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CONTENTS

PROOF OF CLASSWIDE INJURY

Sergio J. Campos[*]

INTRODUCTION

Imagine a country with a law that mirrors Title VII.[1] Suppose that an employer in that country has put up posters stating that persons of a certain race "need not apply" for pay increases.[2] A worker of that race requests a pay raise and the employer rejects the request. The worker

* Associate Professor of Law, University of Miami School of Law. Email: scampos@law.miami.edu. Phone: (305) 284-5899. This Article is a contribution to a symposium on the Globalization of the U.S. Litigation Model held at Brooklyn Law School. Many thanks to the symposium participants for their comments. This Article also benefited from comments I received from workshop participants at Cardozo, Miami, and American law schools. I want to thank Caroline Bradley, Lester Brickman, Zanita Fenton, Myriam Gilles, Jim Greiner, Pat Gudridge, Steve Halpert, Fred McChesney, Arad Reisberg, David Rosenberg, Stewart Sterk, Markus Wagner, and Adam Zimmerman for their helpful comments on previous drafts. Lauren White and Alyssa Karp provided excellent research assistance. All errors are my own.

1. 42 U.S.C. § 2000e *et seq.* (2006).

2. *See* Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 459–60 (2001) (contrasting obvious, "first genera-

then asserts a disparate treatment claim against the employer for a "pattern or practice" of racial discrimination.[3]

The worker would like to bring a class action because her damages, as well as the damages for all other affected workers, would be small. But to proceed as a class action in that country, the worker must first prove that each member of the class was injured by the alleged discriminatory practice. The worker must do so even though, to prevail on the claim, Title VII does not require plaintiffs "to offer evidence that each person for whom it will ultimately seek relief was a victim of the employer's discriminatory policy."[4] Proving the fact of injury on a classwide basis may be difficult because some class members may not have deserved a pay increase in the absence of the discriminatory practice.

The requirement of proof of classwide injury, in effect, prevents the worker's class action from being certified, even though the employer's conduct is manifestly unlawful, and the class would certainly prevail on the merits. Given the small claims of each of the class members, the requirement likely prevents all actions from being filed. As it turns out, this requirement applies to class actions in the United States.

This symposium addresses the spread of the U.S. litigation model to other jurisdictions, and arguably there is no procedure more American than the class action.[5] Recently, however, other countries have adopted class actions or similar collective procedures.[6] This Article discusses the

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tion" forms of discrimination, such as signs stating "Irish need not apply," from more complex, "second generation" forms of discrimination, such as unconscious bias).

3. 42 U.S.C. § 2000e-2(a)(1) ("It shall be an unlawful employment practice for an employer . . . to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race"); *see also* Int'l Bhd. of Teamsters v. United States, 431 U.S. 324, 336 (1977) (defining disparate treatment pattern-or-practice claims).

4. *Teamsters*, 431 U.S. at 360–61 (noting that after a "pattern-or-practice" has been found to violate Title VII, "a district court must usually conduct additional proceedings after the liability phase to determine the scope of individual relief").

5. Richard A. Nagareda, *Aggregate Litigation across the Atlantic and the Future of American Exceptionalism*, 62 VAND. L. REV. 1, 2 (2009) [hereinafter Nagareda, *Aggregate Litigation across the Atlantic*] (noting "several exceptional features of the U.S. civil justice system," including "class actions"); Edward F. Sherman, *Group Litigation under Foreign Legal Systems: Variations and Alternatives to American Actions*, 52 DEPAUL L. REV. 401, 401 (2002) ("The class action is a uniquely American procedural device.").

6. Manuel A. Gomez, *Collective Redress in Latin America: The Regulation of Class Actions and Other Forms of Aggregate and Group Litigation for the Protection of Consumer Rights*, *in* L'ART. 140 BIS DEL CODICE DEL CONSUMO: L'AZIONE DI CLASSE 265 (Lorenzo Mezzasoma & Francesco Rizzo eds., 2011) (It.) (discussing class actions and similar procedures in Latin America); Nagareda, *Aggregate Litigation across the Atlantic*, *supra* note 5, at 4 (noting recent implementation of procedures "within the broad

merits of the class action both here and abroad, but takes an American focus. It examines a recent requirement of U.S. class action doctrine illustrated by the hypothetical above—proof of classwide injury. The Article argues that the requirement reveals misunderstandings about the class action. It then uses these misunderstandings to suggest factors that both the United States and other jurisdictions should consider in implementing class actions or similar procedures.

Federal courts in the United States have recently required proof of "classwide injury" to certify a class action for damage remedies.[7] Proof of classwide injury is generally understood as proof that the defendant injured every member of the class.[8] Such proof does not have to show the amount of damages for each plaintiff. Instead, it only has to show that each plaintiff was in fact injured by the defendant's alleged unlawful conduct.[9]

Proof of classwide injury is referred to in antitrust litigation as proof of classwide or common "impact,"[10] and in securities fraud and Racketeer Influenced and Corrupt Organizations Act ("RICO") fraud litigation as

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rubric of 'aggregate litigation,'" such as "English group litigation orders" and "Italian class actions"). Many of the contributions to this symposium discuss in great detail collective procedures in different countries.

7. *E.g.*, Blades v. Monsanto Co., 400 F.3d 562, 572 (8th Cir. 2005) (affirming denial of class certification since plaintiffs "cannot prove classwide injury with proof common to the class"); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 187 (3d Cir. 2001) (finding that there was no proof of classwide "injury" since "[w]hether a class member suffered economic loss from a given securities transaction would require proof of the circumstances surrounding each trade, the available alternative prices, and the state of mind of each investor at the time the trade was requested").

8. *In re* Hydrogen Peroxide Antitrust Litig., 552 F.3d 305, 311–12 (3d Cir. 2008) ("[T]he task for plaintiffs at class certification is to demonstrate that the element of antitrust impact is capable of proof at trial through evidence that is common to the class rather than individual to its members.").

9. *In re* Potash Antitrust Litig., 159 F.R.D. 682, 694 (D. Minn. 1995) ("[T]he issue in the common impact analysis is the fact, not the amount, of injury.").

10. *E.g.*, *Hydrogen Peroxide*, 552 F.3d at 311 ("Importantly, individual injury (also known as antitrust impact) is an element of the cause of action; to prevail on the merits, every class member must prove at least some antitrust impact resulting from the alleged violation." (citing Bogosian v. Gulf Oil Corp., 561 F.2d 434, 454 (3d Cir. 1977))); *In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 19 (1st Cir. 2008) ("The real dispute revolved around whether common evidence could be used to prove the impact of the alleged conspiracy on U.S. consumers ('common impact')."); *see also id.* at 19 n.18 (noting that "[t]he element of injury in the antitrust context is often referred to as 'impact' or 'fact of damage,'" (quoting Alabama v. Blue Bird Body Co., 573 F.2d 309, 317 n.18 (5th Cir. 1978))).

classwide proof of "transaction causation."[11] Courts have similarly required proof of classwide "specific causation" in mass tort cases,[12] as well as proof of the common "glue" that injured the plaintiffs in employment discrimination cases.[13] In all contexts proof of classwide injury is referred to as common proof of the "fact" of injury.[14]

Courts generally require proof of classwide injury to satisfy the "predominance" requirement of Federal Rule of Civil Procedure 23(b)(3), which requires plaintiffs seeking to certify a class to show that "the questions of law or fact common to class members predominate over any questions affecting only individual members."[15] In *Wal-Mart Stores, Inc. v. Dukes*,[16] decided this past term, the Supreme Court suggested that "significant proof" of classwide injury may be required to satisfy the "commonality" requirement of Rule 23(a)(2), which only requires a showing that "there are questions of law or fact common to the class."[17]

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11. *E.g.*, McLaughlin v. Am. Tobacco Co., 522 F.3d 215, 222 (2d Cir. 2008); *Newton*, 259 F.3d at 172 (noting, in the context of civil RICO fraud litigation, that "[r]eliance, or transaction causation, establishes that but for the fraudulent misrepresentation, the investor would not have purchased or sold the security" in securities fraud litigation). *But see* Bridge v. Phoenix Bond & Indem. Co., 553 U.S. 639 (2008) (holding that plaintiffs are not required to prove reliance to assert a civil RICO claim, but still requiring a showing of proximate cause).

12. *E.g.*, *In re* Vioxx Products Liab. Litig., 239 F.R.D. 450, 462 (E.D. La. 2006) (finding a lack of predominance despite common issues of general causation, since "each individual plaintiff must meet his or her own burden of medical causation" (quoting Steering Comm. v. Exxon Mobil Corp. 461 F.3d 598, 603 (5th Cir. 2006))). *Cf.* Amchem Products, Inc. v. Windsor, 521 U.S. 591, 624 (1997) (finding no predominance in settlement class action involving asbestos claims "given the greater number of questions peculiar to the several categories of class members," including injury).

13. Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2545 (2011).

14. *E.g.*, *New Motor Vehicles*, 522 F.3d at 20 (noting that "[i]n antitrust class actions, common issues do not predominate if the fact of antitrust violation and the fact of antitrust impact cannot be established through common proof").

15. FED. R. CIV. P. 23(b)(3); *see also New Motor Vehicles*, 522 F.3d at 20 (requiring "common proof" of "antitrust impact" to satisfy the predominance requirement). Some courts also require proof of classwide injury to satisfy the "superiority" requirement of Rule 23(b)(3), although here I will focus on the predominance requirement. FED. R. CIV. P. 23(b)(3) (requiring, for purposes of class certification, a showing "that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy"); *Newton*, 259 F.3d at 192 ("Because injury determinations must be made on an individual basis in this case, adjudicating the claims as a class will not reduce litigation or save scarce judicial resources. Under these circumstances, plaintiffs fail to satisfy the superiority standard.").

16. *Wal-Mart*, 131 S. Ct. 2541.

17. FED. R. CIV. P. 23(a)(2); *see also Wal-Mart*, 131 S. Ct. at 2545 (holding that the commonality requirement of Rule 23(a)(2) requires "significant proof that an employer

Unlike Rule 23(b)(3), which defines a residual category that mainly applies to class actions seeking monetary remedies, Rule 23(a)(2) is a prerequisite for all class actions.[18]

This Article examines proof of classwide injury as a requirement for certification of a class action. Although the requirement has not attracted much scholarly attention, most scholars, such as the late Richard Nagareda, have concluded that proof of classwide injury should be a prerequisite for class certification.[19] In fact, the Supreme Court in *Wal-Mart* quoted a seminal article by Nagareda to support its view that the "commonality" requirement of Rule 23(a)(2) not only requires "common questions," but proof of "common answers" as to injury:

> What matters to class certification . . . is not the raising of common "questions"—even in droves—but, rather the capacity of a classwide proceeding to generate common *answers* apt to drive the resolution of the litigation. Dissimilarities within the proposed class are what have the potential to impede the generation of common answers.[20]

The *Wal-Mart* Court did not find sufficient proof of "common answers" because the plaintiffs, all female employees of Wal-Mart, challenged the thousands of allegedly discriminatory pay and promotion decisions made

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operated under a general policy of discrimination" (quoting Gen. Tel. Co. of Sw. v. Falcon, 457 U.S. 147, 159 n.15 (1982))).

18. FED. R. CIV. P. 23(b) (providing that "[a] class action may be maintained if Rule 23(a) is satisfied and" the proposed class action fits into one of the categories defined under Rule 23(b)).

19. Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. REV. 97, 98–109 (2009) [hereinafter Nagareda, *Class Certification*]; *see also* Richard A. Nagareda, *Common Answers for Class Certification*, 63 VAND. L. REV. EN BANC 149, 149–55 (2010) [hereinafter Nagareda, *Common Answers*]. Some scholars have not addressed the issue of classwide injury but have implied such a requirement in arguing that the predominance requirement requires a finding that the cases can be substantially "resolved" on a common basis. *See, e.g.*, Allan Erbsen, *From "Predominance" to "Resolvability": A New Approach to Regulating Class Actions*, 58 VAND. L. REV. 995, 1005–06 (2005); Samuel Issacharoff, *Class Action Conflicts*, 30 U.C. DAVIS L. REV. 805, 831–32 (1997). The American Law Institute's PRINCIPLES OF THE LAW OF AGGREGATE LITIGATION has adopted this "resolvability" approach to the predominance requirement, and has specifically cited Allan Erbsen's seminal article for support. AM. L. INST. [ALI], PRINCIPLES OF THE LAW OF AGGREGATE LITIGATION § 2.02(a)(1) cmt. a (2010). Other scholars have required an assessment of the merits prior to class certification, which would entail a finding of classwide injury. *See* Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251, 1253–54 (2002); Geoffrey C. Hazard, Jr., *Class Certification Based on Merits of the Claims*, 69 TENN. L. REV. 1, 3–6 (2001).

20. *Wal-Mart*, 131 S. Ct. at 2551 (quoting Nagareda, *Class Certification*, *supra* note 19, at 132).

by store and regional managers at Wal-Mart's many stores. The Court concluded that "[w]ithout some glue holding the alleged *reasons* for all those decisions together, it will be impossible to say that examination of all the class members' claims for relief will produce a common answer to the crucial question *why was I disfavored*."[21]

This Article argues that the proof of classwide injury requirement arises from three fallacies about the class action. The first fallacy is that class actions require a court to resolve all issues in one fell swoop. Thus, proof of classwide injury is necessary because, without such proof, the class action would unravel into separate trials on the issue of injury.[22] But, as argued below, the class action does not require an all-at-once determination of the merits because the class action is not primarily an all-at-once trial device but a trust device. The function of the class action is to assign dispositive control over the plaintiffs' claims to a third party, class counsel, for the benefit of the plaintiffs. It does so to allow the class attorney to make common investments, which, because of economies of scale, lowers the average costs for each plaintiff. The trust function of the class action is essential for litigation involving small claims because without it no plaintiff would have incentive to bring suit. More importantly, the trust function of the class action does not entail an all-at-once determination of the merits. A class action can incorporate multiple trials of the issues as long as the class attorney can make common investments for the class.

The second fallacy is that the class action is an extraordinary remedy that, like a preliminary injunction, requires the plaintiffs to show a likelihood of success on the merits.[23] In *In re New Motor Vehicles Canadian Export Antitrust Litigation*,[24] for example, the court required proof of

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21. *Id.* at 2552 (emphasis in original).

22. *See* Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 187 (3d Cir. 2001) (concluding that, in the absence of proof of classwide impact, proving injury on an individual basis would be a "Herculean task," which "counsels against finding predominance"); *see also* Nagareda, *Class Certification*, *supra* note 19, at 132 ("What matters to class certification . . . [is] the capacity of a class-wide proceeding to generate common *answers* apt to drive the resolution of the litigation."); *Wal-Mart*, 131 S. Ct. at 2551 (quoting Nagareda, *Common Answers*, *supra* note 19, at 132) (same); Erbsen, *supra* note 19, at 1025 (proposing a "finality principle" for the predominance requirement that provides that "a certified class action seeking damages should eventually result in a judgment resolving the claims of all class members").

23. *E.g.*, Winter v. Natural Res. Def. Council, Inc., 555 U.S. 7, 20 (2008) (noting that "[a] plaintiff seeking a preliminary injunction must establish that he is likely to succeed on the merits," among other things.).

24. *In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6 (1st Cir. 2008).

classwide injury in part to test the "novel and complex" theory supporting the plaintiffs' claims.[25] Other circuits have required merits determinations to justify granting the "extraordinary leverage" the plaintiffs gain from the class action, which can create undue pressure for the defendant to settle.[26] But permitting a court to preview the merits before certifying the class action is at odds with the trust function of the class action. The trust function of the class action is designed to equalize the stakes between the plaintiffs and the defendant because the defendant can automatically exploit economies of scale to invest in common issues.[27] Accordingly, the class action corrects a structural bias the defendants have in developing the merits. To avoid this bias, class certification should be awarded *before* any merits determination, not *after*.

The third fallacy is that, in the absence of proof of classwide injury, individual trials are required to accurately determine each individual plaintiff's injury, and thus prevent uninjured plaintiffs from recovering. Setting aside the all-at-once fallacy, this individualist fallacy suggests that individual trials are always better than classwide trials to determine individual issues. However, and as suggested by the hypothetical above, the lack of proof of classwide injury arises mainly from uncertainty as to the counterfactual world. Whether a plaintiff has suffered damage depends on how he or she would have fared in the absence of the alleged unlawful conduct. As argued below, proving the counterfactual may involve evidence that is common to some or all of the members of the class. Moreover, many other areas of the law express no concern for uninjured plaintiffs recovering. Most importantly, the deterrence function of the litigation does not require any improved accuracy that may result from individualized hearings. As discussed below, the deterrence function only requires an assessment of the damage at the class level, not the individual level, leaving distributional accuracy a matter of secondary importance.

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25. *Id.* at 26–28 (concluding that a searching inquiry as to classwide impact is necessary since "the granting of class status 'raises the stakes of litigation so substantially that the defendant likely will feel irresistible pressure to settle'" (quoting Waste Mgmt. Holdings, Inc. v. Mowbray, 208 F.3d 288, 293 (1st Cir. 2000))).

26. Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 267 (5th Cir. 2007), *overruled by* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011).

27. This is one of the great insights of David Rosenberg's work on mass tort litigation. *See, e.g.*, David Rosenberg, *Mass Tort Class Actions: What Defendants Have and Plaintiffs Don't*, 37 HARV. J. LEGIS. 393, 395 (2000) [hereinafter Rosenberg, *Mass Tort Class Actions*]; *see also* Sergio J. Campos, *Mass Torts and Due Process*, 65 VAND. L. REV. 1059, 1074–76 (2012) (discussing the problem of asymmetric stakes).

After correcting these fallacies, the Article concludes that proof of classwide injury should not be required to certify a class. Instead, a class action should be certified if, along with the other prerequisites of Rule 23, the class shares common questions of liability, not common answers of injury. Accordingly, the trend of requiring proof of classwide injury, most strikingly seen in the *Wal-Mart* decision and its interpretation of the commonality requirement, should reverse course. Otherwise, to insist on such barriers to class certification would "impair the deterrent effect of the sanctions which underlie much contemporary law."[28]

The Article further argues against adopting the class action as a common answer in other jurisdictions. As discussed below, clarifying the function of the class action in the U.S. context suggests a number of factors other jurisdictions should consider in importing the class action device. This is not to say that the class action can only work in the United States. Instead, the goal of the Article is to ensure that other jurisdictions learn from the United States' mistakes.

