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The EU'S Struggles with Collective Action for Securities Fraud: An American Perspective

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THE EU'S STRUGGLES WITH COLLECTIVE ACTION FOR SECURITIES FRAUD: AN AMERICAN PERSPECTIVE

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I. Introduction

Notwithstanding the apparent exit of the United Kingdom,[1] the European Union ("EU")[2] has grown in membership and power since its modest beginnings after World War II, now rivaling the U.S. in economic strength.[3] With the goal of promoting the security and prosperity of all the citizens of the countries that belong to it, the EU is pressing ahead to adopt laws that will promote their political and financial integration.[4] Along those lines, it has also recently acknowl-

1. The UK continues to have difficulty finding a way to arrange its departure from the EU. Stephen Castle & Ellen Barry, *May and Brexit Face Uncertain Future After Crushing Vote in Parliament*, N.Y. Times (Jan. 15, 2019), https://www.nytimes.com/2019/01/15/world/europe/brexit-vote-theresa-may.html [https://perma.cc/TWC8-28AD]. Because of that, Boris Johnson has now replaced May as Prime Minister of the U.K. *See* Sarah Lyall & Stephen Castle, *Boris Johnson Becomes U.K. Prime Minister, Replacing Theresa May*, N.Y. Times (July 24, 2019), https://www.nytimes.com/2019/07/24/world/europe/britain-johnson-may-prime-minister.html [https://perma.cc/CKQ6-AK75].

2. Georgetown University's Research Guide to the European Union contains this description of the EU: "The European Union (EU) is a supranational organization that is currently composed of 27 European countries. The member countries have decided to adopt uniform laws on a number of issues related to their economies, finances, and security." *European Union Research Guide*, Georgetown Law, http://guides.ll.georgetown.edu/EuropeanUnion (last visited June 8, 2019) [https://perma.cc/2JAV-82HS].

3. Ignazio Visco, Governor of the Bank of Italy, *Investment Financing in the European Union*, Keynote Address at the OECD—Euromoney Conference on Long-Term Investment Financing (Nov. 19, 2015) at 3. The EU's gross domestic product is $5 trillion ahead of China's and only $2 trillion behind that of our country. Josef Joffe, *The Sick Man of Europe is Europe*, Wall Street J. (May 27, 2019, 4:43 PM), https://www.wsj.com/articles/the-sick-man-of-europe-is-europe-11558989783 [https://perma.cc/3655-68TB]. As one international expert recently wrote, "[e]ver since World War II, the liberal global order that has spread more freedom and prosperity around the world than at any other time in history has been held up by two pillars: the United States of America and the United Nations of Europe, now known as the European Union." Thomas L. Friedman, *The End of Europe?*, N.Y. Times (Dec. 19, 2018), https://www.nytimes.com/2018/12/18/opinion/europe-france-economy.html [https://perma.cc/22S2-7VAS]. Despite such success, Friedman is now concerned that the imminent exit of Great Britain from the Union as well as political turmoil in France may be jeopardizing all that progress. This ideal of European unity, however, remains difficult to achieve due to the innate nationalism of many of its member states. In that regard, this recent reference to the European Parliament indicates the lack of commitment that citizens of the continent feel toward that assembly. "[I]t is rare to hear Europeans express any measure of reverence toward the body; its name is evoked more often in the matters of regulating light bulbs and Roquefort cheese." Elisabeth Zerofsky, *The Illiberal State: Viktor Orban's Vision for Europe*, New Yorker (Jan. 14, 2019), https://www.newyorker.com/magazine/2019/01/14/viktor-orbans-far-right-vision-for-europe [https://perma.cc/Z9YK-V3CB]. Another commentator saw the EU's parliamentary elections in May 2019 as further evidence of this fragmentation where "the Europe bashers and nationalists" scored big victories. Joffe, *supra* note 3. The Trump administration's disregard of the value of international institutions may also be undermining the future of the EU. *See* Steven Erlanger, *U.S. Downgraded E.U.'s Diplomatic Status (but Didn't Say Anything)*, N.Y. Times (Jan. 8, 2019), https://www.nytimes.com/2019/01/08/world/europe/eu-us-diplomatic-status.html [https://perma.cc/8W8B-MVTT].

4. In that regard, Jean-Claude Juncker, president of the European Commission, recently stated the EU's aspirations for "a Europe that protects . . . defends . . . [and]

edged a deficiency in the legal systems of its member states when it comes to allowing collective actions for victims of various types of economic harm. To address that, the EU is now developing guidelines for such procedures that can redress those injuries.[5]

In the area of securities fraud, establishing such measures has taken on more importance after both a spate of financial frauds by European companies[6] and a significant decision from the United States Supreme Court, *Morrison v. National Australia Bank*.[7] That ruling cut back on the jurisdiction of American courts to adjudicate these claims against foreign defendants—even when a significant amount of the wrongdoing has occurred in the U.S.[8]

This EU initiative to develop a collective jurisprudence to redress securities fraud also supports another goal that would foster European economic well-being. It would promote a shift in the financing of businesses there from debt to equity. That would particularly help small- and medium-size firms by giving confidence to investors in those enterprises that if they were cheated they would have an effective means to remedy that wrong.

As it is now, such stock frauds can typically involve a large number of investors, many of whom have relatively small holdings. Individual actions in those situations are not only too expensive to maintain but are often inadequate to compensate all their victims and deter future misconduct. The availability of effective collective remedies would help Europeans overcome their reluctance to make equity investments and therefore provide more flexible capital structures to businesses.[9]

The European Commission[10] ("Commission") is therefore trying to fashion legal tools to address that problem. This involves enhancement of the EU's mechanisms for stockholder litigation—what one commentator defines as "an umbrella term for various forms of suit

can deliver for its citizens when and where it matters." European Commission Speech/17/3165, President Jean-Claude Juncker's State of the Union Address 2017 (Sept. 13, 2017).

5. *See infra* Section IV.A.–IV.B.

6. *See generally* Stefano M. Grace, *Strengthening Investor Confidence in Europe: U.S. Style Securities Class Actions and the* Acquis Communautaire, 15 J. OF TRANSNATIONAL L. & POL. 281, 282 (2006).

7. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).

8. *Id.*; *see also* discussion *infra* Section III.

9. *See infra* Section I.A–B.

10. "The European Commission is the EU's politically independent executive arm. It is alone responsible for drawing up proposals for new European legislation, and it implements the decisions of the European Parliament and the Council of the EU." EUROPEAN UNION, *European Commission*, https://europa.eu/european-union/about-eu/institutions-bodies/european-commission_en (last visited June 8, 2019) [https://perma.cc/Z63E-WXSM].

and a range of claims brought by shareholders against the company in which they hold shares or against its directors and officers."[11]

The EU's proposals in that regard seek to encourage what it calls "collective actions,"—its analog to U.S. class actions[12]—where many stockholders with small claims can join together and adjudicate them in one suit. Without such a corrective mechanism, the costs of litigation would be too great for those individuals, and they would not be able to counter the substantial resources that the defendants typically have.[13]

The EU's proposals, however, lack features that have made American class actions so effective. The Commission is reluctant to embrace that model because of what it calls our "abusive practices." Chief among them are contingent fees that compensate lawyers who represent shareholders harmed by these frauds.

In addition, the Europeans appear determined to hold on to several rules that discourage lawyers from taking these cases.[14] One is "loser pay," which makes those who are unsuccessful in litigation liable for the legal fees of their counterparties who prevail. The potential of that heavy extra charge is a disincentive for lawyers who would take these cases. Another is that only plaintiffs who directly consent to be parties can be part of these actions (opt-in), as opposed to the more generous opt-out practice which includes all victims of the common fraud as plaintiffs unless they specifically choose not to participate.[15]

This Article will therefore offer comment on those deficiencies in the developing European model and encourage our friends across the Atlantic to take a more realistic approach to their reforms. The American experience with securities class actions certainly has its detractors and may have had some failings which have now been corrected. All and all, however, the U.S. approach has served our economy well by protecting investors, checking corporate wrongdoing, and affording compensation to defrauded investors.

First, this Article will give a brief overview of the historic problems that European companies have had with an over-reliance on debt financing. It will then discuss how reforms like better redress for fraud can change that by giving equity investors a stronger belief that they will get a fair shake. The EU's proposals are a step in the right direction to address that concern, and the Article will go on to describe the current state of their development. After that, it will use an American

11. Matteo Gargantini & Verity Winship, *Private Ordering of Shareholder Litigation in the EU and the US*, *in* The Elgar Handbook for Representative Shareholder Litigation (Sean Griffith et al. eds., 2018).

