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Issuer Liability: Ownership Structure and the Circularity Debate

Law Working Paper N° 647/2022
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Martin Gelter
Fordham University and ECGI

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Abstract

In many countries worldwide, publicly traded companies can be held liable by investors for misstatements. In most cases, this is despite the beneficiary of misstatements being managers rather than the firm itself. The economic burden of liability falls on the issuer and its stockholders. Because of this "circularity" problem, compensation does not provide a strong policy rationale for issuer liability. Collective action problems among shareholders undermine deterrence. This chapter argues that this critique, which arose against the backdrop of US corporate governance, is less persuasive in corporate governance systems with concentrated ownership. It suggests that more effective issuer liability could have beneficial effects in many countries where concentrated ownership prevails. However, concentrated ownership's effect of creating a powerful interest group explains why issuer liability is not strongly enforced in many countries.

Keywords: Issuer liability, securities class action, ownership structure, corporate governance, interest group, circularity

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Issuer Liability: Ownership Structure and the Circularity Debate

MARTIN GELTER*

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1. Introduction

Issuer liability refers to a publicly traded firm being financially responsible for misstatements in disclosures under securities law. While it may seem intuitively appealing to hold issuers liable, the advantages are far less clear from a policy perspective. As in many other areas of collective litigation in the United States, there is an intense debate about the merits of securities class actions. Besides the more general discussion about whether and to what extent plaintiff attorneys produce benefits for their clients,[1] issuer liability has been subject to a debate about the "circularity" critique. Because issuer liability is ultimately borne by shareholders, compensation of losses by wrongdoers cannot be a plausible policy goal.

Deterrence also suffers from considerable difficulty. Stockholders should have incentives to avoid their entity's liability by monitoring and selecting conscientious and honest managers. However, because relatively dispersed shareholders suffer from collective action problems, incentives rarely translate into action. However, the arguments developed against the backdrop of the US corporate governance system do not apply in other jurisdictions where there are typically large blocks of shares. Therefore, this chapter argues that issuer liability potentially has greater social value in corporate governance systems with concentrated ownership.[2]

This chapter proceeds as follows. Section 2 provides a brief international survey on issuer and individual liability for false disclosures under securities law. Section 3 explores the rationale for issuer liability, focusing on compensation and deterrence. It explores the circularity critique and factors that undermine deterrence. Section 4 investigates the impact of ownership structure and suggests that issuer liability creates better incentives in concentrated ownership systems. Section 5 examines the comparative political economy of issuer liability and discusses entrenched interest groups motivated to block reform. Section 6 summarizes and concludes.

2. A brief international survey

Issuer liability contrasts with and complements the liability of individuals who personally initiate false disclosures, such as managers. Vicarious liability of the corporation for the actions of its officers is rooted either in general legal principles (such as *respondeat superior* in common law countries) or a statute explicitly establishing issuer liability. While the legal basis of liability is typically different for primary and secondary market cases, the main difference arises between countries that hold directors, officers, and other individuals directly liable and those that do not.

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[1] Arguably, plaintiff lawyers prefer "to proceed by class action rather than derivative action" because they "get paid a share of the recovery." Richard A. Booth, *What's A Nice Company Like Goldman Sachs Doing in the Supreme Court? How Securities Fraud Class Actions Rip Off Ordinary Investors – and What to Do About It*, 66 VILL. L. REV. TOLLE LEGE 71, 79 (2021).

[2] For this argument, *see also* Martin Gelter, *Risk-shifting through issuer liability and corporate monitoring,* 14 EUR. BUS. ORG. L. REV. 497 (2013); Martin Gelter, *Global Securities Litigation and Enforcement,* in GLOBAL SECURITIES LITIGATION AND ENFORCEMENT 3, 46-51 (Pierre-Henri Conac & Martin Gelter eds. 2018).

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In most countries, directors and officers are subject to prospectus liability in the primary market.[3] Germany and the Netherlands are exceptions in only holding liable those "initiating" the prospectus or those determining the content of the prospectus, which does not necessarily include board members.[4] Italy mentions persons responsible for certain parts of the prospectus.[5] German and Israeli law mention controlling shareholders, while some countries hold promoters of the company liable.[6] Countries that do not establish prospectus liability of directors and officers include Finland and Austria (although individuals may be responsible under specific circumstances on some other legal basis).[7]

Similarly, for subsequent disclosures, most countries permit concurrent liability of the issuer with its directors and officers. The laws of some jurisdictions hold any person involved with

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[3] *E.g.* Stéphane Rousseau, *Canada: The Protection of Minority Investors and the Compensation of Their Losses*, in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 143, 161, [hereinafter *Canada*]; Pierre-Henri Conac, *France: The Compensation of Investors' Losses for Misrepresentation on Financial Markets,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 331, 354 [hereinafter *France*]; Emmanuel P. Mastromanolis, *Greece: Public Enforcement and Civil Litigation in the Greek Paradigm of Minority Investor Protection,* GLOBAL SECURITIES LITIGATION, *supra* note 2, at 412, 430 [hereinafter *Greece*]; Umakanth Varottil, *India: The Efficacy of India's Legal System as a Tool for Investor Protection,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 813, 834 [hereinafter *India*]; Kyung-Hoon Chun, *South Korea: Protection of Minority Investors in Capital Markets,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 988, 1013 [hereinafter *South Korea*]; Paulo de Tarso Domingues, *Portugal: The Legal Framework of the Portuguese Capital Market,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 537, 549 [hereinafter *Portugal*]; Yuliya Guseva, *Russia: Russian Capital Markets and Shareholder Litigation: Quo Vadis?,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 657, 677 [hereinafter *Russia*]; Mónica Fuentes Naharro, *Spain: Minority Investors' Protection in Spain: Civil Liability Remedies under Securities Law,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 595, 615-16 [hereinafter *Spain*]; Mirko Vasiljević, Jelena Lepetić & Jasna Vaslijević, *Serbia: The Protection of Minority Investors and the Compensation of their Losses,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 692, 712-13; Wang-ruu Tseng, *Taiwan: Investor Protection in Taiwan's Capital Market,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 1025, 1037 [hereinafter *Taiwan*].

[4] Dirk A. Verse, *Germany: Liability for Incorrect Capital Market Information*, in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 363, 376 [hereinafter *Germany*]; Loes Lennarts & Joti Roest, *Netherlands: Protection of Investors and the Compensation of their Losses,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 469, 484-85 [hereinafter *Netherlands*] (noting that it is not clear whether directors can be held liable under the securities law).

[5] Dmitri Boreiko & Stefano Lombardo, *Prospectus Liability and the Role of Gatekeepers as Informational Intermediaries: An Empirical Analysis of the Impact of the Statutory Provisions on Italian IPOs,* 20 EUR. BUS. ORG. L. REV. 255, 260-61 (2019).