This Article proceeds as follows. Part I discusses in more detail the requirement of proof of classwide injury. Part II then discusses each of the three fallacies of class actions reflected by the requirement of proof of classwide injury: (1) the all-at-once fallacy, (2) the extraordinary remedy fallacy, and (3) the individualist fallacy. The Article concludes by arguing that common questions, not common answers, should be the standard for class certification, both in the United States and abroad.

I. PROVING CLASSWIDE INJURY

Before discussing the requirement of proof of classwide injury, it is worth discussing the class action law that applies. Federal Rule of Civil Procedure 23 governs federal class actions.[29] Rule 23 requires a proposed class action to satisfy four prerequisites defined under subsection (a) and fit within one of three categories defined under subsection (b).[30] The four requirements are that "(1) the class is [sufficiently] numerous" (the "numerosity" requirement); "(2) there are questions of law or fact common to the class" (the "commonality" requirement); "(3) . . . the representa-

28. Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 686 (1941).

29. FED. R. CIV. P. 23; *see also* Shady Grove Orthopedic Associates, P.A. v. Allstate Ins. Co., 130 S. Ct. 1431, 1437 (2010) (noting that Rule 23 governs all federal class actions).

30. FED. R. CIV. P. 23(a), (b); *see also Shady Grove*, 130 S. Ct. at 1437 ("'[a] class action may be maintained' if two conditions are met: the suit must satisfy the criteria set forth in *subdivision (a)* . . . and it also must fit into one of the three categories described in *subdivision (b)*." (quoting FED. R. CIV. P. 23(b)).

tive parties are typical" (the "typicality" requirement); and "(4) the representative parties will fairly and adequately protect" the class (the "adequacy of representation" requirement).[31]

Rule 23(b)(3) defines a residual category of class actions which applies generally to litigation involving monetary remedies.[32] Rule 23(b)(3) permits a class action only if common questions "predominate over any questions affecting only individual members" (the "predominance" requirement) and the "class action is superior to other available methods" (the "superiority" requirement).[33]

Proving classwide injury primarily implicates the predominance requirement of Rule 23(b)(3). Courts have concluded that a failure to show that every class member was injured would necessarily result in individualized determinations of injury, and such "individual issues . . . would . . . overwhelm[] the common ones."[34]

In *New Motor Vehicles*, for example, the plaintiffs alleged that an unlawful horizontal conspiracy among car manufacturers restricted the flow of Canadian cars into the U.S. market.[35] The restriction allegedly raised the negotiating range—the lower "dealer invoice price" and the higher "Manufacturer's Suggested Retail Price ("MSRP")"—for new U.S. cars.[36] The plaintiffs' experts relied on what the First Circuit considered a "novel and complex theory" to show an increase in the negotiating range caused by the alleged conspiracy.[37]

The district court certified a class of indirect purchasers harmed by the alleged conspiracy under various state antitrust laws, but the First Circuit vacated the certification order. Among other things, First Circuit expressed skepticism that the plaintiffs could prove that all members of the class paid higher prices, because the class contained both "hard bargain-

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31. FED. R. CIV. P. 23(a)(1)–(4).

32. *See* Proposed Rules of Civil Procedure for the United States District Courts, 39 F.R.D. 69, 103 (1966) (discussing creation of Rule 23(b)(3) category); Benjamin Kaplan, *A Prefatory Note*, 10 B.C. INDUS. & COM. L. REV. 497, 497 (1969) (noting that the then-newly created Rule 23(b)(3) category for damage class actions is the "most adventuresome of the new types").

33. FED. R. CIV. P. 23(b)(3).

34. Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988).

35. *In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 8 (1st Cir. 2008).

36. *Id.* at 10. The reason for this range is that, until recently, federal antitrust law considered vertical price-fixing per se unlawful. Leegin Creative Leather Products v. PSKS, Inc., 551 U.S. 877, 882 (2007) (holding that vertical price-fixing is only subject to rule of reason review).

37. *See New Motor Vehicles*, 522 F.3d at 26.

ers" and "poor negotiators."[38] The court noted that some of the poor negotiators may have avoided an injury because they paid the same or less in the actual world, as compared to world that would have existed but for the alleged antitrust violation (the "but-for" world).[39] Given this variance among the class members, the First Circuit concluded that issues of law or fact common to the class did not "predominate."[40]

The lack of predominance in *New Motor Vehicles* was caused, in part, by the variation among the class members. But the actual variation among the class members was not the primary cause of the difficulty in proving classwide injury. After all, if the plaintiffs could determine who the poor negotiators were who suffered no injury, they would have excluded them from the class. Instead, the primary cause is the *potential* variation of the plaintiffs, which arises from uncertainty as to who should be excluded. The plaintiffs in *New Motor Vehicles* had yet to propose a method of determining who the poor negotiators who suffered no injury were,[41] or at least had not proven that there were no such poor negotiators.[42]

The uncertainty as to whether each plaintiff was injured is itself caused by the uncertainty of the plaintiffs' positions in the but-for, or counterfactual, world. In *New Motor Vehicles* a potential plaintiff could negotiate over the price, and thus could choose to accept the higher, MSRP price, bargain to the dealers' invoice price, or bargain somewhere in between. The poor negotiators may have been stuck paying the MSRP in both worlds, suffering no loss. However, because no one can know what would have happened in the but-for world, no one can determine if any poor negotiator would have paid the MSRP in the absence of the alleged anticompetitive conduct.

The ability to negotiate, while sufficient, is not necessary to create the uncertainty in the counterfactual world that prevents common proof of injury. In *McLaughlin v. American Tobacco Co.*,[43] for example, the plaintiffs alleged that the defendant tobacco companies engaged in a scheme to fraudulently market "light" cigarettes as healthier, despite their knowledge that light cigarettes can expose the smoker to the same

38. *Id.* at 29.

39. *Id.*

40. *Id.* at 29–30.

41. *Id.* at 28 (noting that plaintiffs' expert had not devised a model for determining injury and damages).

42. *Id.* at 29 (providing no proof that "the entire negotiating range" was greater in the actual world as compared to the but-for world).

43. 522 F.3d 215 (2d Cir. 2008).

amount of nicotine through compensation.[44] The facts concerning the defendant's marketing scheme and knowledge were largely undisputed.[45] The district court certified a class of light cigarette purchasers harmed by the scheme, with potential damages running "billions of dollars."[46] The district court recognized that the plaintiffs' civil RICO claims required proof of reliance on the fraud, which may raise individual issues, but concluded that the plaintiffs' proffered methodologies for determining reliance were sufficient.[47]

The Second Circuit disagreed. It noted that the civil RICO statute,[48] which served as the basis for the plaintiffs' claims, required a showing of "transaction or 'but-for' causation."[49] Accordingly, the Second Circuit concluded that the proposed class had to show that each plaintiff "relied on the defendant's misrepresentation."[50] However, the Second Circuit concluded that transaction causation could not be proven on a classwide basis, because

> [i]ndividualized proof is needed to overcome the possibility that a member of the purported class purchased Lights for some reason other than the belief that Lights were a healthier alternative—for example, if a Lights smoker was unaware of that representation, preferred the taste of Lights, or chose Lights as an expression of personal style.[51]

The Second Circuit cited a recent Ninth Circuit case, *Poulos v. Caesars World, Inc.*,[52] involving alleged fraudulent representations made

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44. *Id.* at 220.

45. In related litigation, a district court found "overwhelming evidence" that the defendants' intentionally used deceptive brand descriptors to market light cigarettes. *See* United States v. Philip Morris USA, Inc., 449 F. Supp. 2d 1, 27 (D.D.C. 2006).

46. Schwab v. Philip Morris USA, Inc., 449 F. Supp. 2d 992, 1018 (E.D.N.Y. 2005) (Weinstein, J.), *overruled by McLaughlin*, 522 F.3d 215.

47. *Id.* at 1044–46.

48. The Racketeer Influenced and Corrupt Organizations ("RICO") Act provides, among other things, that "[a]ny person injured in his business or property by reason of a violation of [RICO's substantive provisions] may sue . . . and shall recover threefold the damages he sustains." 18 U.S.C. § 1964(c) (2006). The Second Circuit noted that the "by reason of" language in the statute requires a showing "that the defendant's violation not only was a 'but for' cause of his injury, but was the proximate cause as well." *McLaughlin*, 522 F.3d at 222 (quoting Holmes v. Sec. Investor Prot. Corp., 503 U.S. 258, 268 (1992)). Since then, the Supreme Court has held that proof of reliance by the plaintiffs is not necessary. *See* Bridge v. Phoenix Bond & Indem. Co., 553 U.S. 639, 645–59 (2008) (holding that plaintiffs are not required to prove reliance to assert a civil RICO claim, but still requiring a showing of proximate cause).

49. *McLaughlin*, 522 F.3d at 222.

50. *Id.*

51. *Id.* at 223.

52. 379 F.3d 654 (9th Cir. 2004).

concerning video poker and electronic slot machines.[53] There, the Ninth Circuit found no predominance because the plaintiffs could not prove reliance on a common basis. The Ninth Circuit noted that "[g]amblers do not share a common universe of knowledge and expectations—one motivation does not 'fit all.'"[54]

Unlike in *New Motor Vehicles*, the plaintiffs in both *McLaughlin* and *Poulos* did not negotiate over prices. Nevertheless, the same counterfactual uncertainty arose in both contexts because of the discretion the purchasers could exercise in whether to purchase *at all*. As noted in *McLaughlin*, a cigarette purchaser may purchase light cigarettes for lifestyle reasons—she enjoys the flavor or thinks that "smoking Lights [is] 'cool.'"[55] Such "lifestyle" purchasers would not have suffered injury because they would have purchased light cigarettes even in the absence of the fraud. Likewise, video poker players would not be injured if they would have gambled in the absence of the fraudulent representations. Because the plaintiffs in both cases could not ascertain the true motivation for all counterfactual purchase decisions, they could not prove that all purchasers in the class were in fact injured.

The above three cases suggest that the difficulty in proving classwide injury arises mainly from the discretion a plaintiff can exercise. In *New Motor Vehicles*, the plaintiffs could exercise discretion in negotiating prices and thus avoid (or not avoid) injury. Likewise, in *McLaughlin*, the plaintiffs could exercise discretion and also avoid (or not avoid) injury in choosing to purchase the cigarettes at all. [56]

But consider, by way of contrast, *Klay v. Humana, Inc.*,[57] in which the plaintiffs, all doctors, alleged civil RICO claims that major health maintenance organizations ("HMOs") "conspired with each other to program their computer systems to systematically underpay physicians for their services," and fraudulently misrepresented their reimbursement practices to the plaintiffs.[58] The HMOs argued that the doctors could not satisfy predominance because, as in *McLaughlin*, "each individual plain-

53. *Id.* at 659–60; *McLaughlin*, 522 F.3d at 225 (discussing *Poulos*).

54. *Poulos*, 379 F.3d at 665.

55. *McLaughlin*, 522 F.3d at 225.

56. Indeed, the discretion that a party can exercise to avoid an injury, such as by purchasing or not purchasing a product, is an off-shoot of the Coase Theorem, which posits that in the absence of transaction costs, parties can bargain to the most efficient allocation of legal entitlements. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2–15 (1960) (setting forth the Coase theorem).

57. 382 F.3d 1241 (11th Cir. 2004).

58. *Id.* at 1246.

tiff must specifically show that he, personally, relied on the misstatements at issue."[59]

The Eleventh Circuit disagreed. After emphasizing that the existence of an alleged unlawful conspiracy was itself common to the class, it noted that, while the defendants used a variety of communications to defraud the physicians, "they all conveyed essentially the same message—that the defendants would honestly pay physicians the amounts to which they were entitled."[60] The court explained,

> [i]t does not strain credulity to conclude that each plaintiff, in entering into contracts with the defendants, relied upon the defendants' representations and assumed they would be paid the amounts they were due. A jury could quite reasonably infer that guarantees concerning physician pay—the very consideration upon which those agreements are based—go to the heart of these agreements, and that doctors based their assent upon them.[61]

Accordingly, the Eleventh Circuit concluded that each plaintiff's reliance could be proven through common evidence, in this case "through legitimate inferences based on the nature of the alleged misrepresentations at issue."[62]

Klay contains the same discretionary conduct found in cases such as *New Motor Vehicles* and *McLaughlin*. The doctors in *Klay* exercised discretion in entering contracts with HMOs over reimbursement practices, similar to the exercise of discretion in negotiating the price of a car or buying a light cigarette. But the same difficulty in proving classwide injury does not arise because the Eleventh Circuit concluded that the discretionary conduct in *Klay* did not lead to counterfactual uncertainty as to the fact of injury. In both *New Motor Vehicles* and *McLaughlin*, the ability to exercise discretion created uncertainty as to the counterfactual baseline. Would a poor negotiator have done any better without the alleged antitrust violation? Would a plaintiff have bought a light cigarette anyway for "lifestyle" reasons?

By contrast, the *Klay* court concluded that the plaintiffs' discretion did not create similar counterfactual uncertainty. Unlike in *McLaughlin*, it was difficult for the *Klay* court to imagine a counterfactual where the doctors would have assented to the exact same contract terms with full

59. *Id.* at 1258.
60. *Id.*
61. *Id.* at 1259.
62. *Id.*

knowledge of the defendants' real reimbursement practices.[63] The analogue in *New Motor Vehicles* would be proof that the entire negotiating range increased, leaving no doubt that everyone was injured.[64]

As shown by *Klay*, the availability of discretion only causes counterfactual uncertainty if it creates an uncertain link in the causal chain that leads to counterfactual uncertainty as a whole. Indeed, the state of mind of a party is notoriously a black box in the absence of overt manifestations of it. Consequently, the difficulty of proving classwide injury extends to situations where there are similar uncertain links in the causal chain that lead to counterfactual uncertainty.

For example, in consumer fraud litigation involving the seizure drug Neurontin, the plaintiffs alleged a widespread scheme to fraudulently induce doctors to prescribe Neurontin to their patients for off-label use as a general pain reliever, even though Neurontin had no efficacy in treating pain.[65] The plaintiffs showed that, since the start of the alleged fraudulent marketing scheme, the number of prescriptions of Neurontin for pain relief and similar off-label indications skyrocketed.[66]

The district court, however, found no predominance of common issues because, among other things, the court found that the plaintiffs could not prove classwide injury.[67] The court noted that the plaintiffs' proposed econometric models for classwide injury could not "identify which prescribing physicians were exposed to defendants' fraudulent statements." Thus, the court could not "determine *which* consumer class members' Neurontin prescriptions were caused by defendants' alleged fraud," as opposed to those prescriptions "which would have occurred even in the absence of the fraud."[68] As the district court correctly pointed out, only the class members whose prescriptions were caused by the fraud "had a cognizable injury."[69]

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63. As an aside, the contrast presented here is not meant to endorse the *Klay* court's conclusion that it was reasonable to infer that every doctor relied upon the HMO's contract provisions. In fact, it is troubling that the *Klay* court would give the benefit of the doubt to doctors in inferring classwide injury but other courts would not do so for less sympathetic (and probably lower-income) smokers and gamblers.

64. *See, e.g.*, Natchitoches Parish Hosp. Serv. Dist. v. Tyco Int'l, Ltd., 262 F.R.D. 58, 69 (D. Mass. 2009) (finding predominance satisfied since plaintiffs showed that the "'entire negotiating range' . . . was higher than the prices in the but-for world").

65. *See In re* Neurontin Mktg. & Sales Pracs. Litig., 244 F.R.D. 89, 91 (D. Mass. 2007).

66. *Id.* at 96–103 (providing charts and data demonstrating such changes).

67. *Id.* at 110–12.

68. *Id.* at 111–12 (emphasis in original).

69. *Id.*

In *Neurontin* the uncertain link in the causal chain was not the discretion of the plaintiffs, but the discretion of a third party—a doctor—to prescribe the drug. Indeed, as suggested in the *Wal-Mart* case, it can also arise from the discretion of the defendant. Would the defendant (or, as in *Wal-Mart*, one of its subordinates) have discriminated against the plaintiff is she were male?[70]

Similar uncertain links in the causal chain arose in products liability litigation involving the drug Vioxx.[71] There, the plaintiffs provided epidemiological evidence demonstrating that Vioxx increased the risk of heart attacks and strokes. Nevertheless, the district court denied class certification. The district court recognized that "the majority of plaintiffs in this case allegedly suffered a heart attack or stroke as a result of ingesting Vioxx."[72] However, as in *Neurontin*, the court noted that individual issues predominated as to, among other issues, "whether the plaintiffs' physicians would still have prescribed Vioxx had stronger warnings been given."[73] Moreover, the court concluded that it would have to engage in "the highly individualized inquiry of whether Vioxx specifically caused the injury alleged by each plaintiff in light of his or her medical history, family history, and other risk factors, and the use of the drug."[74]

In *Vioxx*, the counterfactual uncertainty did not arise exclusively from the discretion of the plaintiffs or third parties, but from biological uncertainties in the causal chain. It is unclear whether, given individual "risk factors," a particular plaintiff would have suffered a heart attack or stroke in the counterfactual world of not taking Vioxx. Indeed, because issues of specific causation always arise in cases involving pharmaceuticals, the court noted that "courts have almost invariably found that common questions of fact do not predominate in pharmaceutical drug cases."[75]

II. THREE CLASS ACTION FALLACIES

The previous Part discussed the difficulty of proving classwide injury in different substantive areas of the law. It showed that the difficulty in proving classwide injury arises from links in the causal chain that lead to uncertainty as to what would have happened had the alleged legal viola-

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70. Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2547 (2011); *see also* D. James Greiner, *Causal Inference in Civil Rights Cases*, 122 HARV. L. REV. 533, 559–65 (2008) (noting that the central causation issue in employment discrimination cases is whether the decision would have been different if the gender or race was different).

71. *In re* Vioxx Products Liab. Litig., 239 F.R.D. 450, 452 (E.D. La. 2006).

72. *Id.*

73. *Id.* at 461.

74. *Id.* at 462.

75. *Id.* at 461.

tion not occurred. It is this counterfactual uncertainty that prevents plaintiffs from showing that every plaintiff in the class was injured because of the defendant's alleged unlawful conduct.

This Part discusses the premises that underlie the requirement of proof of classwide injury. It argues that the requirement arises from three fallacies about the class action: (A) the all-at-once fallacy, (B) the extraordinary remedy fallacy, and (C) the individualist fallacy.