12. Fed. R. Civ. P. 23(b)(3).

13. *See infra* notes 147–48 and accompanying text.

14. *See infra* notes 100–02 and accompanying text.

15. *See infra* Sections IV.B. & V.C.

perspective to point out their shortcomings with the goal of highlighting the benefits of the U.S. model to European policymakers.

II. The Benefits of Equity Financing

There are two sources of capital that businesses use to fund their enterprises: equity and debt. The former represents money from their owners[16] while the latter are fixed obligations. Those typically require that a company make payments of principal and interest to its lender.[17] Debt financing also has the advantage of being tax deductible,[18] and it allows a firm to leverage its operations, providing greater return to its owners when its profits exceed those required disbursements.[19]

Yet equity financing has several important advantages over debt. Its investors look to the company's success for profit rather than being guaranteed a fixed return regardless of the company's fortunes. It is therefore permanently committed to the business, affording its managers more flexibility.[20] Along those lines, debt financing often comes with restrictions on a company's operations that may prevent it from pursuing new opportunities outside its core business.[21] Because equity does not have to be repaid, it also allows a firm to have more capital available.

Equity funding is therefore particularly attractive for start-ups and small firms. Required debt payments may put unneeded pressure on them when they are having cash-flow problems. These companies are also more susceptible to distress and ultimate failure than well-established enterprises.[22] They will often find it harder to get bank financing than larger or more diversified businesses where creditors can be more secure in getting repayment of the money they have advanced. In addition, small companies typically have much less information available about their operations than large, publicly held ones, making banks and other lenders leery to finance them.[23]

16. *See* John C. Groth, *Capital Structure: Perspectives*, *in* QFinance: The Ultimate Resource 24–27 (4th ed. 2013).

17. Jonathan R. Macey et al., The Law of Business Organizations 243 (13th ed. 2017).

18. *Id.* at 247–49.

19. *Id.* at 244–47.

20. Ronald W. Melicher & Edgar A. Norton, Introduction to Finance 15 (16th ed. 2017).

21. J.B. Maverick, *What Are the Benefits for a Company Using Equity Financing v. Debt Financing?*, Investopedia (Apr. 22, 2015), https://www.investopedia.com/ask/answers/042215/what-are-benefits-company-using-equity-financing-vs-debt-financing.asp (last updated April 19, 2019) [https://perma.cc/2M4K-LWDJ].

22. Susan Coleman et al., *The Debt-Equity Decisions of U.S. Startup Firms*, 40 J. Econ. Finance 105, 107 (2016).

23. *Id.* at 107–08.

Equity is also a good investment because those who purchase shares are getting a stake in the long-term profitability of their companies.[24] Studies show that stocks provide much better long-term returns than bonds, and share ownership is therefore a better way for savers to build their wealth.[25]

A. *The EU's Need for More Equity Financing*

Despite these benefits of equity financing, European firms have historically relied heavily on capital raised from bondholders and other creditors.[26] While this situation has improved somewhat for companies with large capitalizations and those who rely on institutional investors, it remains a problem for small- and medium-size firms.[27] As one commentator put it succinctly, "The retail markets for securities among the EU member states are relatively underdeveloped compared to U.S. securities markets, particularly in terms of substantive participation by individual investors."[28]

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24. MACEY, *supra* note 17, at 275. Equity, i.e., common stock, represents the owner's capital, thus shareholders are said to be the residual claimants of corporations.

25. Bradford DeLong & Konstantin Magin, *The U.S. Equity Return Premium: Past, Present, and Future*, 23 J. OF ECON. PERSPECTIVES 193, 193–94 (2009); Thomas E. MaCurdy & John B. Shoven, *Stocks, Bonds, and Pension Wealth*, *in* TOPICS IN THE ECONOMICS OF AGING 61, 61–78 (University of Chicago ed., 1992). Along those lines, growing inequality in income and wealth in the United States is in large part due to the fact that the richest Americans now own the lion's share of all stocks. Unfortunately, the rising equity market in the last decade has thus not benefitted most of our citizens. Rob Wile, *The Richest 10% of Americans Now Own 84% of All Stocks*, MONEY (Dec. 19, 2017), http://money.com/money/5054009/stock-ownership-10-percent-richest/ [https://perma.cc/Q6WB-KHV6]; Christopher Ingraham, *For Roughly Half of Americans, the Stock Market's Record Highs Don't Help at All*, WASHINGTON POST (Dec. 18, 2017), https://www.washingtonpost.com/news/wonk/wp/2017/12/18/for-roughly-half-of-americans-the-stock-markets-record-highs-dont-help-at-all/?utm_term=.18eb1aba2114 [https://perma.cc/8HRH-6EBA]. In addition, the diminishing number of such investment opportunities may be compounding that problem. U.S. companies whose shares are listed on exchanges have decreased from over 7,000 in the late 1990s to roughly 3,600 today. *Why the Decline in the Number of Listed American Firms Matters*, THE ECONOMIST (Apr. 22, 2017), https://www.economist.com/business/2017/04/22/why-the-decline-in-the-number-of-listed-american-firms-matters [https://perma.cc/6CR9-DRAG]. And to make matters worse for ordinary investors, some "private firms" worth more than one billion dollars (known colloquially as "unicorns") have not made their stock available to the public. However, that may be changing. In 2018, thirty-eight of those billion-dollar companies went public. Corrine Driebusch, *Tech Unicorns are Going Public at a Near Record Pace*, WALL STREET J. (Dec. 18, 2018, 5:23 PM), https://www.wsj.com/articles/tech-unicorns-are-going-public-at-near-record-pace-11545138000 [https://perma.cc/EW6N-AM62].

26. *See* Manfred Schepers, *EU Needs More Equity Finance, Less Debt*, FIN. TIMES (Mar. 11, 2015), https://www.ft.com/content/dc73228a-b1e8-11e4-b380-00144feab7de [https://perma.cc/7SWS-9YCN].

27. *Id.*

28. 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, 1075 (2012).

The EU economy is roughly the same size as America's, but its equity markets are just half as big.[29] And in many European countries the number of shareholders is going down,[30] perhaps owing at least in part to financial crises during the last several decades.[31] Those may have led Europeans to believe that putting their savings in stock is too risky.[32]

While many small- and medium-size businesses in Europe therefore struggle to raise capital, their counterparts in the United States thrive. They employ about 50% of our workforce and largely drive American advancement and international trade. To that end, small firms employ 43% of our high-tech workers and supply about one-third of our exports.[33]

By and large, those businesses prefer equity financing. Perhaps that is because banks may see them as too risky and opaque for loans, but it is also because of the flexibility they afford their founders, particularly those whose companies are start-ups.[34] Rapid economic growth is therefore more likely to occur in countries with an active stock market. As a leading textbook puts it, "[I]t may not be coincidental that Silicon Valley developed in the United States, not in Germany or Japan."[35]

The situation in Europe is thus not promising for small- and medium-size businesses that could be the engines of innovation that the EU needs.[36] That may very well be owing to the lack of confidence that EU investors have that they will be treated fairly if they purchase stock in those firms.[37] It may also be because trading markets for equity capital there are more fragmented and less developed than in the U.S. There are still more than twenty individual stock exchanges in European countries.[38]

As the Commission seeks to remedy that by promoting more integration of the economies of its member states, it is also taking steps to encourage more non-banking financial institutions such as those that

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29. Visco, *supra* note 3, at 3.

30. OBSERVATOIRE DE L'EPARGNE EUROPEENE-OEE, UNDER THE TENDER: WHO OWNS THE EUROPEAN ECONOMY? EVOLUTION OF THE OWNERSHIP OF EU-LISTED COMPANIES BETWEEN 1970 AND 2012 9 (2013).

31. Grace, *supra* note 6, at 282, 298.

32. OBSERVATOIRE DE L'EPARGNE EUROPEENE-OEE, *supra* note 30, at 9.

33. Coleman et al., *supra* note 22, at 106.

34. *Id.*

35. JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 8 (12th ed. 2012). For a fine discussion of this phenomenon, including the role that venture capital and equity financing played in the development of the high-tech industry in the United States, *see generally* MARGARET O'MARA, THE CODE: SILICON VALLEY AND THE REMAKING OF AMERICA (2019).