[6] Robin Hui Huang, *China: Private Securities Litigation: Law and Practice*, in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 879, 887 [hereinafter *China*] (promoters and controlling shareholders); Verse, *Germany*, *supra* note 4, at 376 (controlling shareholders); Varottil, *India*, *supra* note 3, at 835 (using the term "promoters", which typically includes the controlling shareholder); Uriel Procaccia, *Israel: The Protection of Minority Investors and the Compensation of Their Losses*, in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 755, 769 (including controlling shareholders); Aiman Nariman Mohd-Suleiman, *Malaysia: Protection of Minority Investors in the Capital Market – Public Enforcement and Shareholders' Litigation*, in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 944, 977 (promoters); Domingues, *Portugal*, *supra* note 3, at 549 (promoters).

[7] Martin Gelter & Michael Pucher, *Austria: Securities Litigation and Enforcement,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 261, 293 [hereinafter *Austria*]; Ville Ponkä, *Finland: Protecting Minority Investors and Compensation their Losses,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 303, 316-17 [hereinafter *Finland*].

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or responsible for the misrepresentation liable.[8] Other countries explicitly refer to directors or managers.[9] By contrast, in Austria, Finland, Germany, and Switzerland, individuals are liable only under general civil law – which requires exceptional circumstances for compensation of pure economic loss.[10] An exception is South Africa, which apparently relies on individual liability only.[11]

From a practical perspective, the issuer is often the most attractive defendant. The individual responsibility of a specific person may be difficult to establish for the plaintiff, whereas collective responsibility can easily be assigned to the legal entity. Individuals' wealth from which recovery can be sought is typically more limited.[12] In the United States, only the issuer contributes to settlements in most cases.[13] Evidence shows that managers rarely contribute to a settlement fund[14] and do so mainly in insolvency or as part of an agreement to avoid criminal prosecution.[15] Directors' and officers' (D&O) insurance usually covers both individuals and issuers.[16] Moreover, individuals

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[8] Franklin A. Gevurtz, *United States: The Protection of Minority Investors and Compensation of Their Losses,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 109, 133 [hereinafter *United States*]; Olivia Dixon & Jennifer Hill, *Australia: The Protection of Investors and the Compensation of Their Losses*, in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 1063, 1086; Huang, *China*, *supra* note 6, at 887; Mastromanolis, *Greece*, *supra* note 3, at 431.

[9] Viviane Muller Prado, *Brazil: The Protection of Minority Investors and Compensation for Their Losses,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 179, 199-200; Rousseau, *Canada, supra* note 3, at 166; Conac, *France, supra* note 3, at 331, 346-47; Guido Ferrarini & Paolo Giudici, *Italy: The Protection of Minority Investors and the Compensation of Their Losses,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 446, 455; Chun, *South Korea, supra* note 3, at 1014; Lennarts & Roest, *Netherlands, supra* note 4, at 492; Guseva, *Russia, supra* note 3, at 677; Fuentes Naharro, *Spain, supra* note 3, at 624; Ferna İpekel Kayali, *Turkey: The Protection of Minority Investors and the Compensation of Their Losses in Turkish Capital Markets*, in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 729, 744-48.

[10] Gelter & Pucher, *Austria, supra* note 7, at 283, 288; Ponkä, *Finland, supra* note 7, at 317; Verse, *Germany*, *supra* note 4, at 386; for Switzerland Rashid Bahar, Xenia Karametexas & Joël Tawil, *Disclosure Duties: How does Swiss Law protect minority shareholders?*, in LUKAS HECKENDORN URSCHELER, RAPPORTS SUISSES PRESENTES AU XIXE CONGRES INTERNATIONAL DE DROIT COMPARE / SWISS REPORTS PRESENTED AT THE XIXTH INTERNATIONAL CONGRESS OF COMPARATIVE LAW 211, 239-40 (2014); Tseng, *Taiwan, supra* note 3, at 1043 (reporting a debate on whether individuals in charge of disclosures is liable in addition to the issuer).

[11] Here, the seller of securities is liable rather than the issuer. Piet Delport, *South Africa: Investor Protection,* in GLOBAL SECURITIES LITIGATION, *supra* note 2, at 779, 794.

[12] *See generally* Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Control,* 93 YALE L. J. 857, 885 (1984) (considering employee liability as a backstop to company liability limits).

[13] Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1499 (1996); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1551 (2006); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation,* 2009 WIS. L. REV. 333, 337; Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1068-1074 (2006); Urska Velikonja, *Distortion other than Price Distortion,* 93 WASH. U. L. REV. 425, 429 (2015).

[14] Alexander, *id.*, at 1498-1499; Coffee, *id.*, at 1551; Fisch, *supra* note 13, at 337; Bernard Black, Brian Cheffins & Michael Klausner, *id*., at 1068-1074. On the significance of insurer's payments, *see* Tom Baker & Sean J. Griffith, *How the merits matter: directors' and officers' insurance and securities settlements*, 157 U. PA. L. REV. 755, 760-761 (2009).

[15] Coffee, *id.*, at 1551; *see also* Alexander, *id.,* at 1498.

[16] Coffee, *id.,* at 1570; TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT 46 (2010).

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are primarily protected by indemnification agreements with their employers.[17] Thus, to identify the rationale and effects of liability, we need to look at issuer liability.

3. The rationale for issuer liability

3.1. Compensation and deterrence

Liability has two main economic functions: compensation and deterrence.[18] The victim's compensation is perhaps the more intuitive and dominates doctrinal debates.[19] We may not want to saddle a victim with the risk of injury. In economic terms, the risk is assigned to a better risk-bearer.[20] If accident victims are risk-averse, they will suffer a smaller ex ante loss in utility than payers that are risk-neutral and required to compensate them. Compensation will thus be welfare-enhancing because the benefits of the victim's reduced burden outweigh the cost of saddling the payer with it. However, if accident victims can easily purchase insurance, the risk is spread out across the pool of insured individuals.[21] Consequently, who should ultimately bear the financial risk of an activity should depend on the availability and cost of insurance.[22]

The more important function of liability is to create incentives to avoid further harm-doing. If A is responsible for the damage inflicted on B, A should have the motivation to take precautions. A's incentives will be influenced by whether she purchased insurance. However, insurers typically can create incentives for the insured through the pricing mechanism by adjusting premia to risk or engaging in monitoring.[23]

The mandatory disclosure regime created by securities law is intended to instill confidence in investors, improve the basis for decisions, and tackle the agency problem between investors on the one hand and management and controlling shareholders on the other hand.[24] Issuer liability is concerned with harm resulting from violations of these disclosure requirements, particularly false and misleading disclosures. As in other corporate liability cases, the incentive may be indirect because shareholders bear the cost of liability by reducing the value of their stock. Consequently, it

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[17] Baker & Griffith, *supra* note 14, at 797.

[18] Investor confidence is also sometimes cited as a goal. *E.g., Note: Congress, The Supreme Court, And The Rise Of Securities-Fraud Class Actions*, 132 HARV. L. REV. 1067, 1083 (2019). Practically, it is a consequence of deterrence of fraud.

[19] *E.g.,* Lord Bingham of Cornhill, *The Uses of Tort,* 1 J. EUR. TORT L. 3, 4 (2010) ("Securing compensation is, however, the primary function of tort."); Ulrich Magnus, *Why is US Tort Law so Different?* 1 J. EUR. TORT L. 102, 106 (2010); Jean-Sébastian Borghetti, *The Culture of Tort Law in France,* 3 J. EUR. TORT L. 158, 164, 177 n.64 (2012); HELMUT KOZIOL, BASIC QUESTIONS OF TORT LAW FROM A GERMANIC PERSPECTIVE ¶ 3/1 (2013).