A. The All-at-Once Fallacy

As noted above, the primary source of the requirement of proof of classwide injury is the predominance requirement, which requires that "questions of law or fact common to class members predominate over any questions affecting only individual members."[76] The concern is that in the absence of proof of classwide injury, individual issues of injury would "overwhelm" any common issues.[77] As put by the Third Circuit in a securities fraud case involving allegedly fraudulent representations that brokers made trades at the "best reasonably available price":

> Whether a class member suffered economic loss from a given securities transaction would require proof of the circumstances surrounding each trade, the available alternative prices, and the state of mind of each investor at the time the trade was requested.[78]

The Third Circuit concluded that "[t]his Herculean task, involving hundreds of millions of transactions, counsels against finding predominance."[79]

It is easy to miss the premise of the seemingly common-sense observation that, in the absence of common proof of injury, the court will face the "Herculean" task of determining injury on an individual basis. The premise is that the class action requires an all-at-once assessment of the issues. As put by the late Richard Nagareda, "class certification does not turn upon the mere raising of common questions by way of expert submissions or any form of evidence. Class certification instead turns on *the capacity of a unitary proceeding to yield common answers*."[80]

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76. FED. R. CIV. P. 23(b)(3).

77. Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988).

78. Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 187 (3d Cir. 2001).

79. *Id.*

80. Nagareda, *Common Answers*, *supra* note 19, at 154 (emphasis added); *see also* Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2551 (2011) (quoting Nagareda, *Class Certification*, *supra* note 19, at 132) (same).

Consider, for example, *General Telephone Company of the Southwest v. Falcon*,[81] a case involving a Mexican-American plaintiff who was allegedly denied a promotion on the basis of his race.[82] In *Falcon*, the plaintiff sought to certify a class of all Mexican-Americans injured by any of the defendant's allegedly discriminatory employment practices, even though the plaintiff himself was only affected by the defendant's promotion practices. Nevertheless, the plaintiff was permitted to certify a class due to the across-the-board rule then followed by the Fifth Circuit, which permitted an alleged victim of racial discrimination to bring suit on behalf of all similarly situated victims. The Fifth Circuit premised the across-the-board rule on the fact that "racial discrimination is by definition class discrimination."[83] As the case proceeded, the only class claim that survived was a disparate impact claim concerning the defendant's hiring practices, which had little do to with the plaintiff's own case of disparate treatment in his promotion.[84]

The Supreme Court vacated class certification largely because the plaintiff failed to satisfy the "typicality" and "commonality" requirements.[85] The Court noted that

> [c]lass relief is "peculiarly appropriate" when the "issues involved are common to the class as a whole" and when they "turn on questions of law applicable in the same manner to each member of the class." For in such cases, "the class-action device saves the resources of both the courts and the parties *by permitting an issue potentially affecting every [class member] to be litigated in an economical fashion under Rule 23*."[86]

But the Court concluded that the complaint "provided an insufficient basis for concluding that the adjudication of his claim of discrimination in promotion would require the decision of any common question concerning the failure of petitioner to hire more Mexican-Americans."[87]

The premise of *Falcon*, that the function of the class action is to determine all issues "in an economical fashion under Rule 23," is pervasive.[88]

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81. 457 U.S. 147 (1982).

82. *Id.* at 149.

83. *Id.* at 157 (discussing the Fifth Circuit's "across-the-board rule").

84. *Id.* at 152.

85. *Id.* at 158. The Court noted in passing that "[t]he commonality and typicality requirements of Rule 23(a) tend to merge," which also "tend to merge with the adequacy-of-representation requirement." *Id.* at 157 n.13.

86. *Id.* at 155 (emphasis added) (citations omitted) (quoting Califano v. Yamasaki, 442 U.S. 682, 700–01 (1979)).

87. *Id.* at 158.

88. *Califano*, 442 U.S. at 701.

Consider *Wal-Mart Stores, Inc. v. Dukes*, which the Court decided this past term.[89] In *Wal-Mart*, the plaintiffs alleged a disparate treatment claim against Wal-Mart that did not center on any one specific pay or promotion policy, but the lack of one.[90] Specifically, the plaintiffs alleged that the defendant's lack of criteria for such decisions, coupled with a uniform corporate culture, led to excessive subjectivity that caused discriminatory pay and promotion decisions by regional and store managers against over a million of Wal-Mart's female employees.[91]

The plaintiffs emphasized that the core issue of whether the policy of excessive subjectivity supports an inference of discriminatory intent is common to the class.[92] The Court, however, noted that the commonality of discriminatory intent was beside the point, since, quoting Nagareda,

> [w]hat matters to class certification . . . is not the raising of common "questions"—even in droves—but, rather the capacity of a classwide proceeding to generate common *answers* apt to drive the resolution of the litigation. Dissimilarities within the proposed class are what have the potential to impede the generation of common answers.[93]

The Court concluded that the plaintiffs sought "to sue about literally millions of employment decisions *at once*."[94] But, according to the Court, "[w]ithout some glue holding the alleged reasons for all those decisions together, it will be impossible to say that examination of all the class members' claims for relief will produce a common answer to the crucial question *why was I disfavored*."[95]

The plaintiffs in both *Falcon* and *Wal-Mart* sought to certify a class under Rule 23(b)(2), which does not require a finding of predominance.[96] Both cases turned on the commonality requirement of Rule 23(a)(2),[97]

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89. 131 S. Ct. 2541 (2011).

90. *Id.* at 2547–48.

91. *Id.* at 2548.

92. *Id.*

93. *Id.* (emphasis in original) (quoting Nagareda, *Class Certification*, *supra* note 19, at 132).

94. *Id.* at 2552 (emphasis added).

95. *Id.* (emphasis in original).

96. *See* FED. R. CIV. P. 23(b)(2) (providing that a class action may be certified if, along with satisfying the requirements of Rule 23(a), the plaintiff shows that "the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole").

97. *Falcon* also concerned the "typicality" requirement of Rule 23(a)(3), but noted that "[t]he commonality and typicality requirements of Rule 23(a) tend to merge." Gen. Tel. Co. of Sw. v. Falcon, 457 U.S. 147, 157 n.13 (1982).

and as the Court has recognized in other contexts, the "predominance criterion is [a] far more demanding" requirement than commonality.[98]

Nevertheless, the Court's insistence on "common answers" has as its source the predominance requirement. This is particularly true in *Wal-Mart*, where the very text quoted by the Court is a criticism by Nagareda of the *predominance* requirement's focus on common questions. In Nagareda's view, the predominance requirement should focus on "dissimilarities," not "similarities," since "[h]eaps of similarities do not overcome dissimilarities that would prevent common resolution."[99] Other scholars, most notably Allan Erbsen, have similarly stressed the importance of "[s]imilarity among claims" since it "facilitates crafting a judgment that specifies the rights of all class members."[100] In contrast, according to Erbsen, "dissimilarity may necessitate fact-intensive case-by-case inquiries into the propriety of judgment that would make class litigation difficult, if not impossible."[101] Erbsen has gone so far as to suggest that "it is time to excise 'predominance' from the vernacular of class action discourse and replace it with a more practical 'resolvability' approach."[102]

The class action, however, does not require "a classwide proceeding to generate common answers"[103] so that "a judgment . . . specifies the rights of all class members."[104] In fact, if that were the case, then no antitrust, securities fraud, or employment discrimination class action would ever be certified. This is because individual issues of damages are always present in cases involving damage remedies, and thus always require the very case-by-case inquiries that, as suggested by *Falcon* and *Wal-Mart*, would preclude class certification. Nevertheless, there is a consensus that "individual damage questions do not preclude a Rule 23(b)(3) class action when the issue of liability is common to the class."[105]

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98. Amchem Products, Inc. v. Windsor, 521 U.S. 591, 623–24 (1997).

99. Nagareda, *Class Certification*, *supra* note 19, at 132; *see also Wal-Mart*, 131 S. Ct. at 2556 (Ginsburg, J., concurring in part and dissenting in part) (noting that "Professor Nagareda, whose 'dissimilarities' inquiry the Court endorses, developed his position in the context of Rule 23(b)(3)").

100. Erbsen, *supra* note 19, at 1027.

101. *Id.*

102. *Id.* at 1088.

103. Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2551 (2011) (quoting Nagareda, *Class Certification*, *supra* note 19, at 132).

104. Erbsen, *supra* note 19, at 1027.

105. 6 WILLIAM B. RUBENSTEIN, ALBA CONTE & HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 24:124 (4th ed. 2002) (quoted by McLaughlin v. Am. Tobacco Co., 522 F.3d 215, 231 (2d Cir. 2008)) [hereinafter NEWBERG ON CLASS ACTIONS]; *see also In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 28 (1st Cir. 2008)

Courts typically address the problem of individual damage issues by, in essence, denying that the class action requires a "classwide proceeding to generate common answers" to all issues.[106] One common solution is bifurcation, or dividing the class action into a single trial on common issues of liability, followed by individual trials on damages. This approach, in fact, was commonly used in employment discrimination cases prior to *Wal-Mart*,[107] and is currently used in antitrust[108] and civil RICO cases.[109]

Another approach, typically taken in the securities fraud and antitrust contexts, is to paper over individual issues by viewing the determination of damages as "a mechanical task involving the administration of a formula."[110] The use of such formulas to determine damages may result in an inaccurate assessment of individual damages, but courts have not required precision "where such a formula may be used to eliminate the

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("Predominance is not defeated by individual damages questions as long as liability is still subject to common proof."); Amchem Products, Inc. v. Windsor, 521 U.S. 591, 625 (1997) ("Predominance is a test readily met in certain cases alleging consumer or securities fraud or violations of the antitrust laws.").

106. *Wal-Mart*, 131 S. Ct. at 2551 (quoting Nagareda, *Class Certification*, *supra* note 19, at 132).

107. *See, e.g.*, Robinson v. Metro-N. Commuter R.R. Co., 267 F.3d 147, 168–69 (2d Cir. 2001) (holding that district court abused its discretion in "denying partial certification" of a class as to liability only, with individual issues of damages determined separately); *see also* 8 NEWBERG ON CLASS ACTIONS, *supra* note 105, § 24:124 ("The majority of courts have held the bifurcation of class liability and relief phases of Title VII suits to be an appropriate means of litigating employment discrimination claims."). In fact, Rule 23 permits certification as to common issues. *See* FED. R. CIV. P. 23(c)(4) ("When appropriate, an action may be maintained as a class action with respect to particular issues."). However, *Wal-Mart* puts the use of bifurcation in Rule 23(b)(2) class actions in serious doubt. *Wal-Mart*, 131 S. Ct. at 2558–59 (rejecting such bifurcation).

108. *See, e.g.*, *New Motor Vehicles*, 522 F.3d at 28 (noting that "the class action can be limited to the question of liability, leaving damages for later individualized determinations"); *In re* Visa Check/MasterMoney Antitrust Litig., 280 F.3d 124, 145 (2d Cir. 2001) (Sotomayor, J.), *overruled on other grounds by In re* Initial Pub. Offerings Sec. Litig., 471 F.3d 24 (2d Cir. 2006) ("In the event that the district court does find conflicts [as to damage calculation] . . . there are a variety of devices available to resolve the problem [including] . . . the possibilities of bifurcating liability and damage trials.").

109. *See, e.g.*, Carnegie v. Household Int'l, Inc., 376 F.3d 656, 661 (7th Cir. 2004) (Posner, J.) (citing *Visa Check*, 280 F.3d at 141) (affirming RICO class certification and suggesting procedural mechanisms available at a later stage for individual issues such as damages and bifurcation).

110. 7 NEWBERG ON CLASS ACTIONS, *supra* note 105, § 22:65; *see also* Blackie v. Barrack, 524 F.2d 891, 905 (9th Cir. 1975) ("[S]hould the class prevail the amount of price inflation during the period can be charted and the process of computing individual damages will be virtually a mechanical task.").

need for individual proof of damages and thus serve the ends of both justice and judicial economy."[111]

But why can a court permit bifurcation or imprecision for the *amount* of damages, but-for not the *fact* of damages? After all, one could, in theory,[112] define an inchoate class of individuals and determine both the fact and amount of damages during an individual issue phase. One reason why courts distinguish between the fact of damage and the amount of damages arises out of Article III concerns.[113] Although the Supreme Court has not addressed the issue, it has recognized that a class member who cannot show injury-in-fact may lack Article III standing to sue.[114]

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111. 6 NEWBERG ON CLASS ACTIONS, *supra* note 105, § 18:53 (noting that "the court should not reject" class actions in the antitrust context due to inaccurate methods of assessing and distributing damages).

112. I say "in theory" because, along with proof of classwide injury, courts also require plaintiffs to identify all class members, and cite "the bedrock principle that members of a class must be identifiable." *In re* Neurontin Mktg. & Sales Pracs. Litig., 244 F.R.D. 89, 113 (D. Mass. 2007); *see also* Myriam Gilles, *Class Dismissed: Contemporary Judicial Hostility to Small-Claims Consumer Class Actions*, 59 DEPAUL L. REV. 305, 309 (2010) (criticizing the requirement of "ascertainability" in small claims class actions). I criticize this ascertainability requirement below. *See infra Part* II.C.2.

113. Another reason for the insistence on classwide proof of injury arises out of due process concerns. For example, the Second Circuit in *McLaughlin*, quoting *Newton*, noted that since "'actual injury cannot be presumed, . . . defendants have the right to raise individual defenses against each class member.'" McLaughlin v. Am. Tobacco Co., 522 F.3d 215, 232 (2d Cir. 2008) (quoting Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 191–92 (3d Cir. 2001)) (rejecting use of fluid recovery procedures for determining and distributing damages). Similarly, in *Wal-Mart*, the Court rejected the use of sampling to determine damages, concluding that such a "Trial by Formula" is inappropriate because "Wal-Mart will not be entitled to litigate its statutory defenses to individual claims." Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2561 (2011). Thus, if plaintiffs cannot establish the fact of injury on a common basis, courts conclude that the individual rights of the parties, particularly the defendants, must be protected. I discuss these due process concerns in more detail in a separate article. *See* Campos, *supra* note 27, at 1088–1121 (discussing and criticizing due process for procedural rights such as individual defenses). Nevertheless, it should be noted that while the use of imprecise procedures for assessing damages may undermine a defendant's individual defenses, bifurcation keeps intact a defendant's right to assert individual's defenses.

114. *See* Amchem Products, Inc. v. Windsor, 521 U.S. 591, 612 (1997) (acknowledging, but not deciding, issue of whether exposure-only claimants have standing to sue); Ortiz v. Fibreboard Corp., 527 U.S. 815, 831 (1999) (same); *see also* Diane Wood Hutchinson, *Class Actions: Joinder or Representational Device?*, 1983 SUP. CT. REV. 459, 503–04 (discussing standing and mootness issues). The Court recently denied certiorari over the issue of standing in class actions. *See* Stearns v. Ticketmaster Corp., 655 F.3d 1013, 1013 (9th Cir. 2011) *cert. denied*, 132 S. Ct. 1970 (U.S. 2012) (holding that proof of classwide injury is not necessary for the class to have standing for Article III purposes).

This standing issue is of particular relevance because it strikes at the core of the function of the class action. Requiring each class member to demonstrate an injury-in-fact suggests that the class action is a "joinder" device in which the class action merely aggregates disparate plaintiffs together in one suit.[115] In fact, Justice Scalia, who wrote the majority opinion in *Wal-Mart*, has suggested that the class action is a joinder device in other settings.[116] If so, then the class action would require proof of classwide injury to get off the ground for Article III purposes.

One could also view the class action as a "representation" device, in which the only party for purposes of the litigation is the class representative.[117] Understood in this way, each of the absent class members would not have to independently establish standing so long as the representative did so. In fact, as Judge Diane Wood has argued previously, the existing case law supports the "representational" view over the "joinder" view, and the American Law Institute's *Principles of the Law of Aggregate Litigation* (of which Richard Nagareda was a reporter) has explicitly endorsed the "representational" view.[118]

However, the class action is neither a "joinder" device nor a "representational" device. Instead, the class action is a trust device, which becomes apparent once one examines why class actions are preferable in small claims litigation like the antitrust, securities fraud, civil RICO, and employment discrimination cases discussed thus far.[119] The Supreme Court noted in *Amchem Products v. Windsor*,[120] a mass tort case, that:

> The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry po-

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115. *See* Hutchinson, *supra* note 114, at 459–60 (discussing class actions as a "joinder" device).

116. *See, e.g.*, Shady Grove Orthopedic Associates, P.A. v. Allstate Ins. Co., 130 S. Ct. 1431, 1443 (2010) (Scalia, J.) (describing Rule 23 as only "allowing multiple claims (and claims by or against multiple parties) to be litigated together.").

117. Hutchinson, *supra* note 114, at 503–06 (discussing historical vacillation between viewing class actions as "joinder" and as "representational" devices, but arguing in favor of the "representational" view).

118. *See* ALI, *supra* note 19, § 1.01 cmt. c.

119. In what follows I summarize the argument that the class action is a de facto "trust" device. For a more extended argument in favor of the trust function of the class action, see *Campos*, *supra* note 27, at 9. I also discuss the class action trust function and the issue of Article III standing in much more detail in a separate article. *See* Sergio J. Campos, The Trust Function of the Class Action (June 20, 2012) (unpublished manuscript) (on file with author).

120. Amchem Products, Inc. v. Windsor, 521 U.S. 591 (1997).

> tential recoveries into something worth someone's (usually an attorney's) labor.[121]

This rationale for the class action for small claims litigation has been invoked repeatedly by the Court[122] and by scholars.[123]

It is worth unpacking this rationale. In small claims litigation an individual plaintiff lacks an "incentive . . . to bring a solo action prosecuting his or her rights" because the stakes are too small.[124] It would be irrational for a plaintiff to spend his or her own money, or secure financing, when the investment would cost more than the expected return. Put more bluntly by Judge Posner, "only a lunatic or a fanatic sues for $30."[125]

The class action solves this problem of insufficient individual incentive to sue by "aggregat[ing] the paltry potential recoveries" of the plaintiffs.[126] The class action collects together the expected recoveries of the plaintiffs so that the costs of bringing an action, as well as other common investments, are spread among the plaintiffs. In doing so, the class action lowers the average per-plaintiff costs of common investments by increasing the scale of the expected recovery. Put another way, the class action exploits economies of scale to give the plaintiffs incentives both to bring and to invest in the litigation.[127]

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121. *Id.* at 617 (quoting Mace v. Van Ru Credit Corp., 109 F.3d 338, 344 (7th Cir. 1997)).