36. Schepers, *supra* note 26.

37. *See infra* Section II.B.

38. Schepers, *supra* note 26.

would underwrite the issuance of stock.[39] Those would help place equity in firms which focus on innovative projects that are riskier than those of established companies.[40]

At present, however, private equity funding does not flow to those companies because trading markets for their shares are too illiquid.[41] And while the end-game of an IPO[42] provides a real incentive in the U.S. for smaller firms to access capital and convert the wealth that its founders and early investors have created into cash,[43] that attractive exit strategy is a lot less available in the EU.[44]

European advocates for more equity funding also point to the difficulties their countries face during recessions when bank lending becomes problematic. Shareholder capital would provide more flexibility and resistance to such economic downturns.[45] They also note that the ability to buy shares of companies gives investors more opportunities to increase their wealth.[46] Such an improved financial system, they say, has been a long-standing goal of the EU ever since its inception in the Treaty of Rome.[47] It will promote economic growth[48] and job creation by encouraging entrepreneurship and allocating capital to its most productive uses.[49]

B. *The Importance of Investor Confidence*

Purchasers of securities have a special need to believe that those who seek their funds will not cheat them. U.S. securities regulation is premised on that, concentrating on financial markets "that allocate capital, moving it from savers through financial intermediaries (e.g., underwriters, dealers, and other financial firms) to users (i.e., those

39. Visco, *supra* note 3, at 4.

40. *Id.* at 5.

41. Schepers, *supra* note 26.

42. *See* James Chen, *Initial Public Offering – IPO*, INVESTOPEDIA, https://www.investopedia.com/terms/i/ipo.asp (last visited Jun. 6, 2019) [https://perma.cc/UDS8-T8VN]. The process of offering shares of a private corporation to the public for the first time is called an initial public offering ("IPO"). Growing companies that need capital will frequently use IPOs to raise money. Other more established firms may use an IPO to allow the inside shareholders to exit some or all their ownership by selling shares to the public. In an initial public offering, the issuer, or company raising capital, brings in underwriting firms or investment banks to help determine "the best type of security to issue, offering price, amount of shares and time frame for the market offering." *Id.*

43. *See* MARC I. STEINBERG, SECURITIES REGULATION 249–50 (7th ed. 2017).

44. *See* Justina Lee & Swetha Gopinath, *Europe IPOs at Lowest Since Crisis Fuel Shrinking Market Fears*, BLOOMBERG (Aug. 18, 2019, 11:00 PM), https://www.bloomberg.com/news/articles/2019-08-19/stock-market-shrinkage-exacerbated-by-europe-ipos-at-decade-low [https://perma.cc/MU88-TM98].

45. Visco, *supra* note 3, at 3.

46. *Id. See also supra* note 24 and accompanying text.

47. Visco, *supra* note 3, at 9.

48. Schepers, *supra* note 26.

49. Visco, *supra* note 3, at 9.

who have productive uses for capital and are willing to pay a competitive return)."[50] That process is unlike investment in other goods: "Not only is it impossible for the typical buyer [of stock] to examine the company, but the value of the security depends heavily on the likely future earnings of the issuing corporation (or other entity)."[51]

Because of those complexities, securities have been called "intricate merchandise" and are heavily regulated in the United States.[52] Those laws include liberal provisions for defrauded investors to sue those who have swindled them.[53] These legal protections are designed to support the confidence that is necessary if individuals and groups are to commit their financial resources to businesses with the hope of sharing in their profits.

As a recent report from the Securities and Exchange Commission ("SEC") put it: "Several research studies have found that greater trust both at the individual and national levels is related to higher levels of investment and participation in the stock market."[54] It also noted that investors' confidence was degraded when they feared "possible expropriations by other market participants" because of fraud, theft, or other abuses. In addition, it found that "revelation[s] of corporate fraud in a US state decrease[ ] investment in the stock market by residents of that state."[55] Professor Lynn Stout succinctly stated the reasons for that with these comments:

> Without investor trust, our market would be a thin shadow of its present self. Suspicious and distrustful investors would refuse to exchange their hard-earned cash for such abstract and intangible goods as corporate securities. Instead, they would put their savings into tangible assets like gold or real estate, or under their mattresses.[56]

Professor Stout went on to note the great benefits our country enjoys from having such a "trusting investor who has made it possible for the United States to develop a multi-trillion dollar public securities market in which corporations can annually raise hundreds of billions of dollars of new capital."[57] She then asked this rhetorical question about the reasons for that confidence which American investors have: "Why don't they believe, instead, that if they purchase corporate securities their money will be stolen or squandered by unscrupulous

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50. Coffee & Sale, *supra* note 35, at 1.
51. *Id.* at 5.
52. SEC, Report of the Special Study of Securities Markets, H.R. Doc. No. 88-95, pt. 4 at 694 (1963).
53. *See generally*, Marc I. Steinberg et al., Securities Litigation (2016).
54. K. Jeremy Ko, *Economic Note: Investor Confidence*, Securities and Exchange Commission, October 2017.
55. *Id.*
56. Lynn A. Stout, *The Investor Confidence Game*, 68 Brooklyn L. Rev. 407, 408 (2002).
57. *Id.* at 430.

corporate directors, larcenous executives, and dishonest brokers, investment advisors and mutual fund managers?"[58] Professor Stout in turn answered that with this direct response: "And one of the first things the trusting investor needs, quite bluntly, is at least some degree of government-imposed investor protection."[59] Robust remedies for defrauded investors are a big part of that legal regime. With such remedies lacking in the EU, however, corporate scandals have weakened investor confidence there.[60] The predicable result has been a continuing decline in the willingness of Europeans to buy stock.[61]

III. The Impact of the *Morrison* Decision

Another factor contributing to the EU's more receptive approach to securities class actions may be the U.S. Supreme Court opinion in *Morrison v. National Australia Bank Ltd*.[62] Commentators have called it "part of a significant sea change in the globalization of securities fraud litigation."[63] The case deals with the extraterritorial reach of Rule 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act"), a leading provision of U.S. federal law used by shareholders to recover for securities fraud.[64]

A. *Pre-*Morrison *Litigation*

Until *Morrison* was decided in 2010, the global jurisdiction of American courts in this area was fairly broad. Lower courts had entertained such actions brought by foreign plaintiffs when a large amount of the alleged wrongdoing occurred in the United States.[65] Citing the common American practices of allowing lawyers to be compensated by contingent fees and not requiring losing parties to pay the legal expenses of the winners, the English peer Lord Alfred Thompson Denning said, "As a moth is drawn to the light, so is a litigant drawn to the United States. If he can only get his case into their courts, he

58. *Id.* at 409–10.

59. *Id.* at 430.

60. Grace, *supra* note 6, at 290–91.

61. Observatoire De L'Epargne Europeene-OEE, *supra* note 30, at 9.

62. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).

63. David H. Kistenbroker et al., Developments in Global Securities Litigation 4 (Dechert, LLP, ed., Nov. 2017).

64. 17 C.F.R. § 240. Rule 10b-5 prohibits fraud in connection with the purchase or sale of a security. Courts have implied a private right of action under it. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983). For a discussion of the jurisprudence of 10b-5 by myself, *see* Daniel J. Morrissey, *Guardians of the Galaxy*, *How Shareholder Lawyers Won Big and Vindicated the Integrity of our Economy*, 51 Loy. of L.A. L. Rev. 199 (2019).

65. *See, e.g.*, Schoenbaum v. Firstbrook, 268 F. Supp. 385 (S.D.N.Y. 1967); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972).

stands to win a fortune, at no risk to himself, and at no risk of having to pay anything to the other side."[66]

B. *The* Morrison *Case*

All that changed with *Morrison.* Like earlier cases in which American courts had exercised jurisdiction, a substantial part of the fraud happened in the United States.[67] A Florida subsidiary of the defendant, a major Australian Bank, was in the business of servicing home mortgages.[68] The value of those operations, however, would diminish if the mortgages were paid back before they came due.[69] The plaintiffs charged that some of the company's top officials manipulated its financial models to hide that its rates of such early repayments were unrealistically low. That materially inflated the firm's financial statements.[70]

The action of those officials took place in Florida, and when the truth came out about their corrupt practices, the worth of the bank's shares dropped.[71] Australians who held that stock sued in the U.S., but the Supreme Court overturned existing precedent and dismissed the shareholders' action on several grounds. First, it found no warrant in section 10(b) of the Exchange Act to counter what it said was the normal presumption against the extraterritorial scope of federal causes of action. The Court then parsed that statute and cited its language requiring a fraud to be "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered."[72] That meant, the Court said, that it covered only domestic transactions. Since the Australian plaintiffs did not buy their shares in the U.S., they lacked standing for their suit.

