>431</sup> Burkhard Fassbach & Niklas Rahlmeyer, MARSHALL PLAN FOR D&O POLICIES IN GERMANY, THE D&O DIARY (Sep. 21, 2015), <http://www.dandodiary.com/2015/09/articles/international-d-o/guest-post-marshall-plan-for-do-policies-in-germany/>.

<sup>432</sup> Burkhard Fassbach & Niklas Rahlmeyer, MARSHALL PLAN FOR D&O POLICIES IN GERMANY, THE D&O DIARY (Sep. 21, 2015), <http://www.dandodiary.com/2015/09/articles/international-d-o/guest-post-marshall-plan-for-do-policies-in-germany/>.

<sup>433</sup> Friederike Krieger, GERMAN MANAGERS NEED BETTER D&O PROTECTION AS LITIGATION MOUNTS, COMMERCIAL RISK EUROPE (Sep. 22, 2011), <http://www.commercialriskeurope.com/cre/936/93> (introducing assertion that the risk of board members being sued in Germany by their companies due to neglect of duties has increased considerably).

sory board.<sup>434</sup> So, the supervisory board may have to file and pursue a claim against the managers.<sup>435</sup>

If there are indeed active filings of the supervisory board against managers, then why do we not see many court decisions in Germany? The reason could be the same reason as in the U.S., that is most cases are either being dismissed or settled.<sup>436</sup>

There are some possible rationales for the supervisory board to opt for settlement in such a case. The first rationale seems to be the fee shifting rule. The corporation may settle because of the possibility of paying for the legal fees in case the corporation loses.<sup>437</sup> But because there is a cap on the amount of fee which may be shifted in Germany, and because the rule regarding the manager's duty of care violation is strict, the supervisory board will have less reason to fear defeat.

Secondly, the corporation may opt to settle to keep the negative information out of the press.<sup>438</sup> Since court decisions have more chances of being accessed by the public compared to the settlement, the corporation may want to settle rather than pursue the litigation. This may be something that can be made as a business decision. However, although the company may be able to keep the details of the case from the public by settling the case, it is not clear whether settling the case will allow to keep the entire facts from the market, let alone the fact that there has been a case.

Another rationale has to do with the current D&O insurance practice in Germany. As have seen above, currently German D&O insurance is a group insurance in the sense that the exec-

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<sup>434</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 78 (2015).

<sup>435</sup> Burkhard Fassbach & Thilo Fleck, ADDRESSING D&O INSURANCE IN GERMAN BOARD MEMBERS' AND MANAGING DIRECTORS' MANAGEMENT SERVICES AGREEMENTS, D&O DIARY (Jan. 17, 2014), <http://www.dandodiary.com/2014/01/articles/international-d-o/guest-post-addressing-do-insurance-in-german-board-members-and-managing-directors-management-services-agreements/>.

<sup>436</sup> Burkhard Fassbach, D&O (DIRECTORS AND OFFICERS) LIABILITY INSURANCE IN GERMAN SUPERVISORY BOARD PRACTICE, [www.fassbach.com](http://www.fassbach.com) (last visited Feb. 18, 2016), [http://www.fassbach.com/media/raw/Directors and Officers Liability Insurance in German Supervisory Board Practice.pdf](http://www.fassbach.com/media/raw/Directors%20and%20Officers%20Liability%20Insurance%20in%20German%20Supervisory%20Board%20Practice.pdf) (“Following time-consuming litigation, most cases result in either the dismissal of a claim or in an eventual settlement.”).

<sup>437</sup> Burkhard Fassbach & Niklas Rahlmeyer, MARSHALL PLAN FOR D&O POLICIES IN GERMANY, THE D&O DIARY (Sep. 21, 2015), <http://www.dandodiary.com/2015/09/articles/international-d-o/guest-post-marshall-plan-for-do-policies-in-germany/> (“Plaintiff companies refrain from litigating through the entire court system because of the risk of having to bear the gargantuan amount of court costs and attorneys' fees in the event of defeat.”).

<sup>438</sup> Burkhard Fassbach & Niklas Rahlmeyer, MARSHALL PLAN FOR D&O POLICIES IN GERMANY, THE D&O DIARY (Sep. 21, 2015), <http://www.dandodiary.com/2015/09/articles/international-d-o/guest-post-marshall-plan-for-do-policies-in-germany/> (“Companies are anxious to avoid reputational damages as a consequence of negative litigation press releases.”).

utive board and the supervisory board is insured by the same policy.<sup>439</sup> When managers are sued by the corporation headed by the supervisory board, the managers may retaliate by giving third party notice to the individual supervisory board members alleging liability of the supervisory board member.<sup>440</sup> When the supervisory board risks being sued, the supervisory board has to consider the possibility of the bucket being depleted when the supervisory board needs the policy at a later date.<sup>441</sup> Although this problem may directly affect the incentive of the supervisory board to settle, there is a proposal to solve this problem by keeping the insurance of the executive board and the supervisory board separate.<sup>442</sup> By keeping the insurance policy of the supervisory board separate from the policy of managers, it will be possible to allow the supervisory board to pursue the case without being tempted to settle.<sup>443</sup>