122. *See, e.g.*, Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 812–13 (1985) (noting that "[r]equiring a plaintiff to affirmatively request inclusion would probably impede the prosecution of those class actions involving an aggregation of small individual claims, where a large number of claims are required to make it economical to bring suit"); Deposit Guar. Nat'l Bank v. Roper, 445 U.S. 326, 339 (1980) ("Where it is not economically feasible to obtain relief within the traditional framework of a multiplicity of small individual suits for damages, aggrieved persons may be without any effective redress unless they may employ the class-action device.").

123. See Brian T. Fitzpatrick, *Do Class Action Lawyers Make Too Little?*, 158 U. PA. L. REV. 2043, 2046 (2010); Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103, 105–06 (2006); William B. Rubenstein, *Why Enable Litigation?: A Positive Externalities Theory of the Small Claims Class Action*, 74 UMKC. L. REV. 709, 710 (2006).

124. *Mace*, 109 F.3d at 344; Campos, *supra* note 27, at 1079 & n.79 (quoting *Mace*).

125. Carnegie v. Household Int'l, Inc., 376 F.3d 656, 661 (7th Cir. 2004) (Posner, J.) (discussing a civil RICO small claims class action).

126. *Amchem*, 521 U.S. at 617 (quoting *Mace*, 109 F.3d at 344).

127. The source of this insight is David Rosenberg in his work on mass tort litigation. *See* David Rosenberg, *The Causal Connection in Mass Exposure Cases: A 'Public Law' Vision of the Tort System*, 97 HARV. L. REV. 849, 902–03 (1984). Recent work by Rosenberg clarifying the problem and how a mandatory class action resolves it include David Rosenberg, *Adding a Second Opt-Out to Rule 23(b)(3) Class Actions: Cost Without Benefit*, 2003 U. CHI. LEGAL F. 19; David Rosenberg, *Mandatory-Litigation Class Action: The*

But it is important to be precise about how the class action creates incentives to invest in the suit through economies of scale. As the *Amchem* Court noted, the aggregation of expected recoveries makes the individual actions "something worth someone's (usually an attorney's) labor."[128] The "usually an attorney's" caveat is crucial. The class action is worth an attorney's labor, in part because class attorneys are typically assigned a percentage of the plaintiffs' aggregate recovery.[129] Moreover, under the common fund doctrine, any investment costs are spread among the class members, even those plaintiffs who do not collect.[130] Accordingly, the expected return of the class attorney is a function of the plaintiffs' aggregate net expected recovery. In other words, the class attorney is given a beneficial interest in the recovery that is consistent with owning the total net expected recovery of the plaintiffs.[131]

In addition to an interest in the plaintiffs' net expected recovery, class attorneys are given control over the plaintiffs' claims. This control is exemplified by one of the most controversial aspects of the class action—the ability of class attorneys to settle the claims of all plaintiffs without their consent. A settlement requires a judicial hearing on its fairness and permits individual class members to raise objections to the settlement, but does not require the consent of the class.[132]

Many scholars have criticized this aspect of the class action as a taking of the plaintiffs' property without their consent.[133] Others have suggested

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Only Option for Mass Tort Cases, 115 HARV. L. REV. 831 (2002); Rosenberg, *Mass Tort Class Actions*, *supra* note 27; David Rosenberg, *Of End Games and Openings in Mass Tort Cases: Lessons from a Special Master*, 69 B.U. L. REV. 695 (1989); David Rosenberg, *Class Actions for Mass Torts: Doing Individual Justice by Collective Means*, 62 IND. L.J. 561 (1987); *see also* Campos, *supra* note 27, at 1064 n.19, 1076–79 (discussing Rosenberg and the function of the class action in allowing the plaintiffs to exploit economies of scale).

128. *Amchem*, 521 U.S. at 617 (quoting *Mace*, 109 F.3d at 344).

129. ALI, *supra* note 19, § 3.13(a) cmt. b (noting that "most courts and commentators now believe that the percentage [of the fee] method is superior" to the "lodestar method").

130. Boeing Co. v. Van Gemert, 444 U.S. 472, 478 (1980) (permitting a district court to apportion costs, including attorneys' fees, against the unclaimed portion of a class action judgment under the "common-fund doctrine").

131. Campos, *supra* note 27, at 1077–78.

132. *See* FED. R. CIV. P. 23(e) (permitting a class action to be settled subject to a fairness hearing).

133. *See, e.g.*, MARTIN H. REDISH, WHOLESALE JUSTICE: CONSTITUTIONAL DEMOCRACY AND THE PROBLEM OF THE CLASS ACTION LAWSUIT 149–51 (2009); John Bronsteen, *Class Action Settlements: An Opt-In Proposal*, 2005 U. ILL. L. REV. 903, 904–07; John Bronsteen & Owen Fiss, *The Class Action Rule*, 78 NOTRE DAME L. REV. 1419, 1419–22 (2003).

mechanisms by which the plaintiffs can still exercise their control (or autonomy) over their claims in a class action, such as by opting out of the class[134] or through voting mechanisms.[135]

But the "taking" caused by the class action can be understood as the transfer of an entitlement to exercise dispositive control over the claims for the benefit of the class. Thus, this transfer is functionally an assignment of "title" over the claims, which is analogous to the title that trustees own over trust assets for the benefit of the beneficiaries.[136]

More importantly, this assignment of title to the class attorney should not be considered per se[137] problematic because the assignment is necessary to make the litigation worth an attorney's "labor." Although the class attorney has a percentage interest in the plaintiffs' net expected recovery, the attorney will not have a reason to invest in common issues unless she has dispositive control over the claims, including the power to sell the claims through settlement. Otherwise, any investments can be thwarted by the independent actions of the plaintiffs, who can bring suit separately and deny any share of the recovery to the class attorney.[138] If the class attorney has nothing, he or she has nothing to lose (or win, for that matter).[139]

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134. ALI, *supra* note 19, § 2.07 cmt. e.

135. See David L. Shapiro, *Class Actions: The Class as Party and Client*, 73 NOTRE DAME L. REV. 913, 921–22 (1998); John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370, 376–77 (2000).

136. RESTATEMENT (THIRD) OF TRUSTS § 2 (2003) (defining a "trust" as a "fiduciary relationship" which "subject[s] the person who holds title to the property to duties to deal with it for the benefit of . . . one or more persons, at least one of whom is not the sole trustee."); Sprint Communications Co., L.P. v. APCC Services, Inc., 554 U.S. 269, 278–80 (2008) (defining, and distinguishing, the "beneficial interest" in a claim from the "legal title" to the claim, and noting that those with only a "legal title" to the claim have sufficient standing to sue, even if they remit all of the "beneficial interest" to another party). I have posed this argument before, see Campos, *supra* note 27, at 1076–79 (discussing the dispositive control the class attorney receives through the class action).

137. I say "per se" because there are, of course, concerns with agency costs, which have preoccupied class action scholars. *See* ALI, *supra* note 19, § 3.13(a) cmt. b. But, as I have argued previously, these agency concerns can be addressed without requiring the consent of the class members. *See* Campos, *supra* note 27, at 1115–17.

138. For a formal discussion and model of this, see Bruce L. Hay, *Asymmetric Rewards: Why Class Actions (May) Settle For Too Little*, 48 HASTINGS L.J. 479 (1997) (arguing that class attorneys may suboptimally settle claims if they do not have dispositive control and a sufficient beneficial interest over all of them).

139. The converse is also true, since owning legal title without a beneficial interest also would not amount to much. *Cf. Sprint*, 544 U.S. at 300–01 (Roberts, J., dissenting) (questioning whether plaintiffs with legal title but no beneficial interest in a claim have sufficient standing for Article III purposes, since "'[w]hen you got nothing, you got noth-

Consequently, the class action cannot be understood as a device that solves the problem of insufficient stakes in small claims litigation without also being understood as a trust device. Indeed, courts generally recognize that it is not the representative who controls investments, but the class attorney. This is because the class attorney, "unlike the representative plaintiff[,] receive[s] compensation reflecting any benefits conferred on the class as a whole," thus making her "willing to underwrite the costs."[140] In essence, the class attorney is the "real party in interest,"[141] and locating standing among the various plaintiffs is, for the most part, a fiction to assuage concerns about the Rules Enabling Act.[142]

More importantly, the trust function of the class action does not entail an all-at-once determination of any issues. The trust function of the class action facilitates investment in common issues by providing sufficient incentive for the class attorney to invest in the case. This trust function, however, does not require the resolution of all common issues in one fell swoop. In fact, so long as the class attorney can make common investments and maintain overall control over the claims, a class action can proceed through completely individual actions. Just like an attorney who expressly represents all of the plaintiffs in a case, a class attorney could choose to file individual suits rather than file a class action, while investing in common issues in the background. Indeed, a court could determine

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ing to lose'" (quoting BOB DYLAN, *Like A Rolling Stone*, *on* HIGHWAY 61 REVISITED (Columbia Records 1965))).

140. *See* Rand v. Monsanto Co., 926 F.2d 596, 599 (7th Cir. 1991) (Easterbrook, J.) (rejecting district court finding that the class representative was not adequate because he or she would not bear the total costs of the litigation, noting that "[t]he very feature that makes class treatment appropriate—small individual stakes and large aggregate ones—ensures that the representative will be unwilling to vouch for the entire costs. Only a lunatic would do so. A madman is not a good representative of the class!").

141. FED. R. CIV. P. 17(a) (providing that "[a]n action must be prosecuted in the name of the real party in interest," including "a trustee of an express trust").

142. Specifically, courts have interpreted the assignment of a cause of action as a matter of "substance" that cannot be modified by rules of civil procedure like Rule 23. *See* 28 U.S.C. § 2072(b) (2006) (prohibiting any rule that "abridge[s], enlarge[s], or modif[ies] any substantive right"); Virginia Elec. & Power Co. v. Westinghouse Elec. Corp., 485 F.2d 78, 83 (4th Cir. 1973) ("Whether a plaintiff is entitled to enforce the asserted right is determined according to the substantive law."). *Cf.* 6A CHARLES A. WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE & PROCEDURE § 1545 (4th ed. 2010) (concluding that substantive law relating to the assignment of claims is the basis for the real-party-in-interest rule). I address this concern in a prior work and in a current project on the Rules Enabling Act. *See* Campos, *supra* note 27, at 1117–21; *see also* Sergio J. Campos, Erie *as a Choice of Enforcement Defaults*, 64 FLA. L. REV. (forthcoming 2012) (on file with author).

both common issues and each plaintiff's damages in individual suits, allowing the common issues to "mature" over time.[143]

The trust function of the class action shows that the class action can provide many of the beneficial features of consolidation procedures such as multidistrict litigation. Scholars have praised the use of multidistrict litigation as a substitute for class actions because it allows for separate suits while permitting better coordination among the plaintiffs for common benefit work.[144] A class action, however, can mimic these same features. In fact, multidistrict litigation, like the class action, often results in the assignment of collective control to attorneys, with some scholars going so far as to call such multidistrict litigation "quasi-class actions."[145]

B. The Extraordinary Remedy Fallacy

In *New Motor Vehicles*, the First Circuit found no predominance of common issues because of the potential variance among the class members' injuries, which, in the court's view, would necessitate individualized trials.[146] The court added, however, that without a "searching inquiry" of the plaintiffs' "novel and complex" theory of injury, "many resources will be wasted setting up a trial that plaintiffs cannot win."[147] Indeed, earlier in the opinion, the First Circuit noted that

> [i]nterlocutory appeals from class certification under Rule 23(f) are especially appropriate where the plaintiffs' theory is novel or where a doubtful class certification results in financial exposure to defendants so great as to provide substantial incentives for defendants to settle

143. *See* Francis E. McGovern, *Resolving Mature Mass Tort Litigation*, 69 B.U. L. REV. 659 (1989) (discussing the benefits of having common issues "mature" through separate actions); *see also* Castano v. Am. Tobacco Co., 84 F.3d 734, 748–49 (5th Cir. 1996) (same); *In re* Dow Corning Corp., 211 B.R. 545, 576, 579 (Bankr. E.D. Mich. 1997) (same).

144. Edward F. Sherman, *The MDL Model for Resolving Complex Litigation if a Class Action is Not Possible*, 82 TUL. L. REV. 2205, 2206 (2008); *see also* Roger Trangsrud, *Joinder Alternatives in Mass Tort Litigation*, 70 CORNELL L. REV. 779, 820–22 (1985).

145. *See* Charles Silver & Geoffrey P. Miller, *The Quasi-Class Action Method of Managing Multi-District Litigations: Problems and a Proposal*, 63 VAND. L. REV. 107, 109–10 (2010) (noting that multi-district litigation in which judges have unfettered discretion to appoint lead counsel are recognized as "quasi-class actions"); *see also* ALI, *supra* note 19, § 1.05 cmt. a ("[A] common structural feature of all aggregate proceedings [is] the loss of control of litigation by persons whose interests are at issue.").

146. *In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 26–28 (1st Cir. 2008).

147. *Id.* at 26, 29.

> nonmeritorious cases in an effort to avoid both risk of liability and litigation expense.[148]

The First Circuit is not alone. Nearly all circuits have emphasized "'[t]he effect of a class certification in inducing settlement to curtail the risk of large awards.'"[149]

One of the strongest examples of this concern can be found in *Oscar Private Equity Investments* v. *Allegiance Telecom Co.*,[150] where the Fifth Circuit reviewed the denial of a securities fraud class action.[151] As background, plaintiffs in securities fraud class actions are required to prove their reliance on the alleged fraudulent statements in buying or selling their shares.[152] Like the reliance requirement in *McLaughlin*, the reliance requirement in securities fraud litigation is an individual issue that could prevent the plaintiffs from satisfying the predominance requirement.[153] However, unlike in cases like *McLaughlin*, the parties can satisfy the predominance requirement by establishing the "fraud-on-the-market" presumption, which is a rebuttable presumption that every member of the class relied on the alleged fraud if the security was traded on an efficient market.[154]

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148. *Id.* at 8 (citing Tardiff v. Knox Cnty., 365 F.3d 1, 3 (1st Cir. 2004); Waste Mgmt. Holdings, Inc. v. Mowbray, 208 F.3d 288, 293 (1st Cir. 2000)).

149. *Id.* (quoting West v. Prudential Sec., Inc., 282 F.3d 935, 937 (7th Cir. 2002) (Easterbook, J.)); *see also* Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 267 (5th Cir. 2007), *overruled by* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011) ("We cannot ignore the *in terrorem* power of certification."); *In re* Hydrogen Peroxide Antitrust Litig., 552 F.3d 305, 310 (3d Cir. 2008) (noting that class actions may "create unwarranted pressure to settle nonmeritorious claims on the part of defendants." (quoting Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 162 (3d Cir. 2001))); McLaughlin v. Am. Tobacco Co., 522 F.3d 215, 231 (2d Cir. 2008) (noting that "[p]ossible recoveries [may] run into astronomical amount [and] generate more leverage and pressure on defendants to settle" (quoting Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1019 (2d Cir. 1973))); *see also* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 558–59 (2007) (noting potential of "*in terrorem*" suits to induce settlements in the context of antitrust class action).

150. 487 F.3d 261.

151. *Id.*

152. Specifically, "reliance is an element of a Rule 10b-5 cause of action" based on fraud because reliance "provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988); *see also* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (reaffirming that "reliance" or "transaction causation" is an element of a § 10(b) and Rule 10b-5 claim).

153. *Basic Inc.*, 485 U.S. at 227–30 (noting the difficulty of satisfying the predominance requirement of Rule 23(b)(3) in securities fraud class actions given the need to prove reliance on an individual basis).

154. *Id.* (discussing the presumption). I discuss the presumption in more detail below. *See infra* Part II.C.2. In addition, and as I discuss below, in *McLaughlin* the Second Cir-

Prior to *Oscar*, the Fifth Circuit held that proof of loss causation, or proof that the alleged fraudulent statement caused a change in the stock price, was a prerequisite for establishing the fraud-on-the-market presumption for purposes of summary judgment.[155] In *Oscar*, the Fifth Circuit considered whether the plaintiffs had to prove loss causation to obtain certification of a securities fraud class action in the first place.[156] This is of particular significance to securities fraud class actions because loss causation is also an element of a securities fraud claim.[157] Thus, requiring the plaintiffs to prove loss causation to establish the fraud-on-the-market presumption at the class certification stage would, in effect, require the plaintiffs to prove the merits of their claims to certify a class.

The Fifth Circuit concluded that the plaintiffs did have to prove loss causation, noting that it could not "ignore the *in terrorem* power of class certification."[158] The *Oscar* court did not stop there. It went on to point out numerous limitations to the class action caused by amendments to Rule 23 and the Private Securities Litigation Reform Act, noting that these changes "recognize that a district court's certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it."[159]

Scholars have also commented on or criticized the extraordinary leverage a class action bestows upon plaintiffs, which may place undue settlement pressure on defendants.[160] In fact, shortly after the passage of the 1966 amendments permitting damage class actions under Rule 23,[161] the great Judge Friendly lambasted the "blackmail settlements" caused by the class action.[162]

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cuit rejected the use of a similar fraud-on-the-market presumption in civil RICO litigation. *See id.*; *see also McLaughlin*, 522 F.3d at 224 n.5 (rejecting use of the fraud-on-the-market presumption in civil RICO litigation).

155. Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 662, 665–66 (5th Cir. 2004).

156. *Oscar*, 487 F.3d at 266.

157. *Dura*, 544 U.S. at 341.

158. *Oscar*, 487 F.3d at 267.

159. *Id.*

160. *E.g.*, Lester Brickman, *On the Relevance of the Admissibility of Scientific Evidence: Tort System Outcomes are Principally Determined by Lawyers' Rates of Return*, 15 CARDOZO L. REV. 1755, 1780–82 (1994); Peter H. Shuck, *Mass Torts: An Institutional Evolutionist Perspective*, 80 CORNELL L. REV. 941, 958 (1995); *see also* Bruce Hay & David Rosenberg, *"Sweetheart" and "Blackmail" Settlements in Class Actions: Reality and Remedy*, 75 NOTRE DAME L. REV. 1377, 1378 nn.4–6 (2000) (citing the scholarly literature on "blackmail" class action settlements).

161. *See generally* Proposed Rules of Civil Procedure for the United States District Courts, 39 F.R.D. 69, 103 (1966) (discussing creation of Rule 23(b)(3) category).