In addition, the Supreme Court expressed its concern that such U.S. actions would be incompatible with the laws of other countries where foreign plaintiffs and foreign companies were residents. It noted that the regulations of those other nations covering these situations might differ in many ways from American laws. It would be inappropriate therefore for our country to interfere in their legal systems if the purchases or sales were made outside the United States or involved a security not listed on a domestic exchange.

Justice Scalia, who wrote the Court's opinion, could also not resist taking a swipe at American attorneys who bring those suits. He turned aside an argument that the Court's holding would make the United

66. Bernhard Grossfeld, The Strength and Weakness of Comparative Law, 67–68 (Tony Weir trans., Oxford Press 1990).
67. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).
68. *Id.* at 251.
69. *Id.*
70. *Id.* at 252.
71. *Id.*
72. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 266 (2010).

States a "Barbary Coast" for those perpetrating such frauds with this retort: "[S]ome fear that it has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[73]

C. *Post-*Morrison *Opinions*

After the *Morrison* decision, lower courts in the U.S. took their cue and barred foreign plaintiffs from seeking redress for securities fraud. That occurred even when shares of foreign corporations were cross-listed on an American exchange if their purchase or sale took place outside the country.[74]

U.S. lower courts, however, have reached conflicting results in situations where American Depositary Shares ("ADRs") of the defendant companies were listed on an American exchange. Those give their owners the right to purchase the firm's ordinary (i.e., common) shares. Even though such ADRs were publicly sold in the U.S. and registered with the SEC, one court,[75] citing the spirit of *Morrison*, barred the plaintiffs from bringing a 10b-5 claim in its forum. It did so because the ultimate acquisitions of that stock would take place in a foreign country.

But another court found that when the ADRs of a foreign company were trading over-the-counter in the U.S., it could have jurisdiction over a 10b-5 claim. It held that ADRs were securities and when the parties to such a transaction incur "irrevocable liability" in the U.S., it would entertain such an action.[76]

In yet another situation where ADRs traded on an American exchange were sponsored by the foreign defendant, the court held that it had to scrutinize the individual nature of the transactions to see if they could be deemed "domestic" under *Morrison*. Such a particularized determination involving who sold the securities and what documentation was required had to take place, the court said, before it could certify a class as having common questions.[77]

73. *Id.* at 270.

74. City of Pontiac Police & Fireman Ret. Sys. v. UBS AG, 752 F.3d 173 (2d Cir. 2014).

75. *In re* Vivendi, SA Securities Litig., 838 F.3d 223, 264–65 (2d Cir. 2016).

76. Stoyas v. Toshiba Corp., 896 F. 3d 933, 948–49 (9th Cir. 2018); *see also* Choi v. Tower Research Capital, LLC, 890 F.3d 60, 68 (2d Cir. 2018) where the court upheld allegations that a New York based high frequency trading firm violated the anti-fraud provision of the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.* by manipulating transactions involving orders for futures contracts placed on a Korean exchange which were matched with an electronic trading platform in Illinois. The Court indicated that *Morrison* would not preclude it from taking jurisdiction over that case. *Choi*, 890 F.3d at 67.

77. *In re* Petrobras, 862 F.3d 250, 253–54 (2d Cir. 2017).

D. Morrison*'s Effect on Global Securities Litigation*

Despite the efforts of shareholder lawyers to keep their suits in American courts, it is apparent that such actions face a substantial barrier after *Morrison*—what one commentator called a "devastating blow to plaintiffs' securities counsel filing class actions in U.S. courts against foreign companies."[78] It effectively foreclosed claims in the U.S. against foreign issuers whose shares are not traded here. Commentators have referred to these cases as "F-cubed" (foreign investors, suing a foreign issuer, traded on foreign exchanges).[79]

The focus has thus shifted to other jurisdictions which might provide more promising fora for securities class actions. Those suits have been called "the world's most economically significant form of litigation,"[80] and one that "strikes fear in the hearts of executives of publicly-held companies[.]"[81] In that regard, two distinguished commentators stated that: "As shareholder litigation expands globally and increases in economic significance, so does the interest of parties in fighting over the rules that govern it and determine its scope."[82]

Until now, when its courts were open to these F-Cubed suits, the United States "stood virtually alone in its commitment to ordinary civil litigation as an instrument of economic regulation."[83] For instance, just several decades ago, European countries had nothing resembling American securities class actions.[84] But in the wake of *Morrison*, things may be changing.

The Netherlands, with its Collective Settlement Act, has come on strong in the post-*Morrison* era as perhaps the most promising home for such global actions.[85] Among the attractive features of that law is an opt-out provision that automatically joins all similarly situated claimants, even non-Dutch ones, unless they specifically elect not to

78. Warren, *supra* note 28, at 1080.

79. DAVID KISTENBROKER, ET AL., A NEW ERA IN GLOBAL SECURITIES LITIGATION: PART 1, 3 (Dechert, ed., 2018).

80. William Savitt, *Preface to* THE SECURITIES LITIGATION REVIEW, v. (William Savitt, ed., 2017).

81. Warren, *supra* note 28, at 1080. As a well-respected authority noted, "[c]orporate counsel tend to perceive . . . securities class actions as a threat." John C. Coffee, Jr., *"Loser Pays": The Latest Installment in the Battle-Scarred, Cliff-Hanging Survival of the Rule 10b-5 Class Action*, 68 SMU L. REV. 689, 695 (2015).

82. Gargantini & Winship, *supra* note 11, at 439.

83. Hannah L. Buxbaum, *Class Actions, Conflict and the Global Economy*, 21 IND. J. GLOBAL L. STUD. 585, 586 (2014).

84. Stefann Voet, *The Crux of the Matter: Funding and Financing Collective Redress Mechanisms*, *in* EU CIVIL JUSTICE: CURRENT ISSUES AND FUTURE OUTLOOK 1 (Burkhard Hess et al. eds., 1st ed. 2015). As one observer noted, the European legal systems have "historically not permitted . . . class actions for monetary damages on the U.S. model: that is, true representative litigation in which one plaintiff can act for, and bind the rest of the class members." Buxbaum, *supra* note 83, at 586.

85. *See generally*, Xandra E. Kramer, *Securities Collective Action and Private International Law Issues in Dutch WCAM Settlements: Global Aspirations and Regional Boundaries*, 27 GLOBAL BUS. & DEV. L. J. 235 (2014).

participate.[86] It also includes liberal settlement mechanisms where courts are actively involved.[87]

These Dutch actions may be maintained by representative groups, which are loosely defined and need not be non-profits. In addition, something akin to contingent awards called "success fees" can be made to prevailing lawyers.[88] Yet collective actions in the Netherlands may only ask for declaratory or injunctive relief. Individuals seeking money damages must press their own claims and establish causation. Even there, though, those have furnished some plaintiffs with ample recoveries.[89]

Next door to the U.S., the Canadian province of Ontario also appears to have become receptive to suits for shareholders aggrieved by financial misrepresentations because a decision there allowed international plaintiffs to obtain jurisdiction.[90] Down under, Australia has also become a player in world-wide securities litigation by, among other things, showing a more favorable attitude toward external funding of these suits.[91] In the United Kingdom as well, collective actions which in former times were rarely used, are now more in vogue, perhaps because of a recent tendency to allow third parties to fund them.[92]

IV. EU Proposals

The thrust of this Article, however, will be on specific initiatives recently undertaken by the European Union to encourage its member states to adopt collective redress mechanisms for securities fraud. Citing a number of scandals and abuses that have caused large scale injuries to its citizens, the Commission recently noted that they have "shed light on the debate regarding whether collective redress mechanisms were missing at the European Union level."[93] The Commission went on to state that those wrongs pose an issue of "effective and timely access to justice for all citizens." It also called that "a particularly pressing question in a context of . . . increased risks of cross-border mass harm situations due to greater interconnected economies."[94]

86. Kistenbroker et al., *supra* note 63, at 13.
87. Kramer, *supra* note 85, at 240.
88. Kistenbroker et al., *supra* note 63, at 11.
89. *Id.* at 12–15.
90. Marc I. Steinberg, *The Emergence of a New Battleground: Liability for Secondary Market Violations in Ontario*, 48 Int'l L. 17, 17 (2014).
91. Steinberg, *supra* note 53, at 942–43.
92. Kistenbroker et al., *supra* note 63, at 15.
93. Directorate General for Internal Policies, Policy Department for Citizens' Rights and Constitutional Affairs, *Collective Redress in the Member States of the European Union* at 8, Sept. 2018, https://www.transeuropexperts.eu/documents/Study%20-%20Collective-redress-.pdf [https://perma.cc/72ED-B4DN].
94. *Id.*

Part of the challenge for the EU is increasing access to justice for investors injured by wrongful financial practices. As two observers pointed out, individual Europeans have faced substantial difficulties seeking redress there. Chief among them have been the high cost and lengthy nature of proceedings to adjudicate those claims. In addition, these plaintiffs usually have relatively small losses and encounter stiff resistance from powerful defendants who have significant advantages over them because of the information they possess.[95]

There had to be a way to address situations when a large number of people were hurt by the same illegal practice and needed a remedy where they could aggregate their claims and together seek damages.[96] Momentum kept building for legal vehicles to effectively redress those wrongs.