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

[21] *E.g.,* SHAVELL, *id.*, at 268.

[22] SHAVELL, *id.* at 268-269 *see also* Borghetti, *supra* note 19, at 164 (pointing out the role of the social insurance system for victim compensation).

[23] Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on the Securities Market: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 712.

[24] *E.g.,* Iris H-Y Chiu, *Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the UK*, 38 DEL. J. CORP. L. 983, 987-90 (2014).

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is thought to create indirect incentives: shareholders will *ex ante* be interested in having directors and officers in charge who will not cause the corporation to be liable to third parties *ex post*.[25] Therefore, the effectiveness of shareholders' incentives will depend on how easily they can appoint, monitor, remove, and replace directors.

3.2. The compensation rationale and the circularity problem

3.2.1. Pocket-shifting

In the context of issuer liability, the compensation rationale suffers from several additional problems relating to a phenomenon known as "circularity."[26] It is trivial to point out that a payout on issuer liability reduces firm value by the same amount, with a corresponding effect on market capitalization. As plaintiff investors often own stock in the defendant corporation, money is distributed from one of the investors' "pockets" to the other, except for the cut taken by attorneys.[27]

False disclosures will typically inflate the stock price. In "primary market" cases, where the corporation issued stock, the stock bought by new investors is diluted, from which the existing stockholders benefit.[28] These cases are less troublesome because the rescission of stock sales averts the redistributive effects of fraud. Consider the stylized example in Table 1, where nine original shareholders gain $20 each because of the price at which the defrauded plaintiff pays $180 for newly issued shares. Rescission in the form of returning stock against the purchase price eliminates the redistributive effect.

	Loss/gain due to mis-information	**Loss of share value due to judg-ment**	**Judgment received**	**Net harm**
Plaintiff(s)	-$180	$0	$180	$0
Each of the nine old shareholders	$20	-$20	$0	$0

Table 1: Redistributive effects of issuer liability in primary markets

[25] Richard A. Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159, 169-170 (1986).

[26] Amanda M. Rose, *Better Bounty Hunting: How the SEC's New Whistleblower Program Changes the Securities Fraud Class Action Debate*, 108 NW. U. L. REV. 1235, 1243 (2014).

[27] *E.g.,* Thomas E. Dubbs, *A Scotch Verdict on "Circularity" and other Issues*, 2009 WIS. L. REV. 455, 456; Manning Gilbert Warren III, *The U.S. Securities Class Action: An Unlikely Export to the European Union*, 37 BROOK. J. INT'L L. 1075, 1077-1078 (2012); Rose, *id.*, at 1244.

[28] *E.g.,* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 638-639 (1985); *see also* Coffee, *supra* note 13, at 1556; Richard A. Booth, *The End of Securities Fraud as We Know It,* 4 BERKELEY BUS. L. J. 1, 25 (2007).

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By contrast, in "secondary market" cases, where inflated prices affect trades in the market, the beneficiaries are former shareholders who happened to sell before the misinformation was corrected.[29] If the issuer is held liable for misstatements, the cost of a judgment is borne by all current shareholders through the loss in share value. These may include the plaintiffs themselves as well as buy-and-hold investors, but notably not those lucky enough to sell stock at a high price.[30] Consider a corporation with ten shareholders, one of whom suffered a loss of $200 because she bought stock when the price was inflated. Table 2 shows how each shareholder loses $20 from the payment corresponding to their share in the firm.[31]

	Loss/gain due to misinformation	Loss of share value due to judgment	Judgment received	Net harm
Plaintiff (10%)	**-$200**	**-$20**	**$200**	**-$20**
Each of the other shareholders (10%)	**$0**	**-$20**	**$0**	**-$20**

Table 2: Redistributive effects of issuer liability in secondary markets

Issuer liability thus spreads the risk of fraud from the buyers across all shareholders.[32] One could consider this diffusion of risk desirable because it implicitly creates a form of insurance.[33] However, there are reasons to object to exposing innocent stockholders to risk because they abstained from selling. Those sellers who gained from an inflated price get off without contributing to the cost of a payout.[34] Buy-and-hold investors may also bear additional losses, such as a reduction in firm value resulting from reputational losses following the discovery of fraud.[35]

3.2.2. Diversification

The term "circularity" is also used to describe the effects of diversification. In theory, investors with broad portfolios will sometimes be members of the plaintiff class that gains from a

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[29] Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 646 (1996); Coffee, *supra* note 13, at 1556; James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 331 (2009); Merritt B. Fox, *Why civil liability for disclosure violations when issuers do not trade?* 2009 WIS. L. REV. 297, 302; William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market,* 160 U. PA. L. REV. 69, 94 (2011); Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 69 BUS. LAW. 307, 313 (2014).

[30] *But see* James Cameron Spindler, *We Have A Consensus on Fraud on the Market-and It's Wrong*, 7 HARV. BUS. L. REV. 67, 70, 95-96 (2017) (modelling how plaintiffs are arguably compensated by non-plaintiff shareholders under the assumption that stock prices accurately reflect the possibility of liability as soon as the fraud is revealed).

[31] For a similar example, *see* Park, *supra* note 29, at 336.

[32] *See* Fox, *supra* note 29, at 303 n.6.

[33] Fox, *id.*, at 304-305; Langevoort, *supra* note 29, at 649.

[34] Coffee, *supra* note 13, at 1557-1558.

[35] Park, *supra* note 29, at 330; *see also* Richard A. Booth, *The Future of Securities Litigation*, 4 J. BUS. & TECH. L. 129, 140 (2009); Booth, *supra* note 1, at 79-80; Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1703 (2011); Velikonja, *supra* note 13, at 429.

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securities class action and sometimes they will be stockholders who lose from issuer liability.[36] Diversification reduces the exposure to the risk of fraud at any individual company, which replicates the effect of the "insurance" provided by issuer liability.[37] Across a portfolio, a diversified investor will suffer a loss due to the cut for litigation costs.[38] Arguably, even a stock picker might disfavor issuer liability because it is not predictable for her *ex ante* if she will be on the winning or losing site of a lawsuit.[39]

One could counterargue that liability is important to keep certain types of traders in the market. Other investors may be particularly vulnerable because they neither diversify nor pick stock based on in-depth information. This includes employees with restricted stock[40] and certain retail investors.[41] Information trading will bring stock prices closer to firms' intrinsic value, thus making the market more informationally efficient.[42]

3.2.3. Trading frequency

Whether gains and losses from issuer liability balance-out will depend not only on diversification but also on the frequency of trades. To be part of the plaintiff class, one must have bought or sold during the period when the price was distorted by misinformation. This is often not true for retail investors, who typically pay less attention to market movements and hold on to shares for extended periods.[43] "Buy-and-hold" investors will more often be on the losing side than institutional investors, who often adjust their portfolios.[44] The latter are more likely to benefit than less diversified investors even if compensation provides smaller benefits to them in light of their already well-spread risk.[45]

This redistributive effect may play out differently in the modern world of passive investing: When retail investors participate in the market primarily through passive index funds, they benefit

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[36] Park, *id.*, at 328-329.