162. HENRY J. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 118–20 (1973); *see also* Milton Handler, *The Shift from Substantive to Procedural Innovations in Anti-*

This concern with the extraordinary leverage of the class action is partially due to the all-at-once fallacy. For support of the view that class actions put undue pressure on defendants to settle, courts have cited *In re Rhone-Poulenc Rorer, Inc.*[163] There, the Seventh Circuit reviewed a petition for a writ of mandamus challenging the certification of a class action of claims related to blood allegedly tainted with the HIV virus.[164] The district court proposed certifying a class action to decide common issues of liability, with the remaining issues decided in individual trials.[165]

The Seventh Circuit court granted the writ of mandamus, ordering the district court to vacate the class certification order. In an opinion by Judge Posner, the Seventh Circuit pointed out that the plaintiffs had lost twelve of thirteen individual actions, and the defendants "are likely to win most of the remaining ones as well."[166] Since the class could run well into the thousands, the Seventh Circuit concluded that a writ of mandamus was warranted given "the sheer *magnitude* of the risk to which the class action, in contrast to the individual actions pending or likely, expose[d]" the defendants.[167] According to the court, separate actions reduce this error risk because they provide "a pooling of judgment . . . of many different tribunals."[168]

As argued above,[169] the class action does not require an all-at-once resolution of common issues. Thus, the class action can take advantage of the pooling of judgment of many trials. In fact, a class action do so by allowing the plaintiffs, under the direction of the class attorney, to sue separately in their preferred forums.

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trust Suits—the Twenty-Third Annual Antitrust Review, 71 COLUM. L. REV. 1, 8–9 (1971) (discussing "blackmail" class actions in the antitrust context, and inspiring Judge Friendly's views on the topic).

163. 51 F.3d 1293 (7th Cir. 1995) (Posner, J.); *see, e.g.*, Castano v. Am. Tobacco Co., 84 F.3d 734, 746 (5th Cir. 1996) (noting that "[i]n addition to skewing trial outcomes, class certification creates insurmountable pressure on defendants to settle, whereas individual trials would not" (citing *Rhone-Poulenc*, 51 F.3d at 1298)). *Cf.* Klay v. Humana, Inc., 382 F.3d 1241, 1274–75 (11th Cir. 2004) (citing *Rhone-Poulenc*, but noting that "[m]ere pressure to settle is not a sufficient reason for a court to avoid certifying an otherwise meritorious class action suit").

164. *Rhone-Poulenc*, 51 F.3d at 1294. Rule 23 has since been amended to permit the interlocutory appeal of class certification orders. *See* FED. R. CIV. P. 23(f).

165. *See* Fed. R. Civ. P. 23(c)(4)(A) (permitting issue only class actions).

166. *Rhone-Poulenc*, 51 F.3d at 1298.

167. *Id.* at 1297 (emphasis in original).

168. *Id.* at 1300.

169. *See supra* Part II.A; *see also* Hay & Rosenberg, *supra* note 160, at 1382 (noting the availability of multiple trials in a class action to reduce error risk in deciding common issues).

But the Seventh Circuit echoes a widely shared view that the class action is analogous to extraordinary remedies, such as the preliminary injunction, that should only be awarded based on a likelihood of success on the merits.[170] The writ of mandamus at issue in *Rhone-Poulenc* is itself a remedy that is "issued only in extraordinary cases," and is only awarded when the challenged order would, among other things, cause "irreparable harm."[171] The *Rhone-Poulenc* court concluded that irreparable harm would result from the class certification order because the plaintiffs' claims were *not* likely to be meritorious, yet would likely lead to, among other things, a "blackmail settlement" that could not be undone by appellate review.[172] In fact, some scholars have argued explicitly for a merits inquiry prior to class certification precisely because of the class action's extraordinary ability to significantly increase the leverage of the plaintiffs.[173]

Many courts follow similar logic in concluding that the class action, like a preliminary injunction, should only be certified based on a likelihood of success on the merits for the plaintiffs. But they do so somewhat clandestinely. In *Eisen v. Carlisle & Jacquelin*,[174] a fairly early decision concerning Rule 23(b)(3), the district court assigned notice costs to the defendant based on a finding that the plaintiffs were likely to succeed on

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170. *E.g.*, Winter v. Natural Res. Def. Council, Inc., 555 U.S. 7, 22 (2008) (noting that preliminary injunctive relief is "an extraordinary remedy that may only be awarded upon a clear showing that the plaintiff is entitled to such relief"); *see also* Mazurek v. Armstrong, 520 U.S. 968, 972 (1997) (per curiam) ("It frequently is observed that a preliminary injunction is an extraordinary and drastic remedy, one that should not be granted unless the movant, *by a clear showing,* carries the burden of persuasion." (quoting 11A CHARLES A. WRIGHT, ET AL., FEDERAL PRACTICE AND PROCEDURE § 2948 (2d ed. 1995))).

171. *Rhone-Poulenc*, 51 F.3d at 1294–95.

172. The court ultimately concluded that the "irreparable injury" here was sufficient given that, along with the undue settlement pressure that would be created by the class action, the proposed class action could lead to a reexamination of issues in violation of the parties' Seventh Amendment rights. *Id.* at 1299. But, as I have argued previously, bifurcation along the lines proposed by the district court in *Rhone-Poulenc* would not result in any reexamination of issues. *See* Campos, *supra* note 27, at 1073.

173. *See* Bone & Evans, *supra* note 19, at 1254; Hazard, *supra* note 19, at 3–6. Others have at least noted the potential for class actions to lead to the settlement of nonmeritorious claims, although many disagree as to the precise effect. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991); Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991); Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action under the Federal Securities Laws:The Commission's Authority,"* 108 HARV. L. REV. 438 (1994).

174. 417 U.S. 167 (1974).

the merits.[175] The district court did so by explicitly analogizing the class action to a "preliminary injunction."[176] The *Eisen* Court, however, vacated the district court's order because it "f[ound] nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action."[177] Thus, under *Eisen*, a district court deciding to certify a class action cannot review the merits unless it has authority to do so under Rule 23.

As it turns out, courts have found a way to review the merits at the class certification stage by insisting on proof of classwide injury to satisfy the predominance requirement of Rule 23(b)(3). After all, to provide proof of "common answers" as to injury, plaintiffs must prove a common injury. Accordingly, this "overlap" between the predominance requirement and the merits permits courts to review the merits without running afoul of *Eisen*.[178] In *New Motor Vehicles*, for example, the court held that the district court must test the plaintiffs' "novel and complex" theory of common impact, both to satisfy the predominance requirement of Rule 23(b)(3) and to avoid "a doubtful class certification" that puts undue pressure on the defendants to settle.[179] Similarly, in *Oscar*, the court concluded that proof of loss causation was both "central to the certification decision," as well as necessary given the "*in terrorem* power of certification."[180]

In some cases the overlap between the "predominance" requirement and the merits leads to overreaching. In *Oscar*, for example, the insistence on proof of loss causation to support a finding of predominance is unwarranted for at least two reasons. First, proof of loss causation is

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175. *Id.* at 179.

176. *Id.* at 168.

177. *Id.* at 177; *see also* Nagareda, *Class Certification*, *supra* note 19, at 100 (discussing *Eisen* and acknowledging that "Rule 23 does not require proponents of class certification to satisfy a preliminary injunction-like standard cast in terms of the likelihood of success on the merits").

178. *See, e.g.*, *In re* Initial Pub. Offerings Sec. Litig., 471 F.3d 24, 33–34 (2d Cir. 2006) (concluding that requiring proof of classwide injury in a securities fraud class action does not violate *Eisen* because such proof is required to satisfy the predominance requirement); *see also* Nagareda, *Class Certification*, *supra* note 19, at 100 (noting, and approving, trend by courts to "make a 'definite assessment' that the [class action] requirements have been met, even if that assessment entails the resolution of conflicting proof and happens to overlap with an issue—even a critical one—on the merits").

179. *In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 8, 28 (1st Cir. 2008).

180. Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 267 (5th Cir. 2007), *overruled by* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011).

common to the class. Either the fraud affected the share price or it did not. Second, and more importantly, proof of loss causation is unrelated to proof of transaction causation, because proof of any price change caused by the fraud (as opposed to other causes) does not necessarily imply proof of reliance by each investor. Indeed, the Supreme Court focused on this reason in reversing *Oscar*.[181] In fact, insofar as the fraud-on-the-market presumption establishes loss causation by permitting an inference that any fraud in an efficient market would affect the price, insisting on proof of loss causation would "requir[e] the plaintiffs to prove . . . the very facts that are to be presumed."[182]

More generally, the extraordinary remedy fallacy, like the all-at-once fallacy, is itself flawed because it takes a mistaken view of the function of the class action. As discussed earlier, the class action can be understood as a trust device that assigns dispositive control over the plaintiffs' claims, plus an interest in any potential net recovery, to the class attorney.[183] In doing so, the class action allows the class attorney to spread the costs of investments in common issues among all of the plaintiffs.[184] Moreover, the class attorney will have an incentive to invest in common issues because he or she will have a partial interest in the plaintiffs' total net recovery.

But why go through the ordeal of certifying a class action to economize on common investments? It may turn out that, from the plaintiffs' perspective, the costs of litigation simply fail to justify the litigation, even when they are spread across the entire class.[185] Admittedly, much has been said about increasing access to justice, particularly in light of other developments in civil procedure doctrine.[186] In small claims litiga-

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181. *Halliburton*, 131 S. Ct. at 2186, *overruling Oscar*, 487 F.3d 261 (noting that proof of loss causation "has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory").

182. *Oscar*, 487 F.3d at 274 (Dennis, J., dissenting); *see also* Nagareda, *Class Certification*, *supra* note 19, at 140 (criticizing *Oscar* on these grounds).

183. *See supra* Part II.A.

184. Campos, *supra* note 27, at 1077–79; *see also* Rosenberg, *Mass Tort Class Actions*, *supra* note 27, at 395.

185. For an extreme example, see Kamilewicz v. Bank of Bos., 92 F.3d 506, 508, 512 (7th Cir. 1996) (upholding a state-court class action settlement in which a class member received $2.19 but was assessed a fee of $91.33).

186. *See, e.g.*, A. Benjamin Spencer, *The Restrictive Ethos in Civil Procedure*, 78 GEO. WASH. L. REV. 353, 353–54 (2010) (criticizing a "restrictive ethos" among courts in which rules pertaining to pleading, case management, and the class action, among others, are "being developed, interpreted, and applied in a manner that frustrates the ability of claimants to prosecute their claims and receive a decision on the merits in federal court").

tion, however, the stakes for an individual plaintiff do not seem to justify the extraordinary measures needed for the class action. In fact, most small claims plaintiffs never bother to collect whatever the class attorney happens to recover.[187]

The trust function of the class action makes more sense once one considers the defendant's incentives to invest in common issues. Unlike the plaintiffs, the defendant owns all of the expected liability associated with any common issue.[188] Thus, the defendant does not need a class action to aggregate the stakes and spread the costs of investments in common issues. It follows that, in the absence of a class action, the defendant will invest more in common issues than the plaintiffs because the defendant has more at stake.

Moreover, the plaintiffs cannot voluntarily match the stakes of the defendant, such as through joinder or informal aggregation, because of collective action problems caused by market limitations, transaction costs, and strategic behavior.[189] Put another way, legal limits on selling a claim, the costs of coordinating the plaintiffs' common investments, and the potential for free-riding and hold-outs, make it impossible for the plaintiffs to match the stakes of the defendant, at least voluntarily.

Consequently, the class action is utilized in small claims litigation because of the asymmetry of stakes.[190] The class action, in effect, equalizes the stakes between the plaintiffs and the defendant by incentivizing the class attorney to invest in common issues as if he or she had the entire amount at stake. It does so to correct the bias in favor of the defendant in the litigation. Otherwise, the defendant in small claims litigation can escape significant liability because of its advantage in investing in common issues. Thus, even if the plaintiffs are indifferent to recovering in a small claims class action, the class action at least prevents the defendant from enjoying the fruits of its illegality.[191]

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187. *See* Gilles, *supra* note 112, at 315 (noting that "[i]nvariably, in small-claims consumer class actions, less than twenty percent or so of class action damages funds are distributed to plaintiff claimants" (citing Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 FLA. L. REV. 71, 120 (2007)).

188. This expected liability is the flipside of the expected recovery for the plaintiffs. *See* Campos, *supra* note 27, at 1074–76.

189. *See id.* at 1079–81.

190. *See id.* (discussing the asymmetry). *Cf.* ROBERT G. BONE, THE ECONOMICS OF CIVIL PROCEDURE 246–48 (2003) (discussing the problem of "asymmetric stakes" in the context of nonmutual offensive collateral estoppel).

191. This concern with preventing the defendant from escaping its liability has an obvious deterrence function, which I will discuss in more detail later when I discuss the defendant's ex-ante conduct. *See infra* Part II.C.

Admittedly, the class action increases the leverage of the plaintiffs, but the whole point of the class action is to do precisely that. In the absence of the class action, the defendant has an inherent advantage in leverage that can allow it to avoid some or all of the liability associated with any common issue. As noted by Richard Nagareda, even if the class action increases the plaintiffs' leverage and increases the settlement pressure on the defendant, it does not necessarily mean that this increase is unjustified.[192] This is particularly so when the claims are small and the alternative to a class action is no litigation at all. In fact, ensuring the parties negotiate on a level playing field is necessary to prevent the class attorney from selling out the plaintiffs' interests by accepting a too-low, "sweetheart" settlement with the defendant.[193]

Accordingly, a merits determination prior to class certification defeats the purpose of the class action. The class action is designed to permit the plaintiffs to invest in the merits on equal terms with the defendant. Thus, a class action only works if it is available before a court decides the merits, not after. As put by Judge Torruella's dissent in *New Motor Vehicles*:

> In this case, an inquiry that tests each stage of the plaintiffs' theory is, in effect, an assessment of the case's merits. As such, *we are putting the cart before the horse* and turning the class certification stage into a motion for summary judgment proceeding—the appropriate juncture at which to fully vet the viability of the plaintiffs' theory.[194]

In fact, in putting the cart before the horse by examining the merits before class certification, courts are allowing defendants to escape some or all of their liability.

C. The Individualist Fallacy

The all-at-once fallacy presumes that the class action requires an all-at-once determination of all issues. But the all-at-once fallacy relies on a further premise. It presumes that separate actions are required to resolve issues that are specific to each individual plaintiff. Thus, if the fact of injury cannot be proven on a classwide basis, then it must be determined separately for each plaintiff. This further premise is what I call the individualist fallacy.

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192. RICHARD A. NAGAREDA, MASS TORTS IN A WORLD OF SETTLEMENT 43–48 (2007).

193. Hay & Rosenberg, *supra* note 160, at 1379–82 (discussing sweetheart settlements and the need for a mandatory class action to curtail them).

194. *In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 32 (1st Cir. 2008) (Torruella, J., dissenting) (emphasis added).

The individualist fallacy is motivated by the need to prevent uninjured plaintiffs from recovering.[195] In *Neurontin*, which is discussed earlier, the district court denied class certification of a class allegedly harmed by the fraudulent marketing of the drug Neurontin as a pain reliever.[196] The court was persuaded by the evidence of the plaintiffs' expert, which showed the aggregate damages caused by the fraudulent marketing scheme.[197] However, the district court rejected the plaintiffs' proposed procedure for distributing the damages.[198] The court recognized that a "fluid recovery" or "cy pres" process, in which the aggregate amount of damages is assessed and then later distributed to the class, can be permissible in a class action even if the procedure does not guarantee "absolute precision."[199] According to the court, however, a "fluid recovery" procedure cannot "circumvent the bedrock principle that members of a class must be identifiable."[200] Thus, the proposed procedure was fatally flawed because it "failed to articulate a method of identifying *any* members of the consumer class."[201]

Like the previous fallacies, the individualist fallacy appears to be a matter of common sense. Shouldn't individual issues be determined in individual trials? Why should uninjured plaintiffs recover? But like the previous fallacies, the individualist fallacy is mistaken. This is so for three reasons.

1. Accuracy

First, the individualist fallacy is mistaken because individual trials are not necessarily more accurate than common, all-at-once trials in determining whether each plaintiff was injured. As an initial matter, the individual evidence of injury may be unreliable. Eyewitness testimony, for example, is notoriously unreliable—memories fade, individuals often color past events when recalling them, and the plaintiffs are far from disinterested parties.[202] Moreover, given the low monetary amounts at stake

195. Gilles, *supra* note 112, at 310 (discussing, and criticizing, courts' "[u]neasiness with disunity—with the possibility of compensating uninjured parties").

196. *In re* Neurontin Mktg. & Sales Pracs. Litig., 244 F.R.D. 89, 91 (D. Mass. 2007); *see also supra* Part I (discussing *Neurontin*).

197. *Id.* at 111 ("Based on this preliminary record, I conclude that [the] proposed methodology is a plausible way of determining aggregate class-wide liability.").

198. *Id.* at 111–13.

199. *Id.* at 112 (quoting 3 NEWBERG ON CLASS ACTIONS, *supra* note 105, § 10:5).

200. *Id.* at 113.

201. *Id.* (emphasis in original).

202. This point has been made extensively in the criminal context. *See* Suzannah B. Gambell, *The Need to Revisit the* Neil v. Biggers *Factors: Suppressing Unreliable Eyewitness Identifications*, 6 WYO. L. REV. 189, 196–202 (2006); *see also* State v. Hender-

in small claims litigation, it is unlikely that any individual plaintiff would preserve relevant evidence.[203]

More importantly, individual trials are not necessarily more accurate than common ones because the evidence of each plaintiff's injury may not be unique to each plaintiff. As argued above, the difficulty in proving classwide injury arises from counterfactual uncertainty.[204] The plaintiffs cannot prove that every plaintiff was injured by the defendant's alleged conduct because there is uncertainty as to whether some of the plaintiffs were in the same position or better off in the absence of the alleged legal violation. If the plaintiffs could identify which plaintiffs were, in fact, not injured, they would simply exclude them from the class. Thus, proving classwide injury requires evidence of the counterfactual that would demonstrate which specific plaintiffs were, in fact, injured.