A. *Early Actions*

The first initiative came in 2005 when the Commission issued a Green Paper[97] on antitrust damage actions. It continued in 2008 when the same group came out with a White Paper that included suggestions for specific collective redress. In the same year, the Commission also published another Green Paper with proposals for joint consumer redress, and in 2011, the Commission held a public consultation on that subject with the title "Towards a More Coherent European Approach to Collective Redress."[98]

All that led to a resolution from the European Parliament in February 2012 adopting the consultation's stated goal and calling for a coherent effort to fashion a common set of principles for collective redress. Those principles would specifically, but not exclusively, cover infringement of consumer rights. While the resolution spoke of respecting the legal traditions of individual member states, its clear aim

95. Verica Trstenjak & Petra Weingerl, *Collective Actions in the European Union, American or European Model*, 5 Beijing L. Rev. 155, 156 (2014).

96. Commission Recommendation on Common Principles for Injunctive and Compensatory Collective Redress Mechanisms in the Member States Concerning Violations of Rights Granted under Union Law, 2013 O.J. (L 201) (60) [hereinafter *2013 Recommendations*].

97. A green paper is a "first-draft document on a specific policy area circulated among interested parties who are invited to join in a process of consultation and debate. The objective of a green paper is to arrive at a general consensus before drafting the official policy document, the white paper." *Green Paper*, Bus. Dictionary, http://www.businessdictionary.com/definition/green-paper.html [https://perma.cc/7D4B-VWVF].

98. *2013 Recommendations*, *supra* note 96, at 60(3). For a comment on these initiatives from an American perspective, *see* Samuel Issacharoff & Geoffrey Miller, *Will Aggregate Litigation Come to Europe*, 62 Vand. L. Rev. 179 (2009). There the authors argued the previous European attitude toward class actions was the result of its view on the "perversity of rapacious Americans." *Id.* at 179.

was to enhance the coordination of their efforts to create a common mechanism for such group action.[99]

With all those papers and resolutions, the Commission was now acknowledging that it needed some rules, or at least guiding principles, that would, in the words of one commentator, "harmoniz[e] [a] pattern for group actions."[100] She also observed that this new initiative would have to be flexible enough to go beyond anti-trust and consumer litigation.[101] Yet the only certainty in that undertaking was that the Commission would follow its own way and not go with the American model, which it said was "not only at odds with European legal traditions, but also a 'toxic cocktail' that could open the door to abusive litigation."[102]

B. *The 2013 Recommendations*

All those efforts came to a head in 2013 when the Commission issued its Recommendations "on common principles for injunctive and compensatory collective redress mechanisms."[103] There it presented its initiative that would allow private persons to pursue their claims as a group for violations of certain rights. Among other wrongful conduct that could be redressed, it would authorize individuals to bring suits to supplement public enforcement of financial service legislation and laws geared to investor protection.[104] The Commission's recommendations were supposed to set "minimum standards" that its member states would adopt to make sure those actions were "fair, equitable, timely, and not prohibitively expensive."[105] The two vehicles for this collective redress were to be group litigation and representative action.

In the former, individuals who have suffered similar harm could join together to bring an action and manage it to recover their losses.[106] In the latter, a representative could litigate on behalf of common claimants.[107] These would be "limited to ad hoc certified entities, designated representative entities that fulfill certain criteria set by law or to public authorities"[108] and there was a clear preference that those entities would be non-profits.[109]

99. *2013 Recommendations*, *supra* note 96, at 60(4).
100. Elizabeth Silvestri, *Towards a Common Framework of Collective Redress in Europe? An Update on the Latest Initiatives of the European Commission*, 1 RUSSIAN L. J. 45, 48 (2013).
101. *Id*.
102. *Id.* (citing *Commission Green Paper on Collective Redress*, at 3, COM (2008) 794 final (Nov. 27, 2008)).
103. *2013 Recommendations*, *supra* note 96.
104. *Id.* at 60(7).
105. Silvestri, *supra* note 100, at 49.
106. *2013 Recommendations*, *supra* note 96, at 61(17).
107. Trstenjak & Weingerl, *supra* note 95, at 160.
108. *2013 Recommendations*, *supra* note 96, at 61(18).
109. Silvestri, *supra* note 100, at 50; Trstenjak & Weingerl, *supra* note 95, at 160.

In addition, the representatives would have to show that they had the "administrative and financial capacity" to maintain the suits in the best interest of the group members.[110] Accordingly, they would need to have not only the necessary economic resources to fund such an endeavor, but also the human and legal expertise to adequately represent the injured plaintiffs.[111]

It was also important for the Commission that all potential group members be furnished adequate information about the proceedings—both before they begin and during their prosecution.[112] That went hand in hand with one of the more questionable recommendations of the Commission—that all group members make a decision to join the litigation. This "opt-in" requirement contrasts with the American practice (and that adopted by the Netherlands)[113] that members of a class must affirmatively signal that they do not want to be part of it, i.e., opt-out, or else they will be bound by its result.[114]

The Commission also made dubious suggestions on how such litigation would be funded. Adequate resources, or the lack thereof, can "make or break" these actions.[115] Departing again from the U.S. model, the Commission stated a distaste for contingent fees—the arrangement where the lawyer for the class finances the litigation and is compensated by a percentage of the recovery.[116] In its place, the Recommendations indicated that these actions could be financed by the parties or entities bringing the suits.

The Recommendations suggested that if those plaintiffs were foundations or representative associations, they might have sufficient resources to undertake them.[117] Funding, the Commission said, might also come from public sources or legal aid associations.[118] Yet as one observer commented, that is unlikely today when government expenditures are under severe pressure.[119] And if the alternative is that all costs and legal expenses have to come out of the pockets of the claimants, it would be a substantial hindrance to these actions, especially if they have relatively small amounts at stake.[120]

110. *2013 Recommendations*, *supra* note 96, at 61(18).

111. Silvestri, *supra* note 100, at 50; Trstenjak & Weingerl, *supra* note 95, at 160.

112. Silvestri, *supra* note 100, at 50.

113. *See* Kramer, *supra* note 85, at 239–40.

114. *See* Silvestri, *supra* note 100, at 50, 52.

115. *See* Voet, *supra* note 84, at 222.

116. *See* Trstenjak & Weingerl, *supra* note 95, at 161.

117. *See* Voet, *supra* note 84, at 208.

118. *Id.*

119. *Id.* at 215. As that author also noted, with such limited public resources, government authorities would become "gatekeepers," funding only actions that they deemed meritorious. *Id.* at 208–09. Or worse, they might act for "political imperatives or the interests of particular stakeholder groups, which could raise concerns regarding access to justice." *Id.* at 208.

120. *Id.* at 206–07.

The Commission also expressed its preference for the traditional European "loser pay" rule where, unlike the American model, the party that does not prevail must pay the legal fees and expenses of the winning side.[121] That, of course, would serve as an additional deterrent to this litigation. Plaintiffs would have to think long and hard about their chances of being successful because if they were not, they would not only have to bear their own costs and expenses but those of the defendants as well.