[37] Booth, *supra* note 35, at 139-140; Booth, *supra* note 28, at 17; Grundfest, *supra* note 29, at 313-14.

[38] Amanda Marie Rose, *The shifting raison d'être of the Rule 10b-5 private right of action,* in RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION 39, 48 (Sean Griffith, Jessica Erickson, David H. Webber & Verity Winship eds. 2018); Rose, *supra* note 26 at 1244; Richard A. Booth, *Sense and Nonsense About Securities Litigation*, 21 U. PA. J. BUS. L. 1, 6 (2018).

[39] Richard A. Booth, *OOPs! The Inherent Ambiguity of Out-of-Pocket Damages in Securities Fraud Class Actions*, 46 J. CORP. L. 319, 334 (2021).

[40] Booth, *supra* note 38*,* at 15; James. D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law,* 6 EUR. COMPANY & FIN. L. REV. 164, 176 (2009).

[41] *See e.g.* Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 234-236 (2007); Velikonja, *supra* note 13, at 430.

[42] Park, *supra* note 29, at 342-344; David H. Webber, *Shareholder Litigation Without Class Actions*, 57 ARIZ. L. REV. 201, 258-59 (2015); *see also* Fisch, *supra* note 13, at 347.

[43] Evans, *id.,* at 232-234.

[44] Langevoort, *supra* note 29, at 649-650; Coffee, *supra* note 13, at 1559-1560; Bratton & Wachter, *supra* note 29, at 97.

[45] *E.g.* Booth, *supra* note 35, at 147; Alexander, *supra* note 13, at 1502.

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from diversification. However, as index funds do not adjust their portfolio in reaction to market movements, they are more likely harmed by issuer liability than managed funds.[46]

3.3. Issuer liability and the deterrence rationale

3.3.1. The social cost of securities fraud

The second traditional rationale for liability is deterrence. According to the classic law and economics view, harm should be matched by a corresponding level of sanctions to induce an efficient level of care.[47] This typically means that not *all* harmful conduct should be deterred, but only actions where the expected social cost exceeds social benefits. These include benefits to the acting person, including cost savings from taking fewer precautions.[48] Moreover, for the system to be viable, a "liability regime must save more in social cost than it creates in enforcement cost."[49]

This standard rationale does not apply directly to securities litigation, where social cost is harder to identify compared to accident law. Following the logic of private law, aggrieved investors will sue for compensation of losses corresponding to the difference between the purchase price of the stock and the value "without" false information.[50] However, as outlined above, this purchaser's loss is balanced by a mirroring gain captured by the seller. The transaction is thus merely redistributive, with a net zero social cost.[51]

The actual social costs are thus not related to the injury to the plaintiff. First, they include resources spent to conceal fraud[52] as well as increased monitoring costs borne by investors.[53] Second, mispricing because of pervasive fraud results in a misallocation of capital between different issuers.[54] Consequently, capital will not flow to its highest value use.[55] Since this risk is systemic

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[46] Booth, *supra* note 39, at 334.

[47] *E.g.* SHAVELL, *supra* note 20, at 178.

[48] *E.g.* Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions As A Deterrent*, 85 COLUM. L. REV. 1232, 1234-35 (1985); ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 300-302 (3rd ed. 2000). *See* Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2188-2189 (2010).

[49] Rose, *supra* note 38, at 42.

[50] *See generally,* Gelter, *Global Securities Litigation, supra* note 2, at 76-79 (surveying damages in securities fraud cases across countries).

[51] *E.g.* Richard A. Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159, 169-170 (1986); Paul G. Mahoney, *Precaution Cost and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 629-630 (1992); Fox, *supra* note 29, at 302; Marcel Kahan, *Securities laws and the social costs of "inaccurate" stock prices*, 41 DUKE L.J. 977, 1006-1007 (1992).

[52] Posner, *supra* note 51, at 170; Easterbrook & Fischel, *supra* note 28, at 623; Mahoney, *supra* note 51, at 631.

[53] Posner, *id.*; Easterbrook & Fischel, *id.*; Mahoney, *id.*, at 629-630.

[54] Easterbrook & Fischel, *supra* note 28, at 623-624; Kahan, *id.,* at 1006-1007, 1013; Mahoney, *supra* note 51, at 633-634.

[55] Kahan, *supra* note 51, at 1008-1009.

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and cannot be eliminated through diversification, firms will face a higher cost of capital unless they can signal an absence of fraud risk.[56]

Third, misinformation may increase managerial agency cost by making it harder to use the stock price as a disciplinary mechanism.[57] Fraudulent financial results affect the compensation and performance evaluation of managers and will distort the managerial labor market.[58] If a firm's stock is misleadingly overvalued, managers are overcompensated[59] and less likely to be fired.[60]

Finally, if the firm's financial position appears better, overconfident managers may offer lower prices to consumers and recruit more staff.[61] Other "stakeholders" will make decisions on how to interact with the firm based on false information. Creditors may misprice debt, and employees may forego opportunities to find better employment.[62]

3.3.2. Unclear incentives for deterrence

Considering this complex set of costs, it is not surprising that the US literature debates whether securities class actions over- or under-deter. While the empirical literature suggests that securities litigation creates at least some deterrence,[63] this may be partly due to the inherent unpleasantness of litigation.[64]

According to one theory, plaintiffs' claims exceed social welfare losses.[65] In this view, firms have incentives to err on the side of publicizing information rather than keeping it confidential and to overspend on compliance with securities law.[66] Some scholars add that uncertainties in the law add to these problems.[67]

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[56] Rose, *supra* note 48, at 2179.

[57] Mahoney, *supra* note 51, at 634; Rose, *supra* note 48, at 2179; Rose, *supra* note 26, at 1246.

[58] *See* James D. Cox, *Making Securities Fraud Actions Virtuous*, 39 ARIZ. L. REV. 497, 510 (1997); Coffee, *supra* note 13, at 1562; Arlen & Carney, *supra* note 23, at 702-703, 720-734 (lending empirical support to this thesis).

[59] Rose, *supra* note 48, at 2182.

[60] Arlen & Carney, *supra* note 23, at 720.

[61] Urska Velikonja, *The Cost of Securities Fraud,* 54 WM. & MY. L. REV. 1887, 1915-29 (2013).

[62] Velikonja, *id.*, at 1916-23.

[63] Dain C. Donelson, Justin J. Hopkins & Christopher G. Yust, *The Role of Directors' and Officers' Insurance in Securities Fraud Class Action Settlements,* 58 J. L. & ECON. 747 (2015); Simi Kedia, Kevin Koh & Shivaram Rajgopal, *Evidence on Contagion in Earnings Management*, 90 ACCT. REV. 2337, 2363-65 (2015) (suggesting that firms are deterred from fraudulent disclosures by litigation and enforcement actions against peer firms); James P. Naughton, Tjomme O. Rusticus, Clare Wang & Ira Yeung, *Private Litigation Costs and Voluntary Disclosure: Evidence from the Morrison Ruling,* 94 ACCT. REV. 303 (2019) (finding that the Morrison decision resulted in a reduction of voluntary disclosures); Justin Hopkins, *Do Securities Class Actions Deter Misreporting?*, 35 CONT. ACCT. RES. 2030 (2018).