If establishing classwide injury turns on proof of the counterfactual, it may turn out that evidence of the counterfactual may be common to some or all of the class members. In *Klay*, for example, the Eleventh Circuit concluded that it did not "strain credulity to conclude" that each of the plaintiff doctors relied on the HMOs' representations that the plaintiffs would be paid in accordance with the terms of their contracts.[205] In so concluding, the Eleventh Circuit relied on its judgment and experience as to how a doctor would behave in negotiating contracts with HMOs, both with and without the fraud.[206] In contrast, the Second Circuit could not provide the same benefit of the doubt to the smokers that comprised the class in *McLaughlin*. There, the court could imagine some smokers in the class who would have smoked light cigarettes even in the absence of the fraud. Indeed, the district court in *McLaughlin* acknowledged that possibility as well.[207] But the larger point is that the evidence of the

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son, 27 A.3d 872, 894–922 (N.J. 2011) (overruling, in a criminal case, previous rule on eyewitness testimony based on recent research on the unreliability of such testimony).

203. Gilles, *supra* note 112, at 316 (noting that in small claims consumer class actions "[n]o one keeps the receipt for a pineapple").

204. *See supra* Part I.

205. Klay v. Humana, Inc., 382 F.3d 1241, 1259 (11th Cir. 2004).

206. Greiner, *supra* note 70, at 560 (noting that "[t]he trier of fact in individual cases uses the evidence presented at trial and its own understanding of how the world works to fill in the missing potential outcome and, subject to other relevant legal principles, decides the case accordingly").

207. Schwab v. Philip Morris USA, Inc., 449 F. Supp. 2d 992, 1021 (E.D.N.Y. 2005) (Weinstein, J.), *overruled by* McLaughlin v. Am. Tobacco Co., 522 F.3d 215 (2d Cir. 2008) (noting that "the amount of economic damages it suffered appears to be quite weak—and plaintiffs have been less than candid in failing to acknowledge that deficiency in their proof").

counterfactual may point in the direction of similarity (reliance by doctors) rather than dissimilarity (reliance by smokers).

In fact, individual actions utilize common evidence all the time. In individual mass tort actions, for example, plaintiffs often prove injury by analogizing to other cases, in effect importing the counterfactual from one case to another.[208] Indeed, a classwide proceeding could improve upon the use of common evidence in individual actions by using statistical techniques to avoid any biases.[209]

2. Avoiding Compensating Uninjured Plaintiffs

As noted above, the individualist fallacy demands accurate measures of injury for each individual plaintiff to prevent uninjured plaintiffs from recovering. But the individualist fallacy is further mistaken because there is, in fact, no "bedrock principle" prohibiting uninjured plaintiffs from recovering.[210]

Consider, for example, the fraud-on-the-market presumption in securities fraud litigation.[211] The Supreme Court first blessed the presumption in *Basic Inc. v. Levinson*,[212] a case in which the plaintiffs alleged that the defendant "made three public statements denying that it was engaged in merger negotiations," but nevertheless announced a merger about three months after those statements.[213] The plaintiffs were shareholders who sold their stock in the period between the statements denying the merger talks and the announcement of the merger, when the price of the stock was "artificially depressed."[214] To recover, the plaintiffs were required to prove their reliance on the fraudulent misstatements in selling their shares.[215] Nevertheless, the district court certified the class by permitting

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208. Deborah R. Hensler & Mark A. Peterson, *Understanding Mass Personal Injury Litigation: A Socio-Legal Analysis*, 59 BROOK. L. REV. 961, 967 (1993) (noting that "[i]n mass litigation, the likely amount that one plaintiff will receive for a claim depends upon the values of other claims").

209. Alexandra D. Lahav, *The Case for "Trial By Formula,"* 90 TEX. L. REV. 571, 612–18 (2012) (arguing for the use of statistical methods in aggregate proceedings to avoid outcome bias among plaintiffs); *see also* Greiner, *supra* note 70, at 534 (discussing "potential outcomes" approach that seeks to approximate a randomized experiment to produce strong inferences with respect to issues of fact in civil rights cases).

210. *In re* Neurontin Mktg. & Sales Pracs. Litig., 244 F.R.D. 89, 113 (D. Mass. 2007) (identifying the "bedrock principle" of preventing uninjured plaintiffs from recovering).

211. Basic Inc. v. Levinson, 485 U.S. 224, 247–48 (1988) (discussing the presumption); *see also supra* Part II.B (same).

212. *Id.*

213. *Id.* at 227–28.

214. *Id.* at 228.

215. *Id.* at 243.

the plaintiffs to presume reliance based on the fact that the shares were traded on an efficient market.

The Supreme Court found no error in establishing such a fraud-on-the-market presumption. The Court stated that

> [t]he fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.[216]

The Court further noted that the defendants could rebut the presumption but suggested that any such showing should occur at trial.[217]

Admittedly, the fraud-on-the-market presumption only presumes classwide reliance, not "economic loss."[218] However, once the presumption has been established, courts have further presumed injury, since "the price at which the stock is traded is presumably affected by the fraudulent information, thus injuring every investor who trades in the security."[219]

The Supreme Court recently reaffirmed the availability of the fraud-on-the-market presumption.[220] Few courts, however, have extended the use of such a presumption beyond the securities context. In *McLaughlin*, for example, the court went to great lengths to disavow the use of a fraud-on-the-market presumption for the plaintiffs' civil RICO fraud

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216. *Id.* at 241–42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)). For support of the "fraud on the market theory," the Court noted that then "[r]ecent empirical studies" concerning the efficient capital markets hypothesis ("ECMH") "have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations," although it disclaimed from adopting the efficient capital market hypothesis (at least in its strong form) completely. *Id.* at 246, 246 n.24; *see also* Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1575 (1991) (discussing ECMH).

217. *Basic Inc.*, 485 U.S. at 248.

218. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (noting that "reliance" and "economic loss" are two separate elements of a securities fraud claim); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 179–80 (3d Cir. 2001) (vacating certification of securities fraud class action where classwide reliance was presumed, but economic loss could not be established through common proof).

219. *Newton*, 259 F.3d at 179 (citing *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1419 n.8 (3d Cir. 1997)).

220. Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2186 (2011).

claims.[221] The court stressed that "*Basic* involved an efficient market" while "the market for consumer goods . . . is anything but efficient."[222]

But despite its name, the fraud-on-the-market presumption does not actually establish classwide reliance, at least not in the sense understood in cases such as *McLaughlin*. Instead, it only shows that the fraudulent statements would cause a change in the price of the security.[223] Accordingly, the only reliance established by the fraud-on-the-market presumption is the plaintiffs' "reliance on the integrity of th[e] price."[224] Neither courts nor scholars pretend that such reliance is a presumption "that all investors actually read, heard, or were otherwise aware of the alleged misrepresentation."[225] An investor can get a tip from his uncle, rely on the "integrity of the price," and recover without having any knowledge of the misrepresentation. In *McLaughlin*, a lack of classwide proof of such knowledge was fatal to class certification. In *Basic*, this lack of knowledge was irrelevant.[226]

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221. In fact, the Second Circuit accused the plaintiffs of "invok[ing] the fraud-on-the-market presumption set forth in *Basic*" when the plaintiffs explicitly represented that they "are not advocating the same 'fraud-on-the-market' presumption applicable in a securities case." McLaughlin v. Am. Tobacco Co., 522 F.3d 215, 224, 224 n.5 (2d Cir. 2008).

222. *Id.* at 224.

223. In fact, if the fraud-on-the-market presumption establishes anything, it demonstrates "loss causation," or "a causal connection between the material misrepresentation and the loss." *Dura*, 544 U.S. at 342. Even then, the fraud-on-the-market presumption does not conclusively establish loss causation since it only establishes that an efficient market would have been sensitive to the fraud. The presumption does not show that any price adjustment was in fact caused by the fraud as opposed to other causes. *Cf. Halliburton*, 131 S. Ct. at 2168 (noting that fraud-on-the-market presumption should not be confused with a showing that a "misrepresentation that affected the integrity of the market price also caused a subsequent economic loss.").

224. Basic v. Levinson, Inc., 485 U.S. 224, 247 (1988).

225. Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 158 (noting that the fraud on the market presumption does not presume actual reliance by the plaintiffs); Stark Trading v. Falconbridge Ltd., 552 F.3d 568, 572 (7th Cir. 2009) (Posner, J.) ("[A] fraud affects the price of a publicly traded security [because] investors will be affected *even if they trade without knowledge of the misrepresentations* that influenced the price at which they traded.") (emphasis added); Merritt B. Fox, *After* Dura*: Causation in Fraud-on-the-Market Actions*, 31 J. CORP. L. 829, 839 (2006) (noting that "[f]raud-on-the-market actions are distinctly different from actions based on traditional reliance," since they do not require a plaintiff "to show that she would have acted differently but for the wrongful misstatement").

226. In fact, the *Basic* court came close to eliminating the reliance requirement altogether. Langevoort, *supra* note 225, at 162, 162 n.45 (noting that Justice Brennan pushed Justice Blackmun to adopt a position "in which all persons trading at a distorted price were entitled to the presumption, and found little reason to create grounds for rebuttal"). Moreover, early articulations of the fraud-on-the-market presumption did not invoke reliance at all. *See* Blackie v. Barrack, 524 F.2d 891, 906–07 (9th Cir. 1975) (holding that

A similar presumption is employed in antitrust price-fixing cases, where plaintiffs allege that competitors conspired to fix the price of a good above the competitive price.[227] As in cases that permit the fraud-on-the-market presumption, courts have permitted plaintiffs to presume classwide injury in price-fixing cases because "an illegal price-fixing scheme presumptively damages all purchasers of a price-fixed product in an affected market."[228] In fact, a court is permitted to calculate damages for each plaintiff based simply on the "overcharge"—the difference between the inflated price and "what prices would have been without the unlawful conduct."[229]

The price-fixing context seems to avoid the counterfactual uncertainty found in cases like *New Motor Vehicles* because the shift in the "baseline" of the price—from the competitive price to the fixed price—is the same for every class member. Accordingly, courts have consistently refused to use such "baseline" damages where, as in *New Motor Vehicles*, the parties have the option to negotiate or contract around prices to avoid any loss.[230] Courts have refused to presume impact even in price-fixing cases where the "baseline" price is not the same for the entire class, suggesting that such variation reintroduces the counterfactual uncertainty traditional price-fixing cases avoid.[231]

"proof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market," requiring instead only "proof of purchase and the materiality of the misrepresentations").

227. Horizontal price-fixing among competitors is per se illegal under Section 1 of the Sherman Act. *See* 15 U.S.C. § 1 (2006) ("Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce . . . is declared to be illegal."); United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 228 (1940) ("[P]rice-fixing combinations . . . are illegal per se; they are not evaluated in terms of their purpose, aim or effect in the elimination of so-called competitive evils.").

228. Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 179 n.21 (3d Cir. 2001) (quoting *In re* NASDAQ Market-Makers Antitrust Litig., 169 F.R.D. 493, 526 (S.D.N.Y. 1996)); *see also In re* Pharm. Indus. Average Wholesale Price Litig., 230 F.R.D. 61, 93 (D. Mass. 2005) (accepting plaintiffs' argument that "it may be assumed in [price-fixing] cases that by preventing competition in a typical market defendants have raised prices to all purchasers").

229. 6 NEWBERG ON CLASS ACTIONS, *supra* note 105, § 18:53 (noting that this method can be used to determine "classwide damages" in price-fixing cases).

230. *Pharm. Indus.*, 230 F.R.D. at 94 (rejecting a "baseline-impact" method for determining damages for civil RICO claims given that "the PBM, wholesale, and pharmacy markets for the procurement of prescription drugs are highly-competitive; therefore, unlike in a price fixing conspiracy, 'payors can leverage this competition to dissipate the effects of the alleged AWP scheme'").

231. *See, e.g.*, *In re* Hydrogen Peroxide Antitrust Litig., 552 F.3d 305, 325–26 (3d Cir. 2008) (vacating class certification where court erroneously presumed antitrust impact in

But looks are deceiving. Suppose that a plaintiff would have bought a widget for $10 a unit, the fixed spot price for the widget is $9 a unit, and the competitive spot price is $8 a unit. Further suppose that given his willingness to pay,[232] the plaintiff would have negotiated a contract with the seller to buy the widget for $10 a unit, and would have negotiated such a contract in both the actual world and the counterfactual world because he is a poor negotiator.

If the plaintiff did, in fact, enter into a $10 contract, would he have been injured if the spot price had been $8 in the counterfactual world and $9 in the actual one? According to the *New Motor Vehicles* court, the answer is no, since the plaintiff would pay a $10 price in both worlds.[233] But what if the plaintiff had the same willingness to pay but simply bought at the spot price? In both contexts the buyer faces the risk that the spot price may be less or more than his willingness to pay. If he chooses to assume the risk and only pay the spot price, he can recover. However, if he chooses to avoid the risk and lock in his preferred price ex ante through a contract, then he cannot.

The only relevant difference between the contract context and the spot price context is that the contract context allows the plaintiff to memorialize his ex ante preferences. In the spot price context, by contrast, the plaintiff can have the same ex ante preferences but simply stay quiet about having them in the first place.[234] In essence, the baseline method of

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price-fixing case, because the evidence suggested that some plaintiffs paid divergent prices, and some even paid lower prices, during the class period).

232. Admittedly, introducing the concept of "willingness to pay" raises the possibility of endowment effects, where an individual's "willingness to pay" and "willingness to accept" the same good may depend on whether the individual already has the good or is acquiring it. *See* RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 63–68 (1994). While I acknowledge the effect, it is independent of the basic point I am making here, that a more refined focus on a plaintiff's ex-ante preferences may reveal that he or she is not injured.

233. *In re* New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 29 (1st Cir. 2008) (noting that poor negotiators may not have been injured since they may have paid the same price in both worlds).

234. Indeed, the same method of ignoring the ex-ante preferences of the plaintiff arises in the securities context, where most plaintiffs are effectively purchasing securities at spot prices. Because we seldom have accurate evidence about investors' willingness-to-pay, we permit recovery for an overcharge caused by fraud even if the investor would have paid for the security at the artificially inflated price, or sold at the artificially depressed price, despite the fraud. I thank David Rosenberg for clarifying my thinking on the possibility that ex-ante expectations may vary among the class, leading to situations in which some plaintiffs are not, in fact, injured.

proving classwide injury avoids counterfactual uncertainty by ignoring any uncertainty in each plaintiff's ex ante preferences.[235]

As shown above, the use of presumptions and baselines in the securities and antitrust contexts may permit uninjured plaintiffs to recover. Because of presumptions and baselines, plaintiffs in securities fraud cases may recover without necessarily relying on the fraud, and plaintiffs in price-fixing cases may recover even if they would have paid the same price in the absence of the price-fixing conspiracy.

Although the use of presumptions and baselines in securities and antitrust litigation permit courts greater "flexib[ility]" in processing securities and antitrust claims, they are not necessarily intended to operate in other substantive areas.[236] According to Nagareda, courts permit the use of economic and statistical theories to support presumptions and baselines only in contexts where "economics is one with legal doctrine," such

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235. The ignorance of ex ante expectations becomes clear when one considers the possibility of price discrimination in the counterfactual world. Imagine, for example, a market in which the price is fixed at $6, the competitive average price would be $5, but a seller in a competitive market could engage in some price discrimination. Under this scenario, a plaintiff could pay $9 (his willingness-to-pay) in the competitive world, but only $6 in the actual world. I thank Fred McChesney for clarifying my thinking on these points. *Cf.* MICHAEL D. WHINSTON, LECTURES IN ANTITRUST ECONOMICS 6–7, 7 n.5 (2008) (asking "should a merger of competitors that creates a perfectly discriminating monopolist that leads to a small increase in productive efficiency be allowed? While such a merger raises aggregate surplus it will also make consumers who are not shareholders worse off"). Admittedly, perfect price discrimination is impossible in a perfectly competitive market, and in most cases is otherwise illegal under the Robinson-Patman Act. *See* 15 U.S.C. § 13 (2006) (prohibiting, with some exceptions, "any person engaged in commerce . . . to discriminate in price between different purchasers of commodities of like grade and quality"). But some amount of price discrimination occurs in sufficiently competitive markets, such as markets that provide student discounts.

236. *See* Nagareda, *Class Certification*, *supra* note 19, at 172 (arguing in favor of a context-specific approach since "[a] securities fraud claim is different from an employment discrimination claim. Each, in turn, differs from an antitrust or RICO claim"). *But see* Samuel Issacharoff, *The Vexing Problem of Reliance in Consumer Class Actions*, 74 TUL. L. REV. 1633, 1654 (1999) (suggesting that the use of different standards and presumptions for proving reliance in some contexts but not others is a reflection of "ongoing uncertainty as to the true state of substantive law," and suggesting that the same standards should apply transubstantively). These doctrines could be justified by a preference by Congress to vigorously enforce antitrust and securities fraud law, but the Congressional preference for vigorous enforcement of at least the securities laws has been cast in doubt by the passage of statutes in the late 1990s to limit the use of class actions for securities fraud claims. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227–28 (codified as amended in scattered sections of 15 U.S.C.); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

as securities fraud and antitrust litigation.[237] Indeed, other features of antitrust and securities law, particularly the direct purchaser rule, which explicitly permits noninjured parties to recover,[238] suggest that the procedures that apply in antitrust and securities litigation are unique to those contexts.[239]

But these economic and statistical doctrines are not, in fact, limited to certain substantive areas. The difficulty of proving classwide injury can be understood as a problem of inferential reasoning—to what extent can a court infer causation when it cannot directly compare the actual with the counterfactual. Indeed, recent developments in statistics have returned to the common sense notion of "but-for causation with a special focus on time."[240] Since the problem of proving facts through inferential, or circumstantial, evidence is as old as the law itself, one can view the fraud-on-the-market presumption or the use of baseline damages in price-fixing cases as variations on common legal techniques for dealing with counterfactual uncertainty.

For example, the fraud-on-the-market presumption is analogous to presumptions of reliance used for common law fraud claims, which, similar to securities fraud claims, are based on "entitlement[s] to rely on representations of fact by strangers whether or not there is any reason to trust them, because doing so facilitates economic exchange."[241] Likewise, the use in the antitrust context of "baseline" damages as a "just and reasonable" inference of damage is no more different than the doctrines used to establish "general" damages that are the "foreseeable" and "natural consequences" of the legal violation.[242] Indeed, the use of reasonable infer-

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237. Nagareda, *Class Certification*, *supra* note 19, at 106–07 (noting that in the antitrust and securities context, "economics is one with legal doctrine," and thus competing expert testimony "ultimately convey competing accounts of law," while in the civil RICO and employment discrimination context "the integration of legal doctrine and social science is still a tentative, contested enterprise").