In addition to those initiatives, the Recommendations stated that courts should be given a key role in overseeing and managing these suits.[122] Among other things, the Recommendations would require that any ex-ante financing arrangements be fully disclosed to the court at the onset of the litigation.[123] The Recommendations also looked favorably on the possibility that alternative methods of dispute resolution might afford a quicker and cheaper means of resolving these claims than litigation.[124]

On that point, one commentator noted that the Commission had "great expectations" for that process.[125] She questioned, however, if it would be mandatory and whether there would be adequate judicial safeguards to make sure the claimants got a fair shake.[126] In the United States, such proposals to settle securities fraud claims by arbitration have been quite controversial since it appears they would preclude class actions and thus be unaffordable to small claimants.[127]

C. *Unsatisfactory Follow-Up*

In January 2018, the Commission issued a follow-up report on the progress its member states had made in implementing its 2013 Recommendations.[128] The results, it found, had been uneven and for the most part unsatisfactory.[129] Nine of them still had no provisions to adjudicate collective compensation claims along the lines envisioned in the Commission's 2013 Recommendations.[130]

In the countries that had taken action, the implementation of the Commission's recommendations was spotty. Even in the nations that did have some of those mechanisms, they were not working out in practice due to lengthy procedures or high costs that discouraged their

121. *Id.* at 205.
122. *2013 Recommendations*, *supra* note 96, at (21).
123. *See* Voet, *supra* note 84, at 206.
124. *2013 Recommendations*, *supra* note 96, at (16).
125. *Id.*
126. *See* Silvestri, *supra* note 100, at 53–54.
127. *See infra* note 194 and accompanying text.
128. *Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee*, COM (2018) 40 final (Jan. 25, 2018).
129. *Id.*
130. *Id.* at 3.

use.[131] Nineteen member states did allow aggregate compensatory relief, but that came mainly in consumer cases.[132] New initiatives in collective action legislation seemed likewise restricted to those matters where, contrary to the 2013 Recommendations, opt-out procedures were being allowed.[133]

The Commission's 2018 follow-up study also found that member states were not heeding its recommendation which required that individual claimants be adequately informed about what was happening in their collective actions.[134] Even the "loser pay" principle that it was urging was not uniformly being observed due to differences that countries had about what costs winning parties could recover.[135]

On the matter of funding, the 2018 Report found that none of the member states were putting into practice its recommendation that third-party financing of these actions be strictly limited.[136] Many were allowing unwarranted incentives to bring these suits.[137] In much the same vein, the report lamented that its suggested prohibition on contingent fees was not being followed. At least nine countries were permitting some form of them.[138]

Europe, it seemed, was still a long way from creating a single approach that groups of individuals who had been similarly harmed could use to facilitate access to justice. The Commission concluded its 2018 Report by reasserting its commitment to making collective actions available.[139] To that end, the Commission said it would continue to analyze its recommendations, such as those involving funding, to better understand their practicality.[140]

Just several months later, in April 2018, the Commission made good on that commitment by publishing a proposal for collective lawsuit legislation in the consumer area that would apply to all its member states.[141] A year later, in April 2019, the European Parliament and the European Council reached a provisional agreement to move for its

131. *Id.*
132. *Id.* at 3.
133. *Id.* at 2–3.
134. *Id.* at 7–8.
135. *Id.* at 8–9.
136. *Id.*
137. *Id.* at 9–10.
138. *Id.* at 16.
139. *Id.*
140. *Id.*
141. *A Proposal for a Directive of the European Parliament and of the Council on Representative Actions for the Protection of the Collective Interests of Consumers, and Repealing Directive 2009/22/EC*, at 1, COM (2018) 184 final (Apr. 11, 2018).

formal adoption.[142] The legislation, while geared to "core consumer protection areas," could also encompass financial services.[143]

The proposal contemplates that these actions will be brought by "qualifying entities"[144]—which as before seem to focus on non-profit entities—but might include "ad hoc litigation vehicles."[145] There also appear to be restrictions on third-party funding of those actions. Unlike earlier proposals, however, this one does not rule out what the Commission previously viewed as "a safeguard against abuses of the proposed EU collective action mechanism" such as the opt-in requirement, the loser pay principle, and the exclusion of punitive damages.[146]

V. Securities Class Actions—American Style

While the Commission's recent proposal shows some movement forward for collective actions in the consumer area, its January 2018 follow-up report revealed the ample difficulties its member states are having in facilitating securities class actions. Europe should therefore take a second look at how those suits are maintained in our country. One well-respected corporate scholar gave this apt description of the virtues of the American experience:

> When the single claimant could not proceed individually because her expenses would dwarf the expected recover[y], the class action can be brought on behalf of all who are similarly situated. And the sheer size of the aggregated claim attracts not only the entrepreneurial instincts of the class [action] lawyer but also commands the full attention of the defendant. The class action thereby has an important deterrent feature which give it a quasi-public character; it can thus be seen as an extension of the state's enforcement arm and an expression of society's will.[147]

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142. Press Release IP/19/1755, European Comm'n, New Deal for Consumers: European Commission Welcomes Provisional Agreement on Strengthening EU Consumer Protection Rules (Apr. 2, 2019).

143. *The First EU-Wide Consumer Collective Action System Proposal – How Might This Impact Financial Services Firms?*, Dentons (Aug. 3, 2018), https://www.dentons.com/en/insights/articles/2018/august/3/the-first-eu-wide-consumer-collective-action-system-proposal [https://perma.cc/7WPA-W7Q8].

144. *Id.*

145. *Id.*

146. *Id.*

147. James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 Ariz. L. Rev. 497, 497 (1997). Another noted securities expert made much the same point with these remarks: "Securities class actions have an appealing attraction to those seeking to deter fraud. If a party commits fraud that affects hundreds, if not thousands of dispersed shareholders, allowing a plaintiff's attorney to aggregate the claims into a single class action makes the pursuit of such claims both more manageable and economical." Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465, 1522 (2004).

While the SEC has a mandate to enforce the federal securities laws and pursue fraudsters, it can only prosecute a small fraction of those harms. As a well-respected financial columnist put it: "It's no secret that the Securities and Exchange Commission is terrifically understaffed and wildly underfunded compared with the populous and wealthy Wall Street world it is supposed to police."[148]

Accordingly, both Congress and the Supreme Court have recognized how these suits supplement public enforcement of the securities laws. As a committee from the House of Representatives stated:

> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.[149]

The Supreme Court seconded those sentiments with these remarks: "This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission."[150] In addition, the possibility of these lawsuits encourages investors to enter the market knowing that they have a legal means of recovery if they are defrauded.[151]

To be sure, U.S. securities class actions are not without their critiques. Using a well-worn shibboleth for these actions, "strike suits," now retired Court of Appeals Judge Richard Posner described these suits as being brought "for the sole purpose of obtaining fees for the plaintiffs' counsel."[152] To the contrary, however, many of

148. Gretchen Morgenson, *Quick, Call Tech Support for the S.E.C.*, N.Y. TIMES (Dec. 16, 2007), https://www.nytimes.com/2007/12/16/business/16gret.html [https://perma.cc/2TQS-TW2J].

149. H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.).

150. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007). In another opinion, the Court also had this to say about the importance of private antifraud actions: "[A] dynamic, free economy presupposes a high degree of integrity in all of its parts, an integrity that must be underwritten by rules enforceable in fair, independent, accessible courts." Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 522 U.S. 148, 161 (2008).

151. Marc I. Steinberg, *Curtailing Investor Protection under the Securities Laws: Good for the Economy?*, 55 SMU L. REV. 347, 353–54 (2002). *See also supra* notes 50–61 and accompanying text.

152. *In re* Walgreen Co. Stockholder Litig., 832 F.3d 718, 721 (7th Cir. 2016). Another example of this negative attitude is a report from the United States Chamber of Commerce's Institute for Legal Reform, entitled The Growth of Collective Redress in the EU, which surveyed the developments in various member states of the EU. *See* U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, THE GROWTH OF COLLECTIVE REDRESS IN THE EU (2017). Its position was quite critical of those actions as they exist in the United States because they can lead to "litigation abuse . . . where the risks and

these suits often result in substantial recoveries for defrauded shareholders.[153]

In addition, Congress remedied many of the perceived deficiencies in these actions with amendments to the securities laws enacted in 1995 as the Public Securities Litigation Reform Act ("PSLRA").[154] The PSLRA requires that securities fraud be plead with particularity.[155] It also prohibits discovery[156] until the plaintiff survives a motion to dismiss and demonstrates in its pleading by a "strong inference"[157] that the defendants acted with the requisite state of mind.[158] In addition, to assure that the shareholder plaintiff effectively monitors the suit,[159] the court must appoint lead counsel to represent the client with the most "skin in the game," usually the stockholder with the greatest alleged losses.[160]

A. *The Importance of Contingent Fees*

Securities class actions are complex legal proceedings. The lawyers who bring them must be knowledgeable not only in the intricate laws and policies governing financial instruments, but they must also be skilled in pretrial and trial practice.[161] Success in this litigation requires not just great legal expertise, but also strenuous and persistent effort.[162] Significant financial incentives are therefore needed to encourage lawyers to undertake these important actions. As one legal scholar remarked: "It is often asserted that class action lawyers take too much from settlements . . . [M]uch of this criticism . . . is mis-

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rewards are out of balance, meaning that significant financial incentives exist to file weak (or even entirely meritless) claims." *Id.* at 1.