[64] Velikonja, *supra* note 13, at 430.

[65] Easterbrook & Fischel, *supra* note 28, at 625; Alexander, *supra* note 13, at 1497-1498; Langevoort, *supra* note 29, at 646-647; Rose, *supra* note 26, at 1246; Booth, *supra* note 51, at 8.

[66] Rose, *supra* note 48, at 2190, 2192, 2194; Langevoort, *supra* note 29, at 652; *Note*, *supra* note 18, at 1082.

[67] Rose, *id.,* at 2190-2194; Rose & Squire, *supra* note 35, at 1686.

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Adherents to the contrary view point out that the beneficiaries of false disclosures are typically managers[68] concerned about personal financial and reputational losses resulting from bad financial results.[69] Because managers have access to professional staff and consultants, they will be aware of which statements are accurate and which ones are problematic without incurring a significant cost.[70] Firms are unlikely to be overdeterred in expending too many resources on avoiding or concealing misstatements.

D&O insurance strongly impacts the incentive effects of liability. Insurance that covers all liability extinguishes incentives to avoid misrepresentations.[71] However, insurers should have incentives to reduce moral hazard, for example by monitoring, screening, requiring deductibles, and adjusting the insurance premium to the risk. Thus, insurance is sometimes considered a mechanism that solves collective action problems among shareholders relating to monitoring directors.[72]

Insurers are typically involved in settlement negotiations. Baker and Griffith find that issuer liability cases typically settled close (or slightly above) the insured sum.[73] Contrary to theoretical predictions, D&O insurers rarely monitor and usually do not use premia to create incentives. Baker and Griffith's explanation is agency cost: Insurance is chosen by managers or directors rather than shareholders, which results in the choice of insurance plans serving the interest of the intermediate beneficiaries. These plans reduce liability risk but do not typically result in monitoring or better incentives to avoid liability.[74] Corporations rarely seek reimbursement from individuals, which, if anything, would result in the depletion of insurance coverage.[75]

4. The impact of ownership structures on incentives

4.1. Issuer liability, corporate governance, and individual liability

In practice, issuer liability shifts the financial impact of misrepresentations from personally responsible individuals to the issuer. Even if investors can sue individuals, the issuer tends to have deeper pockets. Insurance, in theory, moves the risk to the insurer, which may push the risk back to the issuer through monitoring and adjusting insurance premia. Issuer liability thus puts shareholders in a position akin to someone strictly (but proportionately) liable because of the effect of

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[68] *E.g.* Coffee, *supra* note 13, at 1562 (suggesting that managers are interested in securing their positions and maximizing compensation); Fox, *supra* note 29, at 280.

[69] Arlen & Carney, *supra* note 23, at 715, 725; Cox, *supra* note 58, at 510; Langevoort, *supra* note 29, at 654.

[70] Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 UC DAVIS L. REV. 1281, 1340 (2011).

[71] BAKER & GRIFFITH, *supra* note 16, at 60-61.

[72] *See* Arlen & Carney, *supra* note 23, at 712.

[73] Baker & Griffith, *supra* note 14, at 760-761; *see also* Fox, *supra* note 29, at 305; Cox, *supra* note 58, at 512 (finding that the settlement amount is covered by insurance in 96% of cases); Bratton & Wachter, *supra* note 29, at 100; *but see* Donelson et al., *supra* note 63 (finding that insurance matters in settlement amounts only in weaker cases, but not typically in those involving accounting fraud).

[74] BAKER & GRIFFITH, *supra* note 16, at 72-74.

[75] Dubbs, *supra* note 27, at 462.

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settlements and insurance premia on the value of their stock. Theoretically, shareholders collectively should have incentives to reduce the probability of misconduct. The critical question is how well they are positioned to prevent wrongdoing to avoid issuer liability and keep insurance premia down.

Boards and significant shareholders could monitor officers potentially responsible for misstatements or select officers that will avoid them.[76] Moreover, shareholders and the board could push to implement incentive structures to prevent wrongdoing. Ideally, officers or managers would suffer financial and career penalties,[77] and firms might consistently attempt to seek reimbursement for financial losses resulting from issuer liability. One technique is clawbacks of executive compensation in the case of restatements of earnings, which have been legally mandated in the US in specific situations[78] but are arguably not effectively implemented.[79] Ideally, one might expect shareholders to push for internal clawback policies to create the right incentives. However, we do not see these in practice.

Arlen and Carney describe three circumstances under which corporate liability is superior to individual liability. First, the corporation must be well-positioned to prevent misconduct. Second, it must be able to impose sanctions more effectively than a court. Third, a suit by the corporation must be more likely than an investor suit.[80] These conditions do not apply to issuer liability because corporations are unlikely to sanction managers engaging in misconduct.[81] Corporations do not have an advantage over outside plaintiffs in identifying responsible individuals.[82] Boards hesitate to sue managers.[83] Suing or sacking a manager is typically a measure of last resort that hints at the board's prior failure in selecting the individual in question. Disciplining a manager may entail a reputational cost for the company or the board.[84]

4.2. How ownership structure shapes monitoring incentives and capabilities

The incentive effects of liability depend primarily on how well the board is incentivized to reduce liability risk. This will depend on the firm's corporate governance structure and environ-

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[76] Posner, *supra* note 51, at 169-170.

[77] *See* Alexander I. Platt, *Index Fund Enforcement,* 53 UC DAVIS L. REV. 1454, 1475-76 (2020) (summarizing evidence on career penalties suffered by managers following securities class actions, including "removal, reduced pay, diminished opportunities at other firms, negative ISS recommendations, and fewer supportive votes from shareholders").

[78] Sarbanes-Oxley Act of 2002, § 304; Dodd-Frank Act of 2010, § 954. The latter provision has not become effective because the SEC has not yet passed implementing rules.

[79] *E.g.,* Jesse Fried & Nitzan Shilon, *Excess-Pay Clawback,* 36 J. CORP. L. 721, 729-35 (2011) (discussing the limited effectiveness of the Sarbanes-Oxley clawback).

[80] Arlen & Carney, *supra* note 23, at 707.

[81] Arlen & Carney, *supra* note 23, at 708; *see also* Velikonja, *supra* note 61*,* at 1308.

[82] Arlen & Carney, *id.*, at 710.

[83] Arlen & Carney, *id.*, at 711-712; *see also* Fox, *supra* note 29, at 281; Coffee, *supra* note 13, at 1564, and Bratton & Wachter, *supra* note 29, at 72-73 (all noting the superior deterrence effects of individual liability).

[84] *See, e.g.,* Rose, *supra* note 26, at 1256-57; Russell M. Gold, *Compensation's Role in Deterrence*, 91 NOTRE DAME L. REV. 1997, 1997 (2016).