238. Hanover Shoe, Inc. v. United Shoe Mach. Corp., 392 U.S. 481, 492–94 (1968) (rejecting "passing on" defense for purposes of challenging standing); Ill. Brick Co. v. Illinois, 431 U.S. 720, 729–36 (1977) (holding that only direct purchasers have standing to sue for violations of the federal antitrust laws).

239. *But see* Gilles, *supra* note 112 (arguing that the direct purchaser rule and the availability of punitive damages argues against requiring a showing of ascertainability of the plaintiffs).

240. Greiner, *supra* note 70, at 537 (discussing the recent "potential outcomes" statistical approach to establishing causation, which focuses on but-for causation over time).

241. Langevoort, *supra* note 225, at 161 (citing RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 111 (7th ed. 2007)).

242. *See, e.g.*, RESTATEMENT OF CONTRACTS § 330 cmt. e, Special Note (1932) (defining "general" damages as those that are "foreseeable" and the "natural consequence" of the breach); RESTATEMENT OF TORTS § 904 (1939) (same).

ences is at work in a case like *Klay*, where the court permitted a finding of common proof of reliance since it "d[id] not strain credulity" that each of the doctors relied on the representations of the HMOs.[243]

The ignorance of a plaintiff's ex ante expectations, which is crucial to the operation of the fraud-on-the-market presumption and the use of baseline damages in antitrust law, is pervasive. Consider a modern, run-of-the-mill personal injury case. Suppose that a plaintiff purchases a car with a defective accelerator[244] and sues to recover from the manufacturer for any design or manufacturing defect.[245] If one takes a *New Motor Vehicles* approach to the issue of injury, one would focus on the ex ante expectations of the plaintiff in purchasing the car. Would the plaintiff have purchased the car for the same price had he or she known of the defect? Or would the plaintiff have negotiated a lower price in the but-for world because of the risk created by the defect? If so, what would the plaintiff have been willing to pay for a defect-free car (assuming, of course, some modicum of negotiating skill)? Isn't the real injury the imposition of an additional risk that the plaintiff would not have accepted in the counterfactual world at the price he or she paid?

In tort litigation involving personal injuries, U.S. courts explicitly reject such "loss of value" claims[246] and typically ignore the "expectancies" of the plaintiff altogether.[247] Instead, courts presume that, in the

243. Klay v. Humana, Inc., 382 F.3d 1241, 1259 (11th Cir. 2004).

244. *E.g.*, *In re* Toyota Motor Corp. Unintended Acceleration Mktg., Sales Practices, & Prods. Liab. Litig., 704 F. Supp. 2d 1379, 1381–82 (J.P.M.L. 2010) (ordering transfer of actions concerning alleged "sudden, unintended acceleration" defect in Toyota cars for consolidation in the Central District of California pursuant to 28 U.S.C. § 1407 (2006)).

245. *See* RESTATEMENT (THIRD) OF TORTS § 2 (1998) (providing for liability for design defects, manufacturing defects, and failures to warn).

246. *See In re* Bridgestone/Firestone, Inc. Tire Products Liab. Litig., 288 F.3d 1012, 1017 (7th Cir. 2002) (Easterbrook, J.) (rejecting claims of breach of implied warranty due to defect in tire, noting that "most states would not entertain the sort of theory that plaintiffs press").

247. *See* DOUGLAS LAYCOCK ET AL., MODERN AMERICAN REMEDIES 50 (4th ed. 2010) ("The conventional wisdom is that expectancy damages are recoverable only in contract, not in tort."). There are exceptions, most notably in the fraud context. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 549 (1977) ("The recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover additional damages sufficient to give him the benefit of his contract with the maker, if these damages are proved with reasonable certainty."). This exception in the fraud context, especially carved out for "business transaction[s]," makes it odd that the *McLaughlin* Court expressed skepticism over whether "expectancies" like the benefit of the bargain are recoverable in the civil RICO context. McLaughlin v. Am. Tobacco Co., 522 F.3d 215, 228 (2d Cir. 2008) (noting, without deciding, that "benefit of the bargain" damages "are generally unavailable in RICO suits," relying upon the "business or property" language of the civil RICO statute); *see also* Schwab v. Philip Morris USA, Inc., 449 F. Supp. 2d 992, 1063–65 (E.D.N.Y.

absence of the negligence, the plaintiff would not have accepted the ex ante risk associated with a defective product. Furthermore, we provide, in effect, tort insurance for any actualized harm, rather than compensate for the cost of bearing the additional risk.[248] Thus, one could imagine situations where the plaintiff is not injured because he would have assumed the same risk of harm in the absence of the tort. Ignoring the plaintiff's ex ante preferences to avoid counterfactual uncertainty is not limited to exceptional doctrines like the fraud-on-the-market presumption and the baseline damages awarded in price-fixing cases. As demonstrated by the hypothetical above, it is an everyday feature of tort law.

3. Deterrence

Third, the individualist fallacy is mistaken given the commonality of the conduct that gives rise to the litigation and the deterrence function of the litigation. Courts and scholars insist on proof of classwide injury in part because they consider it necessary to prove a common legal violation. The Court in *Wal-Mart* illustrates this view. There, the Court concluded that, without proof of classwide injury, the plaintiffs failed to provide "convincing proof of a companywide discriminatory pay and promotion policy," and thereby failed to "establish[] the existence of any common question."[249] Likewise, Nagareda has argued that the use of "aggregate proof" of classwide injury is circular, since it presumes "some doctrine in governing law that unites all class members as victims of the same wrong."[250]

But the existence of a common wrong does not require common proof of injury. Instead, the commonality of the wrong stems from the defendant's ex ante conduct, which, in all of the above cases, is common to the class. In these cases, the defendant necessarily treats the population affected by its conduct as an undifferentiated whole because the defendant cannot know who will be affected by its actions prior to committing a legal violation.

2005) (Weinstein, J.), *overruled by McLaughlin*, 522 F.3d 215 (concluding that "benefit of the bargain" damages are available in civil RICO claims involving fraud).

248. *See Bridgestone/Firestone*, 288 F.3d at 1017, 1017 n.1 (rejecting "loss of value" claims for defective tires, noting that "[i]f tort law fully compensates those who are physically injured, then any recoveries by those whose products function properly mean excess compensation," and showing that recovery for loss of value and recovery for actualized harm add up to the same amount).

249. Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2557 (2011).

250. Nagareda, *Class Certification*, *supra* note 19, at 129; *see also id.* at 101 (defining "aggregate proof" as proof "that presumes a view of the proposed class in the aggregate").

This can be difficult to conceptualize,[251] so consider the disparate treatment claim in *Wal-Mart*. There, the plaintiffs alleged that Wal-Mart's hiring and promotion practices contained excessive subjectivity, which, combined with its uniform corporate culture, permitted an inference that Wal-Mart discriminated against women.[252] The plaintiffs alleged a "disparate treatment pattern-or-practice" claim under Title VII, which requires a showing of discriminatory conduct that "is repeated, routine, or of a generalized nature" rather than "sporadic discriminatory acts."[253] The conduct at issue in *Wal-Mart*, however, appears to be sporadic acts of discrimination, since it involved the thousands of discrete pay and promotion decisions made by Wal-Mart's store, district, and regional managers.[254]

But suppose, for example, that Wal-Mart adopted the practice described above, but is deciding whether to add a checklist that store managers must use in making pay and promotion decisions. The checklist is designed to avoid biases based on gender and thus would decrease Wal-Mart's Title VII expected liability. Wal-Mart, of course, cannot predict the checklist's future effects on specific female employees, but it can estimate its effects over the affected female employee population. In fact, Wal-Mart may intentionally refuse to adopt a checklist given its animus towards its female employees.

The Title VII claim in *Wal-Mart* is, in essence, that Wal-Mart intentionally decided not to impose measures like a checklist to reduce any gender disparities.[255] That allegedly discriminatory decision would be common to the class, even though the effects of that decision were not.[256] Moreover, the claim in *Wal-Mart* does not presuppose any novel theories

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251. *See, e.g.*, Dukes v. Wal-Mart Stores, Inc., 603 F.3d 571, 652 (9th Cir. 2010) (en banc) (Kozinski, J., dissenting) (noting that the plaintiffs "have little in common but their sex and this lawsuit."), *rev'd*, 131 S. Ct. 2541; *see also Wal-Mart*, 131 S. Ct. at 2557 (quoting Judge Kozinski's dissent with approval). I briefly discuss the common violation in *Wal-Mart* in Campos, *supra* note 27, at 1070–71, although I discuss it in more detail here.

252. *Wal-Mart*, 131 S. Ct. at 2548.

253. *See* Int'l Bhd. of Teamsters v. United States, 431 U.S. 324, 336, 336 n.16 (1977) (defining disparate treatment pattern-or-practice claims as claims that concern conduct that "is repeated, routine, or of a generalized nature," where plaintiffs must prove "more than sporadic acts of discrimination").

254. Dukes v. Wal-Mart Stores, Inc., 222 F.R.D. 137, 146–47 (N.D. Cal. 2004).

255. *Wal-Mart*, 131 S. Ct. at 2548.

256. *Dukes*, 603 F.3d at 600–12 (concluding that the plaintiffs' evidence "provide[s] sufficient support *to raise the common question* whether Wal-Mart's female employees nationwide were subjected to a *single set of corporate policies*" which violated Title VII) (emphasis in original).

of Title VII liability. It is no more circular than alleging a legal violation that you intend to prove later. The claim simply alleged "discriminate[ion] in the old-school, intentional sense," albeit on a much larger scale.[257] In fact, in *Falcon*, the Court previously conceded that plaintiffs could bring a Title VII class action "if the discrimination manifested itself in hiring and promotion practices in the same general fashion, such as through entirely subjective decisionmaking processes."[258]

The same can be said of a number of legal wrongs that are common to the class but involve differentiated conduct. One example is the fraudulent mass marketing campaign in *McLaughlin*, which relied on retailers selling cigarettes to individual consumers. Another is the alleged horizontal anticompetitive conspiracy in *New Motor Vehicles*, which relied on dealerships negotiating car prices with buyers.

The commonality of the defendant's ex ante conduct is crucial to understanding why accuracy as to each individual's injury is unnecessary to fulfill the deterrence function of the litigation. In general, liability rules deter misconduct because the defendants seek to avoid or reduce their expected liability.[259] For example, in *New Motor Vehicles*, the litigation would deter the defendants only if the prospect of any liability would have affected their decision to engage in the conspiracy in the first place. In this way the litigation affects the defendant's ex ante decision making even though the litigation occurs after the violation.

If the deterrence function arises from the effect of the expected litigation on the defendant's ex ante conduct, then accurate proof of each plaintiff's individual injury is unnecessary. All that is needed is an accurate assessment of the aggregate liability caused by the defendant's conduct because the defendant will only consider its aggregate expected liability in deciding how to act. The defendant cannot base its actions on a more fine-grained determination of the effects of its conduct on individual plaintiffs because in cases like *New Motor Vehicles* and *McLaughlin*, a defendant cannot know ex ante how its classwide conduct will specifically affect each potential plaintiff.

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257. Nagareda, *Class Certification*, *supra* note 19, at 155. That is why Richard Nagareda is incorrect in concluding that the claim in *Wal-Mart* is only that Wal-Mart "enable[d] discrimination." *Id.* at 153. Rather, the plaintiffs took great pains to allege that the Wal-Mart itself engaged in intentional discrimination. Nagareda further criticizes the proof of such discrimination, calling it "startlingly inept," *id.* at 155, but that is a merits inquiry as to whether there was a wrong at all. Inept proof of a common wrong does not transform a common wrong into an individual one.

258. Gen. Tel. Co. of Sw. v. Falcon, 457 U.S. 147, 159 n.15 (1982).

259. *See generally* GUIDO CALABRESI, THE COSTS OF ACCIDENTS (1970) (discussing the deterrence function of liability rules); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987) (same).

Moreover, determining the defendant's aggregate liability does not depend on an accurate determination of each plaintiff's injury. In theory, the individual injuries of each plaintiff could be summed up to provide an assessment of the aggregate damages. But, as noted above, an assessment of damages at the individual level may lead to significant error as well as significant underreporting, which can bias the result. More importantly, many statistical methods, most notably the use of random sampling, can approximate the aggregate amount of damages with far greater accuracy than the summing up of individual injuries.[260] In fact, the district court in *McLaughlin* mentioned the benefits of random sampling in approving a procedure for determining aggregate damages.[261]

Admittedly, the deterrence function of the liability does not obviate the need to determine each individual's damages. But the deterrence function of the litigation does show that the determination of individual injury and damage is of secondary importance, such that it should not be a relevant factor in determining class certification. The failure to certify a class in small claims cases like *New Motor Vehicles* and *McLaughlin* would result in the suboptimal imposition of aggregate liability on the defendant. Again, that is because the class action corrects for the asymmetric stakes between the plaintiffs and the defendant. These asymmetric stakes lead to the defendant investing more in common issues, which ultimately result in the skewing of the defendant's ex ante aggregate liability in its favor.[262] In fact, given that in small claims litigation no individual plaintiff would bring suit, the absence of a class action means that a defendant avoids its ex ante expected liability altogether.[263]

Accordingly, the failure to certify a class in cases like *New Motor Vehicles* and *McLaughlin* would not only lead to no recovery for the plaintiffs, but permit the defendants to commit the same legal violations with

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260. In fact, the *McLaughlin* court's conclusion that an inaccurate determination of individual damages would taint a classwide determination of damages suffers from a fallacy of composition. By envisioning instances in which the plaintiffs would not recover, they assume that the group as a whole would be reflective of those examples. But one cannot infer population-based statistics like aggregate loss from individual statistics like individual injury, at least not in the absence of procedures like random sampling to avoid biases. *See* Greiner, *supra* note 70, at 563 (noting that "[r]andom assignment assures that, in the absence of bad luck, units who receive one treatment are not systematically different from those who receive the other treatment").

261. Schwab v. Philip Morris USA, Inc., 449 F. Supp. 2d 992, 1244–46 (E.D.N.Y. 2005) (Weinstein, J.), *overruled by* McLaughlin v. Am. Tobacco Co., 522 F.3d 215 (2d Cir. 2008).

262. *See supra* Part II.B. (discussing the problem of asymmetric stakes).

263. *See, e.g.*, David Betson & Jay Tidmarsh, *Optimal Class Size, Opt-Out Rights, and "Indivisible Remedies*,*"* 79 GEO. WASH. L. REV. 542, 546, 562 (2011).

impunity. The relevant trade-off is not between the deterrence provided by the class action and the accuracy provided by the individual trial. The trade-off is between optimal deterrence and imperfect compensation versus no deterrence and compensation at all.

I want to conclude by emphasizing the *private* interest the plaintiffs have in deterrence. Many scholars have correctly noted the public interest in the enforcement of the law provided by deterrence.[264] But the plaintiffs themselves have an interest in preventing the unlawful violation from occurring and would have personally benefitted from a class action rule that, among other things, did not require a showing of class-wide injury. Such a rule would have likely deterred the defendant from committing the wrong in the first place.

The litigation admittedly occurs after the legal violation has occurred, when nothing can be done about it. Unfortunately, we never address the effect of the class action rule when the defendant is considering its conduct ex ante, as we do with injunctions or other ex ante enforcement mechanisms. Instead, we have a vicious cycle of ignoring the deterrent effect of procedure, imposing suboptimal liability, causing more legal violations, ignoring the deterrent effect of the procedure, and so on.

To break this vicious cycle, courts should consider the counterfactual of the effect of the class action on the defendant's ex ante conduct.[265] Accordingly, we need to not only consider the compensatory interests of the plaintiffs after the legal violation has occurred, but also the ex ante effects of the procedure before the violation, since it is the type of consideration that is "capable of repetition, yet evading review."[266] Indeed, this counterfactual, ex ante inquiry is of paramount importance because most, if not all, plaintiffs would prefer to avoid the unlawful conduct than to suffer it and receive compensation, no matter how accurate the compensation would be.

III. AGAINST COMMON ANSWERS

It follows from the above that I am against requiring proof of "common answers" as to each plaintiff's injury to certify a class action. The requirement of proof of common injury arises, in part, from a trend by circuit courts to require proof of each of the requirements of Rule 23 by a "preponderance of the evidence," even if such proof would overlap with

264. *See, e.g.*, Gilles, *supra* note 112, at 309; Rubenstein, *supra* note 123, at 723–28.

265. I argue for such an inquiry in more detail in Campos, *supra* note 27, at 1104–10.

266. *See* Roe v. Wade, 410 U.S. 113, 125 (1973) (citing cases discussing this mootness exception).

the merits.[267] The trend is largely justified because many of the class certification requirements of Rule 23 require factual findings by the court, particularly the "preponderance" requirement of Rule 23(b)(3).[268] As put by Judge Easterbrook, "[t]he proposition that a district judge must accept all of the complaint's allegations when deciding whether to certify a class cannot be found in Rule 23 and has nothing to recommend it."[269]

Nevertheless, both the predominance requirement of Rule 23(b)(3) and the commonality requirement of Rule 23(a)(2) merely require a finding of common "questions," not common answers, and for such a finding the pleadings are more than sufficient.[270] The class action prevents the defendant from using its greater stakes to invest more on common issues than the plaintiffs. Thus, a class action should be certified once common issues are present to allow the plaintiffs to invest in these issues on a level playing field, regardless of whether all issues are amenable to common resolution. Requiring more to certify a class, particularly a showing of likelihood of success on the merits, would frustrate the function of the class action and the substantive areas of the law that utilize it.[271]

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267. *See* Szabo v. Bridgeport Machs., Inc., 249 F.3d 672, 676–77 (7th Cir. 2001) (Easterbrook, J.); *In re* Initial Pub. Offerings Secs. Litig., 471 F.3d 24, 27 (2d Cir. 2006); Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261, 267 (5th Cir. 2007), *overruled by* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011).

268. *E.g.*, FED. R. CIV. P. 23(a)(1) (requiring a finding by the court that "the class is so numerous that joinder of all members is impracticable"); *Id.* 23(a)(4) (requiring a finding by the court that "the representative parties will fairly and adequately protect the interests of the class"); *Id.* 23(b)(3)(requiring that "the court *finds* that the questions of law or fact common to class members predominate over any questions affecting individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy") (emphasis added).

269. *Szabo*, 249 F.3d at 675.