153. *See* Morrissey, *supra* note 64, at 199, for my article describing one such action that resulted in a $1.5 billion settlement and returned a large percent of the shareholders' losses to them.

154. Pub. L. No. 104-67, 109 Stat. 737 (1995) (amending the Securities Act and the Exchange Act by adding new sections 27A and 21D, respectively).

155. Fed. R. Civ. P. 9(b); Exchange Act § 21D(b)(2), 15 U.S.C. § 78u-4 (1995).

156. 15 U.S.C. § 78u-4(b)(3).

157. *Id.* § (b)(2); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

158. The Supreme Court has held that in actions under Rule 10b-5, defendants must have acted with scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

159. *See* Janet Cooper Alexander, *Contingent Fees and Class Actions*, 47 DePaul L. Rev. 347, 359 (1998).

160. 15 U.S.C. § 78u-4(a)(3) (1995).

161. For an in-depth discussion of the litigation skills that these suits require, see Steinberg, *supra* note 43, at 573–623.

162. *See, e.g.*, Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. of Empirical Legal Studies 811, 820 (where the author finds that the average time to settlement in these actions is three years). *See also* Morrissey, *supra* note 64, at 200, 214 (where I describe a major securities class action that took fourteen years to litigate to a successful completion, including three years of pre-trial motions, three years of discovery, a trial, and appeal.)

guided. In particular, I assert that, in many cases, class action lawyers not only do not make too much, but actually make too little."[163]

Along those lines, another author observed, "Contingent fees are the nearly universal form of compensation for class counsel. Indeed, in most class action litigation no other form of compensation would be practical."[164] With the small amounts typically lost by individual claimants in these actions, none of them would advance funds to pay their lawyers for the significant legal work necessary to obtain recovery. But bringing those claims together offers the possibility of a large recovery that will make these actions worthwhile for a good lawyer.[165]

Yet such arrangements are risky for the attorneys who undertake them because of two salient features of contingent fee compensation: "no win, no pay," and "proportionality to the outcome."[166] With contingent fee arrangements, there is no "pay as you go" by the clients; their lawyers advance all the costs of the litigation. They are compensated only if they prevail, typically by a percentage of the recovery—which can be much greater than if the lawyers were only paid their hourly rates. Such remuneration is necessary, however, because of the possibility that the litigation might be unsuccessful and the lawyers would then take nothing.[167]

Class actions thus provide a way for those who "lack the necessary resources . . . to vindicate their legal claims."[168] As Professor Alexander sums up, if contingent fees were abolished, "we can safely assume that class action litigation would be effectively wiped out."[169] Then there would be no remedy for plaintiffs with common claims who have suffered small-scale harms.[170] Wrongdoers could nickel and dime them with impunity.

The EU's fears here about "toxic" litigation[171] echo those often heard in the U.S.—that these suits are "lawyer-driven" hunts for

163. Brian T. Fitzpatrick, *Do Class Action Lawyers Make Too Little*, 158 U. PENN. L. REV. 2043, 2044 (2010).

164. Alexander, *supra* note 159, at 347–48.

165. *See* Cox, *supra* note 147 and accompanying text.

166. Samuel R. Gross, *We Could Pass a Law. . .What Might Happen if Contingent Legal Fees Were Banned*, 47 DEPAUL L. REV. 321, 324, 326 (1998).

167. Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 304 (1998).

168. Alexander, *supra* note 159, at 349–50. For a historical sketch of how the contingent fee arrangement was accepted in the United States, see Phil J. Havers, *Take the Money and Run: Inherent Ethical Problems of the Contingency Fee and Loser Pays Systems*, 14 N.D. J. OF L., ETHICS & PUB. POL. 620, 622 (2000). This article details how contingent fees came into use at the turn of the last century when it became apparent that the poor and middle-class could not afford the legal costs of bringing suit.

169. Alexander, *supra* note 159, at 350.

170. *See* Buxbaum, *supra* note 83, at 589.

171. *Id.* at 594.

bounty that reward the unscrupulous attorneys who bring them.[172] But perhaps, as one commentator speculated, this EU antagonism to the American approach is also motivated by pre-*Morrison* resentment that much of this litigation involving European plaintiffs ended up in U.S. courts or that it inverts the traditional attorney-client relationship by making these suits dependent on the lawyers who bring them.[173]

Yet much of the concerns about meritless litigation have been addressed by the 1995 amendments to the federal securities laws in the PSLRA that require a preliminary showing of viable claims.[174] In addition, other legislation, like the Class Action Fairness Act of 2005[175] which requires that many of these actions be brought in federal rather than state court, has done much to weed out unfounded claims. So have Supreme Court rulings that make these claims more difficult to maintain.[176]

In the American system, moreover, there is a requirement that any settlements of these actions receive court approval at a fairness hearing.[177] Objectors may appear there as "guardians of the interests of absent class members" to challenge the proposed resolution of the action.[178] Often these are class members or their lawyers who are unhappy with the settlement, and courts take their assertions seriously.[179]

Contingent fee awards must thus be approved by the court. One study found in the aggregate those fees averaged 15% of the common fund (the total amount recovered), with the mean and median numbers coming in at roughly 25%. Both figures are lower than what contingent fee lawyers typically receive when they represent individual plaintiffs.[180] While federal courts in the Ninth Circuit use 25% as the

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172. Myriam Gilles, *Opting out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 373 (2005) (quoting Martin H. Redish, *Class Actions and the Democratic Difficulty*, 2003 U. CHI. LEGAL F. 71, 77–83, who calls for the banning of these suits.).

173. Buxbaum, *supra* note 83, at 592–93.

174. *See supra* note 155 and accompanying text.

175. Class Action Fairness Act of 2005, Pub. L. No. 109-2, § 2(a)(4), (b), 199 Stat. 4, 5, (codified as amended at 28 U.S.C. § 1711 (2006)).

176. *See, e.g.*, the requirement that the plaintiff in a 10b-5 claim plead facts leading to a cogent inference that the defendants acted with scienter. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) and text accompanying *supra* note 158. *See also* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc. 552 U.S. 148, 152 (2008) (ruling out 10b-5 liability for aiders and abetters of securities violations).

177. Fed. R. Civ. P. 23(h) authorizes federal judges to award "reasonable" fees in class actions.

178. Alon Klement & Robert Klonoff, *Class Actions in the United States and Israel: A Comparative Approach*, 19 THEORETICAL INQUIRIES L. 151, 166 (2018) (citing cases where that occurred).

179. *Id.*

180. Fitzpatrick, *supra* note 163, at 2045–46. The author advocates that this percentage award should be higher, in some cases 100%, in consideration of the public good that plaintiff lawyers achieve in these actions.

presumptive figure,[181] most courts employ a number of factors to calculate this award, such as the skill and time exerted by the lawyers, the results they have achieved, and the novelty and difficulty of the issues involved.[182]

B. *Loser Pays*

Another arrangement proposed by the EU, "loser pay," would, like the prohibition of contingent fees, greatly discourage securities class actions. In such a legal regime, the party in a lawsuit that does not prevail "must pay the reasonable costs and legal fees of the opposing side."[183] One commentator succinctly summed up how that would make litigation extremely risky and expensive: "As a result, those with less money run the greater risk in any suit and, consequently, many do not see the legal system as a viable means of redress given the risk of losing and its consequences . . . [and therefore such] individuals with a valid grievance have no recourse."[184]

In recent times, however, the American rule where each side pays its own expenses regardless of a suit's outcome has itself been under assault. A Delaware decision, *ATP Tour, Inc. v. Deutscher Tennis Bund*, upheld a corporate bylaw that authorized such fee-shifting, requiring unsuccessful plaintiffs in intra-corporate litigation to pay the defendant corporation's expenses, including the costs of its attorneys.[185] The Delaware legislature overturned that, invalidating such bylaws when they involve "an internal corporate claim."[186]

The language of the Delaware statute covers derivative suits, actions where shareholders typically champion causes of action on behalf of their corporations against officers or directors who have breached their fiduciary duties.[187] It does not, however, pertain to class actions for securities frauds.[188] Would a bylaw prohibiting those be legal and usher in a "loser pay" regime in those actions? That would greatly curtail them and deprive small shareholders or those of

181. Staton v. Boeing Co., 327 F.3d 938, 968 (9th Cir. 2003).

182. *See, e.g.*, Camden I Condo Ass'n v. Dunkle, 946 F.2d 768, 772 (11th Cir. 1991). An alternative, less-used approach is the lodestar method. It takes the number of hours expended by the attorney, multiplies it by an hourly fee, and adds a percentage increment to account for the risk undertaken. Fitzpatrick, *supra* note 163, at 2052.