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ment, which may or may not push board members to implement goals in the interest of the corporation and its shareholders. As in many areas of corporate governance, ownership structure plays a significant role. It is easy to conceptualize the avoidance of issuer liability as an agency problem between shareholders and managers: Managers will often benefit from embellishing corporate performance, whereas shareholders will collectively benefit from avoiding the financial harm from issuer liability.[85]

While issuer liability, in principle, would create incentives to take steps for monitoring and screening that will avoid securities fraud, such incentives will be eviscerated by diversification.[86] With only a small investment in any firm, efforts to reduce agency costs may not be cost-justified both for a diversified retail investor or a fund. Individual shareholders are unlikely to have incentives to ensure the selection of directors and officers who will avoid misconduct and securities fraud.[87] In other words, the classic collective action problem is to blame for the lack of effectiveness of issuer liability.

The extent to which incentives are present for shareholders plays out at two levels, namely at the investor level and the firm level. In a recent paper, Dharmapala and Khanna identify controller wealth concentration as a key factor determining how strongly a shareholder will be motivated to induce a firm to internalize externalities.[88] The same intuition applies to the incentives created by issuer liability: shareholders most of whose wealth is tied up in a particular firm will want to avoid the hit on their finances by an extensive settlement diminishing the value of their stock holdings. Measures to avoid issuer liability in the first place would thus seem to be the self-interest of such stockholders.

Second, dispersed ownership at the firm-level results in a reduction of the ability of shareholders to take effective measures, regardless of whether they have personal incentives. At least in passing, US scholars have noted that the lack of a deterrent effect of securities litigation is likely the result of collective action problems caused by ownership structure.[89] This is because collective action problems prevent shareholder monitoring in the classic Berle-Means corporation.[90] Therefore, the board will consider shareholders' collective financial interests to a lesser extent than is desirable.[91]

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[85] Cox, *supra* note 58, at 511; Fox, *supra* note 29, at 303 n.6.

[86] Rose, *supra* note 26, at 1255.

[87] *See* Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855, 895-97 (2014); Webber, *supra* note 42, at 258; and Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 HARV. J. L. & PUB. POL'Y 1187, 1205 (2013) (all noting that investors may potentially benefit from socially undesirable conduct).

[88] *See* Dhammika Dharmapala & Vikramaditya S. Khanna, *Controlling Externalities: Ownership Structure and Cross-Firm Externalities,* ECGI LAW WORKING PAPER NO. 603/2021.

[89] Rose & Squire, *supra* note 35, at 1689 (pointing out that justification of securities class actions with deterrence is greater if there are large, non-diversified shareholders).

[90] Gelter, *Risk-shifting, supra* note 2, at 511-515.

[91] Arlen & Carney, *supra* note 23, at 693; *see generally* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52. J. FIN. 737, 740-744 (1997).

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Large shareholders do not suffer from collective action problems. Some may even be consulted before essential transactions in order to gain their blessing. Sometimes they are represented on the board, which provides them with direct decision-making powers and access to information.[92] Concentrated ownership structures generally should result in a stronger incentive effect of issuer liability. With controlling shareholders sometimes involved in financial fraud and close to the core of corporate scandals,[93] issuer liability creates incentives against possible wrongdoers. We cannot expect this relationship to change with the rise of institutional investors, specifically those managing index funds. Most observers agree that they have little to gain from firm-specific activism, and they have no incentive to reduce fraud because diversification protects them from firm-specific risk.[94]

The smaller the agency cost in the shareholder-board relationship, the more effective issuer liability is. With more significant shareholders and more shareholder wealth tied up in a particular firm, issuer liability has more potent incentive effects. D&O insurance should be similarly affected: Arguably, the agency problem between shareholders and boards deprives the former of the ability to push for D&O insurance plans that are more tailored toward reducing incidents of liability. Without the collective action problems, shareholders should be able to influence boards to take out insurance that minimizes insurance premia.

It is tempting to object that similar agency problems between shareholders and managers exist between controlling and outside shareholders. Controlling shareholders may hesitate to push for procedures and practices at firms that reduce the likely incidence of issuer liability, such as transparent disclosure mechanisms that inhibit private benefits of control.[95] They will not be interested in having an effective insurance mechanism in place. However, the position of a significant shareholder differs from that of management in that the former absorbs the cost of a large settlement and insurance premia. Consequently, the cost of issuer liability will be (indirectly) borne by a controlling shareholder positioned to avoid misconduct.[96]

4.3. The effects of issuer liability on creditors

In several jurisdictions, there have been debates about how issuer liability should be treated relative to the claims of (other) creditors of the issuer. In the US, § 510(b) of the Bankruptcy Code subordinates issuer liability to other claims that would otherwise be equal in rank. § 308(a) of the

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[92] *E.g.,* Johannes Semler, *The Practice of the German Aufsichtsrat,* in COMPARATIVE CORPORATE GOVERNANCE. THE STATE OF THE ART AND EMERGING RESEARCH 267, 269 (Klaus J. Hopt, Hideki Kanda, Mark J, Roe, Eddy Wymeersch & Stefan Prigge eds. 1998); Claus Luttermann & Jean J. du Plessis, *Banking on Trust: The German Financial Sector, Global Capital Markets and Corporate Finance and Governance,* in GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 329, 335-336 (2nd. ed., Jean J. du Plessis et al. 2012); Martin Gelter & Geneviève Helleringer, *Lift Not the Painted Veil! To Whom are Directors' Duties Owed?,* 2015 ILL. L. REV. 1069, 1079-81.

[93] *See* John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe differ*, 21 OX. REV. ECON. POL'Y 198, 206-207 (2005).

[94] Platt, *supra* note 77, at 1482, 1483 (summarizing the literature on both points); Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance,* 119 COLUM. L. REV. 2029, 2096 (2019).

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

[96] On possible objections based on stock pyramids and sales of control, *see* Gelter, *Risk-shifting, supra* note 2, at 516-18.

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Sarbanes-Oxley Act of 2002[97] heralded a contrary direction by permitting the SEC to set up "fair funds" sourced from penalties for securities law violations to compensate investors. Contrary to the Bankruptcy Code's policy, federal courts have decided against the subordination of such funds.[98]

In Europe, the issue is sometimes discussed in the context of the legal capital system: Payment to shareholders resulting from issuer liability might be considered a return of capital contributions.[99] Yet, according to the Court of Justice of the European Union, issuer liability to shareholders is not contrary to secondary EU law,[100] also considering that EU capital markets law gives the Member States the incentive to establish issuer liability. Member States may therefore put investor claims based on false disclosures on a *pari passu* level with claims of other unsecured creditors.[101]

Concerns about creditor protection should not guide the policy decisions on issuer liability. As the debate about legal capital has shown, creditors cannot rely on a particular equity cushion.[102] Moreover, many creditors can protect themselves against the risk of default by using covenants, adjusting the interest rate to the perceived threat, and refusing to extend credit in the first place.[103] The decision about subordination thus has a marginal impact on the extent to which shareholders or creditors bear the risk of fraud. The guiding question should therefore be what incentives are created for creditors.

Here, the same arguments apply to shareholders: If creditors bear some of the fraud risk, they will be more strongly incentivized to monitor.[104] While US firms are thought to have a rather diffuse debt structure, it is often believed to be more concentrated in Europe, even in the UK.[105] Bank monitoring may be beneficial where the bank enjoys a close relationship to a firm and interacts closely with management.[106] Occasionally, large creditors are even represented on the board.

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[97] PUBLIC LAW 107–204, July 30, 2002.