### III. Implementation of US Style Class Action and Manager Misconduct Deterrence

As we have seen, securities litigation is not common in Germany compared to the U.S. What would happen if U.S. style class action is implemented? Although there are differences in systems which may lead to different results as seen above, it may be possible to incentivize the plaintiff or the plaintiff's attorney to file more securities class actions. Because the managers are not a party to the securities class action in Germany, the case will not be resolved with the corporation indemnifying the managers like in the U.S.

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<sup>439</sup> Burkhard Fassbach & Niklas Rahlmeyer, MARSHALL PLAN FOR D&O POLICIES IN GERMANY, THE D&O DIARY (Sep. 21, 2015), <http://www.dandodiary.com/2015/09/articles/international-d-o/guest-post-marshall-plan-for-do-policies-in-germany/> (“The conventional D&O policy, under which executive and supervisory board members are jointly insured, does not do justice to the company’s constituents and provoke unsolvable conflicts of interest among the parties involved.”).

<sup>440</sup> Burkhard Fassbach, D&O (DIRECTORS AND OFFICERS) LIABILITY INSURANCE IN GERMAN SUPERVISORY BOARD PRACTICE, [www.fassbach.com](http://www.fassbach.com) (last visited Feb. 18, 2016), [http://www.fassbach.com/media/raw/Directors\\_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf](http://www.fassbach.com/media/raw/Directors_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf) (“The defendant executive board’s lawyers almost invariably counsel their clients to engage in third-party practice so as to preserve possible recourse claims.”).

<sup>441</sup> Burkhard Fassbach, D&O (DIRECTORS AND OFFICERS) LIABILITY INSURANCE IN GERMAN SUPERVISORY BOARD PRACTICE, [www.fassbach.com](http://www.fassbach.com) (last visited Feb. 18, 2016), [http://www.fassbach.com/media/raw/Directors\\_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf](http://www.fassbach.com/media/raw/Directors_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf) (asserting that supervisory board risks depletion of insurance money bucket at possible recourse proceeding).

<sup>442</sup> Burkhard Fassbach, D&O (DIRECTORS AND OFFICERS) LIABILITY INSURANCE IN GERMAN SUPERVISORY BOARD PRACTICE, [www.fassbach.com](http://www.fassbach.com) (last visited Feb. 18, 2016), [http://www.fassbach.com/media/raw/Directors\\_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf](http://www.fassbach.com/media/raw/Directors_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf).

<sup>443</sup> See Burkhard Fassbach, D&O (DIRECTORS AND OFFICERS) LIABILITY INSURANCE IN GERMAN SUPERVISORY BOARD PRACTICE, [www.fassbach.com](http://www.fassbach.com) (last visited Feb. 18, 2016), [http://www.fassbach.com/media/raw/Directors\\_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf](http://www.fassbach.com/media/raw/Directors_andOfficersLiabilityInsuranceinGermanSupervisoryBoardPractice.pdf).

Because of the duty of the supervisory board to file claims against managers for violation of their duties, and because of the rule not allowing the corporation to cover the managers in full by D&O insurance in Germany,<sup>444</sup> there may actually be deterrence effects to the manager's conducts. Moreover, there may still be some deterrence effect even if the corporation ends up settling with the managers, as the manager will be paying from his pocket in the form of a deductible or private insurance policy.<sup>445</sup>

## **F. Conclusion**

It is hard to predict whether U.S. style class action will work in Germany. There are many possible obstacles. There may be political obstacles which resist the implementation at all. There are legal obstacles which may act as barriers to implementation such as constitutional constraints, or which may act as barriers to use in practice such as lack of discovery system as we have seen above. Yet we also find German legal rules which show some attributes that may allow the U.S. securities class action to deter the misconduct of managers more effectively.

However, the actual effect on deterrence may give rise to a new problem which we do not address here, that is whether the U.S. style securities class action will work as an over-deterrence mechanism if implemented.<sup>446</sup> This is an issue that will have to be addressed with specific context at a later date.

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<sup>444</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 90 (2015) (explaining the requirement that D&O insurance policies include a deductible that must be borne by the board member).

<sup>445</sup> Gerhad Wagner, *Officers' and Directors' Liability Under German Law—A Potemkin Village*, 16 *Theoretical Inq. L.* 69, 80-81 (2015) (“[C]orporate managers are free to go out themselves and buy insurance that specifically covers the deductible that is excluded from the group insurance policy bought by the company.”) (footnote omitted).

<sup>446</sup> Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 *Va. L. Rev.* 623, 650-655 (1992) (explaining the cost of over-deterrence).

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