183. Havers, *supra* note 168, at 632.

184. *Id.* at 623, 638.

185. ATP Tours, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 555 (Del. 2014).

186. 8 Del. Code § 102(f), § 114(b) (2019).

187. I have written extensively on derivative suits. *See generally* Daniel J. Morrissey, *Shareholder Litigation after the Meltdown*, 114 W. VA. L. REV. 531 (2012); Daniel J. Morrissey, *The Path of Corporate Law in the 21st Century*, 86 OR. L. REV. 975 (2008); Daniel J. Morrissey, *New Rulings Threaten the Derivative Suit—Will the "Needed Policeman" Keep Walking the Beat*, 36 S.C. L. REV. 631 (1985).

188. Coffee, *supra* note 81, at 694.

limited means their day in court, a result that one commentator described as "anathema" to our legal system.[189]

Professor Coffee believes that securities class actions would survive that challenge because federal law would preempt states from condoning fee-shifting bylaws.[190] Coffee also cites criticism of "loser pay" by former SEC Chair Mary Jo White.[191] In addition to weighing in with that view as an *amicus* in its capacity as the "statutory guardian"[192] of the federal securities laws, the SEC could thwart such an approach more directly by refusing to accelerate registration statements for firms that require it.[193] It did that just a few years ago to invalidate mandatory arbitration provisions in prospectuses that would have had the similar effect of killing securities class actions.[194]

C. *Establishing Class Membership on an Opt-Out Basis*

There are two general ways to determine who is a member of a class. In an opt-out regime, like that in the United States,[195] potential members are given notice of the suit[196] and are then presumed to be part of the class unless they affirmatively chose not to participate.[197] In an opt-in system, like that proposed by the EU Commission, they do not join in the suit unless they affirmatively elect to do so.[198]

Advocates of the latter approach claim that it gives the plaintiffs more cohesion and a stronger representative quality.[199] The suit, it is also argued, is less "lawyer driven" and a more voluntary undertaking

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189. Havers, *supra* note 168, at 638.

190. Coffee, *supra* note 81, at 696–701. For a thorough discussion of that rationale, *see* William K. Sjostrom, Jr., *The Intersection of Fee-Shifting Bylaws and Securities Fraud Litigation*, 93 WASH. U. L. REV. 379 (2015). For another thoughtful treatment of that issue, *see* Michael J. Kaufman & John M. Wunderlich, *Paving the Delaware Way: Legislative and Equitable Limits on Bylaws after ATP*, 93 WASH. U. L. REV. 335, 335 (2015) where the authors assert that Delaware would be restrained by its commitment to equitable principles from allowing bylaws to "extinguis[h] meritorious shareholder or securities litigation[.]"

191. Coffee, *supra* note 81, at 701 n.51.

192. SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975).

193. Securities Act of 1933, ch. 38, § 8(a), 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77h(a)).

194. Coffee, *supra* note 81, at 701; I have previously weighed in on that, urging that the law not relegate claims for securities fraud to arbitration where class action relief would not be available. *See generally* Daniel J. Morrissey, *Will Arbitration End Securities Litigation?*, 40 SEC. REG. L. J. 159 (2012). There is a similar danger present in the EU's stated preference that securities fraud claims be resolved by such alternative dispute mechanisms. *See* Hodges, *infra* note 205 and accompanying text. Those procedures that would blunt the beneficial effects of class action litigation were rejected by the SEC for that reason.

195. Fed. R. Civ. P. 23(c)(2)(B).

196. *Id.*

197. Scott Dodson, *An Opt-In Option for Class Actions*, 115 MICH. L. REV. 171, 173 (2016).

198. *Id.*

199. *Id.* at 174.

by its participants. When the U.S. rules were given their most recent form in 1966, however, their drafters wanted to give American civil procedure a "more functional attitude" and one "enabling low value claims" to be effectively adjudicated.[200]

When the Federal Rules of Civil Procedure adopted the opt-out mechanism, the result was stunning. As one commentator noted: "There is no denying that [it] . . . dramatically enhanced the litigation power of consumer-rights, civil-rights, securities-fraud and discrimination victims."[201] To be sure, under the American model, the plaintiffs must still satisfy other requirements to get their class certified, such as showing that their claims are typical of a class[202] whose members share common questions of law and fact.[203] But the likelihood under the opt-out system that the class will encompass large numbers of claimants[204] encourages comprehensive settlement[205] and greatly enhances the possibility that the recovery will benefit as many injured victims as possible. As the Supreme Court said, "Class actions . . . may permit the plaintiffs to pool claims which would be uneconomical to litigate individually. For example, this lawsuit involves claims averaging about $100 per plaintiff; most of the plaintiffs would have no realistic day in court if a class action were not available."[206]

And incidentally, as Professor Cox notes, the possibility of such a large aggregate award will attract skilled and motivated attorneys to prosecute these cases[207] and thus serve as a strong deterrent to future wrongdoing. As another commentator put it: "My intuition is that . . . many prudent corporate decisions are made precisely because the palpable threat of class action liability hangs in the boardroom."[208]

VI. Conclusion

One commentator, discussing all the so-called safeguards in the EU proposals that make them unlike the U.S. model, called them the

200. *Id.* at 177.
201. *Id.* at 180.
202. Fed. R. Civ. P. 23(a)(3).
203. Fed. R. Civ. P. 23(a)(2).
204. Opt-in systems typically capture far fewer plaintiffs for a number of reasons. Potential members may be hard to identify, they may not know of the litigation, or they may have social or psychological issues preventing them from participating. In addition, an opt-in regime entails more individualized litigation that makes it much harder to deal with large scale harms. Rachael Mulheron, *The Case for an Opt-out Class Action for European Member States: A Legal and Empirical Analysis*, 15 Colum. J. of Eur. L. 409, 428–32 (2009).
205. Christopher Hodges, European University Institute, Project European Research Council, US Class Actions: Promise and Reality Working Paper Law 2015/36 4 (2015).
206. Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 809 (1985).
207. Cox, *supra* note 147, at 497, and accompanying text.
208. Gilles, *supra* note 172, at 430.

"death knell for the development of European class actions."[209] In the same vein, another referred to what he saw as a "catch 22" there.[210] If those "safeguards are imposed then litigation will be significantly dampened."[211] In other words, Europe may fear what it sees as our abusive tactics in class actions, but there are "valuable lessons to be learned from the long U.S. experience."[212]

The rules governing those suits in our country have evolved to root out frivolous claims, yet insure that truly meritorious ones prevail.[213] Supported by practices like contingent fee funding, opt-out membership, and no "loser pay," American securities class actions have been a success story. By contrast, the collective action model advocated by the EU Commission that eschews those approaches is failing to gain traction among its member states[214] and the Commission itself is no longer insisting on an opt-in requirement and the loser pay rule in its most recent proposal on collective consumer claims.[215]

The Commission can adopt the U.S. system but do so in ways that comport with the traditions of its member states, which may include greater judicial oversight of collective actions. In a global economy, such a move will not only give defrauded shareholders a meaningful method to recover their losses and deter future wrongdoing, it will also support world-wide investor confidence. It will thereby help provide funding for the development of innovative products and services that will benefit all humankind.

209. Warren, *supra* note 28, at 1108.
210. Hodges, *supra* note 205, at 35.
211. *Id.*
212. Buxbaum, *supra* note 83, at 593.
213. *See* Cox, *supra* note 147, at 522 and accompanying text.
214. *See supra* notes 128–39 and accompanying text.
215. *See supra* note 146 and accompanying text.