[98] In re Adelphia Commc'ns Corp., 327 B.R. 143, 168-170 (Bankr. S.D.N.Y. 2005); Ad Hoc Adelphia Trade Claims Comm. v. Adelphia Commc'ns Corp., 337 B.R. 475, 478 (S.D.N.Y. 2006); SEC v. WorldCom, 273 F. Supp 2d 431, 434 (S.D.N.Y 2003); Official Comm. Unsecured of Creditors of WorldCom Inc. v. SEC, 467 F.3d 73, 85 (2d Cir. 2006). *See* Wendy S. Walker, Alan S. Maza, David Eskew & Michael E. Wiles, *At the Crossroads: The Intersection of the Federal Securities Laws and the Bankruptcy Code*, 63 BUS. LAW. 125, 141-145 (2007).

[99] *E.g.* Gelter & Pucher, *Austria, supra* note 7, at 283-84; Verse, *Germany*, *supra* note 4, at 375-76, 386.

[100] *Hirmann v. Immofinanz*. Case C-174/12.

[101] Martin Gelter, *Global Securities Litigation*, *supra* note 2, at 3, 64.

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

[103] *E.g.* Enriques & Macey, *id.*, at 1188-1195; John *Armour*, Legal Capital: An Outdated Concept? 7 EUR. BUS. ORG. L. REV. 5, 16-17 (2006).

[104] Kenneth B. Davis, Jr., *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L. J. 1, 66; *see also* Nicholas L. Georgakopoulos, *Strange Subordinations: Correcting Bankruptcy's § 510(b)*, 6 BANKR. DEV. J. 91, 95 (1999).

[105] *E.g.,* John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom,* 55 VAND. L. REV. 1699, 1763-1777 (2002).

[106] *See generally* Shleifer & Vishny, *supra* note 91, at 757-58.

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Even if credit concentration is receding in Continental Europe, creditor monitoring may contribute to a reduction of issuer liability risk. Consequently, shifting some of that risk to creditors can create value by setting the right incentives.[107]

5. The political economy of issuer liability

If issuer liability creates monitoring incentives for large investors, why is it not more frequently used in concentrated ownership jurisdictions? Comparative research shows that it is most commonly imposed in the US, where a litigation model rooted in private enforcement based on high-powered incentives of plaintiff attorneys has taken root.[108] The reasons are well-known, particularly contingency fees making up approximately 20-30% of the award or the settlement,[109] and the so-called "American Rule" in civil procedure where each party pays its expenses.[110] Pre-trial discovery makes litigation viable even where the initial evidentiary basis is relatively weak.[111] But most importantly, the nature of securities class actions in the US as an opt-out system, where all members of the class are by default included, means that plaintiff attorneys have a more leverage when negotiating a settlement with defendant issuers.[112]

In much of the world, securities lawsuits remain comparatively rare. Jurisdictions where the model has to some extent expanded include Canada, Australia, and Israel.[113] Most other countries are characterized by an absence of such litigation, including those in Continental Europe, due to a lack of its key elements.[114] However, there has been considerable change in recent years, even in

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[107] Gelter, *Risk-shifting, supra* note 2, at 525-528.

[108] *E.g.,* Thomas M.J. Möllers, *Efficiency as a Standard in Capital Market Law – The Application of Empirical and Economic Arguments for the Justification of Civil Law, Criminal Law and Administrative Law Sanctions*, 2009 EUR. BUS. L. R. 243, 261; Fox, *supra* note 29, at 318-319; Luca Enriques, Gerard Hertig, Reinier Kraakman & Edward Rock, *Corporate Law and Securities Markets, in* The ANATOMY OF CORPORATE LAW 243, 260 (3rd ed., Reinier Kraakman et al. 2017); Gelter, *Global Securities Litigation, supra* note 2, at 80-81.

[109] *E.g.,* Park, *supra* note 29, at 348; on the lodestar method, *see also* Gelter, *id.,* at 88.

[110] *E.g,.* Möllers, *supra* note 108, at 267; Martin Gelter, *Why do shareholder derivative suits remain rare in Continental Europe?*, 37 BROOK. J. INT'L L. 843, 863-864 (2012); Warren, *supra* note 27, at 1082. At least under Delaware law, it appears to be possible for firms to introduce "fee-shifting" bylaws with respect to securities litigation. *See* DGCL §§ 109(b), 115 (prohibiting fee-shifting bylaws for internal corporate claims and defining this term); Salzberg v. Sciabacucchi, 227 A.3d 102 (Del. 2020) (permitting a choice of forum for federal securities law claims based on the definition in § 115); *e.g.* Mohsen Manesh, *The Corporate Contract and the Internal Affairs Doctrine,* 71 AM. U. L. REV. 501, 560-61 (2021) (noting that firms might introduce fee-shifting bylaws concern securities class actions).

[111] *See, e.g.,* Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement*, ECGI WORKING PAPER. NO. 40, 50-51 (2005), http://ssrn.com/abstract=730403; Möllers, *id.*, at 267; Nathan M. Crystal & Francesca Giannoni-Crystal, *Understanding Akzo Nobel: A Comparison of the Status of In-House Counsel, the Scope of the Attorney-Client Privilege, and Discovery in the U.S. and Europe*, 11 GLOBAL JURIST 1, 23-24 (2011); Warren, *id.,* at 1082; Érica Gorga & Michael Halberstam, *Litigation Discovery and Corporate Governance: The Missing Story about the "Genius of American Corporate Law",* 63 EMORY L.J. 1383 (2014).

[112] *E.g.* Warren, *supra* note 27, at 1082; Gelter, *Global Securities Litigation, supra* note 2, at 81-82.

[113] Rousseau, *Canada, supra* note 3, at 175-178; Dixon & Hill, *Australia, supra* note 8, at 1091-1097; Procaccia, *Israel, supra* note 6, at 770-74.

[114] For a comparison, *see* Warren, *id.,* at 1085-1087.

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the civil law world. Most prominently, the Netherlands has introduced a collective enforcement mechanism that replicates some of the effects of securities class actions.[115] Both Taiwan and China use a private enforcement model based on a non-profit entity.[116] Germany, among other countries, has adopted a model litigation mechanism.[117]

In the US, securities litigation seems to hang in an awkward political equilibrium between shareholders, institutional investors, management, and plaintiff lawyers. With stock ownership having become common since the 1970s, even if in the form of investments intermediated through institutions rather than direct retail ownership,[118] it is hard for politicians to neglect shareholder interests.[119] Eliminating issuer liability would therefore be difficult. It would seem unfair to pursue a policy where a seemingly responsible and deep-pocketed corporation is freed from liability.[120]

Still, one might not expect issuer liability to persist because retail investors are not a coordinated interest group. Institutional investors also do not seem to be a strong force for issuer liability; neither mutual funds nor index funds or hedge funds often serve as lead plaintiffs or otherwise promote securities litigation. Arguably, this is because they would bear considerable cost and are concerned about free-riding by other investors;[121] moreover, actively promoting a suit might cost them business brought to them by issuers.[122] Public pension funds serve as lead plaintiffs more often because they do not have to compete for clients and sometimes pursue a public political mission.[123] This means that plaintiff attorneys remain the primary interest group benefiting from keeping issuer liability alive by making strategic political contributions.[124] Obviously, issuers and their management oppose securities class actions at times. However, if these are ineffective in setting strong managerial incentives, one cannot expect political resistance to persist. The critical beneficiary group are attorneys (and possibly insurers), whose rent-seeking opportunities should suffice for the system to stay in place.

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[115] Lennarts & Roest, *Netherlands, supra* note 4, at 499-513; Brigitte Haar, *Regulation Through Litigation – Collective Redress in Need of a New Balance Between Individual Rights and Regulatory Objectives in Europe,* 19 THEORETICAL INQ. L. 203, 215-220 (2018).

[116] Lauren Yu-Hsin Lin & Yu Xiang, *The Rise of Non-Profit Organizations in Global Securities Class Actions: A New Hybrid Model in China,* 60 COLUM. J. TRANSNAT'L L. 493, 516-19, 540-44 (2022).

[117] Verse, *Germany, supra* note 4, at 402-7; Haar, *supra* note 115, at 225-30.

[118] Bratton & Wachter, *supra* note 29, at 138-39.

[119] Martin Gelter, *The Pension System and the Rise of Shareholder Primacy,* 43 SETON HALL L. REV. 909, 948-62 (2013).

[120] Bratton & Wachter, *supra* note 29, at 140 ("So long as catering to shareholder interests appears advantageous to Congress, it is difficult to imagine a political coalition forming to eliminate FOTM); *see also* Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the US Experience,* in INVESTOR PROTECTION IN THE EU: CORPORATE LAW MAKING, THE MIFID AND BEYOND 485, 503 (Guido Ferrarini & Eddy Wymeersch eds. 2006) ("no interest group wants to be caught on the wrong side of investor anger").

[121] Webber, *supra* note 42, at 218-19; *see also* Bebchuk & Hirst, *supra* note 94, at 2112-13 (finding that index funds from the "Big 3" have never served as lead plaintiffs).

[122] Webber, *supra* note 42, at 219-20.

[123] Webber, *id.,* at 221.

[124] Bratton & Wachter, *supra* note 29, at 142, 144 (noting that plaintiff's law firms make strategic political contributions).

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If ownership structure makes a difference for incentives created by issuer liability, one would also expect a different political economy under concentrated ownership. As we have seen, the social value of securities class actions in the US is partly undermined by its dispersed ownership structure. Countries with more concentrated equity and debt structures could benefit from sharpened issuer liability because it creates incentive effects for large investors. The comparative corporate governance literature has amply documented how jurisdictions outside the common law world tend to have more concentrated ownership structures.[125] Despite a constantly evolving landscape, block ownership (e.g., by families or governments) persists in many Continental European and East Asian countries.[126] Intuitively, one could speculate that those for whom the incentives are created – large shareholders and large creditors – also tend to be among the dominant interest groups in corporate governance in these jurisdictions. Opposition by groups who might lose from issuer liability aligns with the literature on path dependence in comparative corporate governance. Powerful interest groups such as these will prevent change that could better protect outside investors.[127]

In many jurisdictions, plaintiff lawyers never developed into a powerful interest group because an effective enforcement system might have been costly and a deterrent for those controlling large companies. In the long run, there may even be a dynamic effect on ownership structure upsetting corporate control: If issuer liability is a common concern, large shareholders (especially those with a large proportion of their assets tied up in the firm[128]) or creditors might be incentivized to diversify their holdings more strongly to avoid exposure to issuer liability. Over time, issuer liability may thus contribute to a more diversified ownership structure (and then potentially lose its bite).

Debates about private enforcement of securities law enforcement often blend into other controversies about corporate liability: The EU Commission's 2011 Public Consultation on Collective Redress[129] (which emphasized consumer protection in general rather than securities law

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

[126] For recent data, *see* ADRIANA DE LA CRUZ, ALEJANDRA MEDINA & YUNG TANG, OWNERS OF THE WORLD'S LISTED COMPANIES, OECD CAPITAL MARKET SERIES 27 (2019), http://www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.htm; Gur Aminadav & Elias Papaioannou, *Corporate Control around the World*, 75 J. FIN. 1191, 1205 (2020).

[127] Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 651-52 (1996); Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

[128] Dharmapala & Khanna, *supra* note 88.

[129] EU Commission, *Towards a More Coherent European Approach to Collective Redress, 31 March 2010*, COM (2010) 135 final.

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specifically) revealed significant opposition from business groups against mechanisms such as contingency fees and an opt-out class action mechanism.[130] Neither the Commission's 2013 recommendation[131] nor the 2020 Directive on Collective Redress establishes a class action mechanism. The Directive requires Member States to give standing in representative actions to consumer protection associations operating on a not-for-profit basis.[132] The existence of stronger anti-litigation interests may explain why mechanisms that were adopted in most countries remained relatively harmless compared to US class action.

The literature on regulatory dualism might provide a way out of this dilemma. Authors writing in this area have proposed a strategy whereby some firms will be able to opt into a more investor-friendly law if they hope to tap the international market, for example by selecting a listing regime with heightened standards. Others may remain subject to the less exacting requirements. Arguably, giving companies a choice will erode political resistance against pro-investor reforms.[133] To some extent, this will be possible in issuer liability if a firm seeks to cross-list. However, as issuer liability often only covers investors in a particular country, it may redistribute wealth to these plaintiffs from shareholders in jurisdictions without an effective issuer liability system.[134]

6. Conclusion

Most countries with a developed securities law provide for issuer liability, typically in addition to individual liability for misstatements to the markets. This chapter has argued that issuer liability creates better incentives to avoid securities fraud in concentrated ownership systems than in dispersed ownership systems. In reality, we tend to see effective enforcement of issuer liability primarily in countries with dispersed ownership, such as the United States. As a matter of policy, a greater emphasis on individual liability for misstatements would be desirable, as some scholars have suggested.[135] Conversely, more effective issuer liability would seem desirable in countries with concentrated ownership.

It is tempting to speculate whether the preferences of key interest groups in corporate governance have contributed to maintaining the current position. The critical interest group benefiting from issuer liability are plaintiff attorneys; the key interest group benefiting from its ineffectiveness

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[130] *See* Warren, *supra* note 27, at 1112 (discussing responses to the public consultation); for a historical overview of the EU Commission's work in this area, *see* Astrid Stadler, *Are Class Actions Finally (Re)conquering Europe?* JURIDICA INT'L 2021, issue 30, at 14, 14-15.

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

[132] Directive 2020/1828 of 25 November 2020 on representative actions for the protection of the collective interests of consumers and repealing Directive 2009/22/EC, 2020 O.J. (L 409) 1, art. 4.

[133] Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union,* 63 STAN. L. REV. 475 (2011).

[134] Érica Gorga, *The Impact of the Financial Crisis on Nonfinancial Firms: The Case of Brazilian Corporations and the "Double Circularity" Problem in Transnational Securities Litigation,* 16 THEORETICAL INQ. L. 131 (2015).

[135] Coffee, *supra* note 13, at 1582-1584; Langevoort, *supra* note 29, at 639-640.

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in Continental Europe are blockholders. Given the respective influence of these groups, we can expect differences in practices to persist.

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