270. *See* FED. R. CIV. P. 23(b)(3) (requiring only a "find[ing] that the *questions* of law or fact common to class members predominate over any questions affecting only individual members") (emphasis added); *Id.* 23(a)(2) (requiring only that "there are *questions* of law or fact common to the class") (emphasis added).

271. If there is a factual showing that a court should scrutinize, it is the numerosity requirement of Rule 23(a)(1), which requires a court to find that "the class is so numerous that joinder of all members is impracticable." *Id.* 23(a)(1). Current law sets the bar for numerosity as low as forty. Stewart v. Abraham, 275 F.3d 220, 226–27 (3d Cir. 2001) ("No minimum number of plaintiffs is required to maintain a suit as a class action, but generally if the named plaintiff demonstrates that the potential number of plaintiffs exceeds 40, the first prong of Rule 23(a) has been met."). However, a higher numerosity threshold, perhaps in the thousands, would ensure that the stakes are so asymmetric that class treatment is more than justified, as well as cut down on the costs associated with class certification. This is not to say that courts should require precise proof of numerosi-

I am also against common answers in another importance sense. The class action has garnered interest from other jurisdictions as a supplement to law enforcement, particularly the use of class actions for the type of small claim, consumer litigation discussed above. For example, the European Union has proposed the increased use of class actions to enforce conduct in violation of its anti-competition and consumer protection laws.[272] Mexico has also recently passed a statute that allows for class action procedures to "help consumers challenge companies that overcharge for goods and services and that fail to meet quality standards."[273] Class action procedures have also been proposed or utilized in Asia.[274]

In discussing the class action, this Article recognizes that the collective procedures adopted or proposed in other countries may differ in material ways. It also recognizes that the legal and social context of the United States also differs from other jurisdictions.

Nevertheless, in adopting, designing, or implementing a class action procedure courts should consider at least three factors, which roughly track the three fallacies discussed above. These factors are by no means exhaustive. However, they are important because the fallacies that lead to doctrines such as the requirement of proof of classwide injury may unduly influence other jurisdictions. If anything, the goal of this Article is to ensure that other jurisdictions learn from the United States' mistakes.

First, and as shown by the all-at-once fallacy, the primary function of the class action in the United States is not to realize savings in adjudicating claims all-at-once. Instead, the function of the class action is to correct what can be called a Coasean problem in U.S. law.[275] Because the private entitlement to bring a cause of action is initially assigned to each

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ty along the lines of listing identifiable plaintiffs, as that would replicate the problem of classwide injury all over again.

272. Tiana Leia Russell, *Exporting Class Actions to the European Union*, 28 B.U. INT'L L.J. 141, 142 (2010) (discussing the use of class actions in the European Union, noting that "[w]ithin Europe, consensus is emerging that competition law requires private enforcement if it is to be collective.").

273. *See* Nathan Koppel, *Class Actions Head South of the Border*, WALL ST. J. LAW BLOG (Sept. 2, 2011, 11:06 AM), http://blogs.wsj.com/law/2011/09/02/class-actions-head-south-of-the-border/ (discussing an article in "Mexico's Official Gazette" about the new class action procedure adopted by Mexico).

274. *E.g.,* Note, *Class Action Litigation in China*, 111 HARV. L. REV. 1523 (1998); Dae Hwan Chung, Note, *Introduction to South Korea's New Securities-Related Class Action*, 30 J. CORP. L. 165 (2005).

275. *See* Coase, *supra* note 56, at 2–15 (setting forth Coase theorem). I have similarly argued that the problem is functionally analogous to a "tragedy of the commons." *See* Campos, *supra* note 27, at 1085–87.

individual victim to recover his or her own damages, it can result in asymmetric stakes situations when a defendant engages in common conduct that injures a large number of dispersed victims. The class action is needed in the United States because it allows the plaintiffs in these situations to avoid easily predictable collective action problems, which otherwise would allow the defendant to escape some or all of its liability.

Accordingly, the utility of a class action in other jurisdictions will depend on the extent to which the assignment of causes of action leads to the type of collective action problems that arise in the United States. For example, one feature of U.S. law that leads to collective action problems is restrictions on the selling of claims under the law of champerty and maintenance. In essence, a victim can sell a claim only if the claim has accrued, and even then, only to the defendant through a settlement.[276] But if a jurisdiction allows for greater freedom in the selling of claims, then plaintiffs may not be as disadvantaged relative to the defendant. Although the defendant, again, owns a monopoly in the defense of its liability, plaintiffs may be able to sell their claims to an entity[277] or, perhaps, to an insurer via subrogation,[278] thereby substantially lessening any asymmetric stakes between the parties.

Moreover, the class action arises in the United States because of gaps in public enforcement. Thus, a jurisdiction considering the use of the class action must also consider how to coordinate such private enforcement with public enforcement. In many cases the use of private enforcement and public enforcement may be complementary, such as the use of private rights of action to supplement ex ante regulation.[279]

In other cases, however, public and private enforcement may be at cross-purposes. Somewhat ironically, in the securities fraud and antitrust contexts in the United States, public enforcement through liability is inevitably followed by private actions, leading to significant overdeter-

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276. Anthony J. Sebok, *The Inauthentic Claim*, 64 VAND. L. REV. 61, 107–20 (2011) (discussing, and criticizing, the law of champerty and maintenance).

277. *See, e.g.*, Deborah R. Hensler, *The Future of Mass Litigation: Global Class Actions and Third-Party Litigation Funding*, 79 GEO. WASH. L. REV. 306, 320–23 (2011) (discussing the adoption of measures in such countries as the Netherlands in permitting "third-party funding" of litigation, which functionally allows third parties to own equity interests in claims).

278. For one such proposal, see Kenneth S. Reinker & David Rosenberg, *Unlimited Subrogation: Improving Medical Malpractice Liability by Allowing Insurers to Take Charge*, 36 J. LEGAL STUD. S261 (2007). Indeed, given the proliferation of government-financed health care systems, one could imagine the government suing to recoup the costs of treating the victims of a tort.

279. SHAVELL, *supra* note 259, at 279–84.

rence.[280] In these contexts the "title" to bring and dispose of claims can be understood as a license granted by the government to enforce. Understood in this way, the class action is a type of "qui tam" or "bounty hunter" procedure that assigns the license (plus an interest in any sanction) to an uninjured party.[281] Consequently, the issue for any policy maker is whether a private license to enforce can peacefully coexist with a public enforcer. This is not to say that ex post liability actions by both public enforcers and private enforcers are substitutes for each other. Instead, a jurisdiction has to be careful in designing both private and public enforcement to take advantage of their comparative advantages.[282]

Second, and as suggested by the extraordinary remedy fallacy, jurisdictions should not flinch given the size of the class or the amount of the liability at stake. The impulse to engage in a "likelihood of success" inquiry when the liability is large is understandable, particularly when class certification could result in the bankruptcy of the defendant. But it is important to recognize that the liability itself is not a function of the class action. Instead, it is a function of mass production, since many of the cases discussed, particularly the *Wal-Mart* case, arise from activities taken by the defendant at a very large scale. To limit liability based on the scale of the conduct at issue would effectively provide one strategic technique a company can use to avoid liability, similar to judgment proofing or using subordinates to commit wrongdoing. There may be reasons to limit the liability of large-scale activities, but the sheer magnitude of the liability should not be one of them, particularly when the liability could equally arise from many defendants instead of one.

Third, and as suggested by the individualist fallacy, jurisdictions should not lose sight of the objectives of the litigation. In the United States, courts and scholars have been preoccupied with protecting both the plaintiffs' rights in their causes of action and the defendant's defense rights.[283] But in the United States, and presumably elsewhere, the func-

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280. RICHARD A. POSNER, ANTITRUST LAW 266–86 (2d ed. 2001) (discussing overdeterrence caused by "follow on" suits in antitrust law).

281. *See* MARTIN H. REDISH, WHOLESALE JUSTICE: CONSTITUTIONAL DEMOCRACY AND THE PROBLEM OF THE CLASS ACTION LAWSUIT 35–42 (2009) (discussing, but criticizing, the delegation of enforcement power to private parties like class attorneys who are not otherwise victims).

282. For one such proposal, see David Rosenberg & James P. Sullivan, *Coordinating Private Class Action and Public Agency Enforcement of Antitrust Law*, 2 J. COMPETITION L. & ECON. 159 (2006).

283. *See, e.g.*, Nagareda, *Aggregate Litigation across the Atlantic*, *supra* note 5, at 10–11 (arguing that one of key issues in any aggregate litigation is "who is to be precluded thereby?"); *see also* Wal-Mart Stores v. Dukes, 131 S. Ct. 2541, 2561 (2011) (noting due process and Rules Enabling Act concerns with proposal to have mandatory class action

tion of private rights of action is to deter potential defendants from committing legal violations in the first place.[284] It makes little sense to restrict class actions out of a respect for the litigation rights of the parties when they would undermine the purpose of those rights. Consequently, courts should not deny a class action out of a concern for accuracy as to individual injury. Not only is such accuracy unnecessary, but, as shown in the cases above, it would lead to the very legal violations for which the plaintiffs seek compensation.

CONCLUSION

One cause of the requirement of proof of classwide injury is the reluctance of courts to utilize exceptional procedures like the class action. Although the American litigation model is itself exceptional, the class action is even more so because it is the great exception to the "principle of general application in Anglo-American jurisprudence that one is not bound by a judgment in personam in a litigation in which he is not designated as a party or to which he has not been made a party by service of process."[285] This reluctance is, in turn, a reflection of the humility of U.S. courts, which recognize that other institutions may be better equipped to handle the policy considerations that underlie the class action. Such humility has its virtues, but not in all cases. The class action is itself "'an invention of equity . . . mothered by the practical necessity' of providing a practical procedure to enable large numbers of litigants to enforce their common rights."[286] After all, and as noted by Judge Weinstein in the *McLaughlin* litigation, it is also a principle of general application in U.S. law that "every right, when withheld, must have a remedy, and every injury its proper redress."[287]

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with sampling of claims, since it would undermine the litigation rights of the plaintiffs and the defendant).

284. Indeed, it is the essential function of all liability rules. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, & Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1090–92 (1972).

285. Hansberry v. Lee, 311 U.S. 32, 40 (1940) (citing Pennoyer v. Neff, 95 U.S. 714 (1877)).

286. Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1023 (1973) (Hays, J., dissenting) (denial of rehearing en banc), *aff'd*, 417 U.S. 167 (1974) (quoting Montgomery Ward & Co. v. Langer, 168 F.2d 182, 187 (8th Cir. 1948)).

287. Schwab v. Philip Morris USA, Inc., 449 F. Supp. 2d 992, 1020 (E.D.N.Y. 2005) (Weinstein, J.), *overruled by* McLaughlin v. Am. Tobacco Co., 522 F.3d 215 (2d Cir. 2008) (quoting Marbury v. Madison, 5 U.S. (1 Cranch) 137, 163 (1803)).

GLOBALIZATION OF SECURITIES ENFORCEMENT: A SHIFT TOWARD ENHANCED REGULATORY INTENSITY IN BRAZIL'S CAPITAL MARKET?

Eugenio J. Cárdenas[*]

INTRODUCTION

> As we are constantly being reminded, capital markets are now so globalized and highly interconnected that a weakness within one market or within its regulatory oversight can serve to undermine other markets, like a weak link in a chain . . . Our partnerships with regulators throughout the world are critically important to rooting out fraud and misconduct in our markets . . . . Over the years . . . we all have come to reach a better understanding of how critical it is—especially in a fast

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* Doctor of the Science of Law (J.S.D.) Candidate, Stanford Law School.

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> moving global marketplace—to . . . learn . . . best practices from around the world that we can incorporate, as appropriate, into our respective enforcement programs. This sharing of best practices results in a race to regulatory quality as opposed to the proverbial race to the bottom. It is my hope, and belief, that such a race to the top will create real benefits for investors in the markets under our jurisdictions.[1]

The above words, recently conveyed by U.S. SEC Commissioner Elisse B. Walter to her counterpart regulators from over sixty jurisdictions of the world, echo the increasing phenomenon of global legal convergence and international cooperation among securities commissions, in the realm of capital market surveillance and enforcement. This Paper, written for the "Globalization of the United States Litigation Model" symposium at Brooklyn Law School, October 21, 2011, ventures into the mentioned phenomenon, to explore the following puzzle of globalization, corporate law enforcement, and financial development—are emerging capital markets shifting toward enhanced regulatory intensity in the enforcement of their securities laws, under the context of global legal convergence?

In that spirit, focus is placed on the emerging Latin American region, namely Brazil's securities market. Aim is set at identifying and reflecting upon selected instances that, when combined and analyzed, suggest that Brazil has pursued the enforcement of its securities laws with enhanced regulatory intensity during the past decade—both in terms of adopting enforcement practices characteristic to developed global markets, and of implementing these practices—in light of preliminary evidence of enforcement on the ground.

By the turn of the century, Latin America had undergone an unprecedented democratization wave[2] accompanied by a period of "intense and growing commercial and financial exchange among countries" usually referred to as globalization.[3] As with other contemporary democracies, countries of the region became tied to the "rule of law," which typically

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1. Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n [S.E.C.], Remarks at the Closing of the U.S. SEC International Institute for Securities Enforcement and Market Oversight (Nov. 18, 2011), *available at* http://www.sec.gov/news/speech/2011/spch111811ebw.htm.

2. *See* LARRY DIAMOND, THE SPIRIT OF DEMOCRACY: THE STRUGGLE TO BUILD FREE SOCIETIES THROUGHOUT THE WORLD 41 (2008). Diamond refers to a third wave of democracy, before the turn of the century, which includes Latin America.

3. Lawrence M. Friedman & Rogelio Pérez-Perdomo, *Latin Legal Cultures in the Age of Globalization*, *in* LEGAL CULTURE IN THE AGE OF GLOBALIZATION 1, 4–5 (Lawrence M. Friedman & Rogelio Pérez-Perdomo eds., 2003).

involves stable rules, honest judges, enforcement of contracts, and a reliable civil service.[4] Further, convergence among legal systems quickly spread across Latin American securities markets. In this legal convergence process, the enforcement of corporate law gained particular relevance for its potential to ensure higher disclosure and governance standards aimed at investor protection and capital market development.[5]

Driven by this global convergence phenomenon, a discourse on "financial regulatory intensity"[6] was triggered within the United States ("U.S.") law and finance literature. Building on theories advancing that the enforcement of corporate law fosters investor protection,[7] and, in turn, capital market development,[8] and economic growth,[9] this discourse seeks to determine the intensity with which jurisdictions should enforce their financial regulations. Conceptually, optimal regulatory intensity may be thought of as enforcement that is enough to deter, and/or compensate,[10] or when considered from a cost-benefit analysis, as an assessment of whether the marginal benefits exceed the marginal costs of additional enforcement. Despite these conceptual views, there is no clear empirical measure of optimality or levels of enforcement. Nevertheless, significant efforts have started to present preliminary evidence of enforce-

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4. *Id.* at 16.

5. Securities enforcement has, for example, been a recurring theme in The Latin American Corporate Governance Roundtable meetings for over a decade. Among other efforts, the roundtable has applied a series of surveys aiming at better understanding the regulatory and institutional frameworks of the main securities enforcement systems of the region. Regulators, policy-makers, and market participants gather on an ongoing basis to discuss these surveys' results, and other developments.

6. *See* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 229–78 (2007) [hereinafter Coffee, *The Impact of Enforcement*]; Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 275 (2007).

7. *See* Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 27–28 (2006) [hereinafter La Porta et al., *Securities Laws*].

8. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1114 (1998) [hereinafter La Porta et al., *Law and Finance*]; Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1131–32 (1997) [hereinafter La Porta et al., *Legal Determinants*]; Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 738 (1997).

9. *See* Robert King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, 108 Q.J. ECON. 717, 717–18 (1993); Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537, 537–58 (1998).

10. *See* Andrew Kuritzkes, *Section V: Sarbanes-Oxley Section 404*, *in* COMM. CAPITAL MKT. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 115 (Jenepher Moseley ed., 2006) [hereinafter INTERIM REPORT], *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

ment in action that speaks to the intensity with which markets enforce their corporate law, providing a better understanding of securities enforcement systems and their benefits across jurisdictions.[11]

This Paper addresses Brazil, the leading Latin American financial system. It looks into its securities enforcement system during the wave of legal and institutional reform dating back to the turn of the century,[12] resulting from competing dynamics between incumbent controlling owners resisting change, and global forces demanding enhanced corporate law and governance.[13] A decade onward, the study attempts to identify whether Brazil's capital market shows signs of enhanced regulatory intensity in the enforcement of its securities laws.

To approach this question, this Paper queries into the extent to which Brazil has (1) adopted a more robust institutional design of enforcement, and (2) boosted its implementation. To that end, the research identifies and reflects upon selected accounts that suggest enhanced enforcement structures and powers, and increases in actual enforcement activity and resources allocation toward enforcement during the past ten years.

Among other findings, this study identifies a transformation of Brazil's securities enforcement system, both in the establishment and implementation of new institutions and enforcement practices and the revival of old ones. This evolution followed a shift in policy in 2005, whereby Brazil's Securities and Exchange Commission (Comissão de Valores Mobiliários—"CVM") decided that securities enforcement was its main priority.[14]

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11. *See* John Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687, 689 (2009); Jackson, *supra* note 6, at 278–86; Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* 11 (Harv. Univ. Law Sch. Pub. Law & Legal Theory Research Paper Series, Paper No. 08–28, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1000086.

12. *See* María Helena dos Santos Fernandes de Santana, Chair, Comissão de Valores Mobiliários [Brazilian Securities & Exchange Commission] [CVM], Presentation at Foro Sobre Modelos de Supervisión: Evolución de la Regulación de los Mercados de Valores en Brazil (Sept. 16, 2008) (Braz.).

13. *See* Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S. and the EU* 45–46 (Eur. Corp. Governance Inst. [ECGI] Working Paper Series in Law, Paper No. 149, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1541226. Gilson et al. discuss how resistance to corporate governance legal reform, by incumbent players of Brazil's financial system, led to the establishment of the Novo Mercado market that, via self-regulation, imposed standards that went beyond the law.

14. CVM's prioritization on enforcement began with the administration of former Chair Marcelo Trindade, and deepened under the responsibility of current Chair María

CVM appears to be evolving into an ex-post enforcement-driven agency. Somewhat like enforcement systems in developed markets, such as the U.S. Securities and Exchange Commission ("SEC") model, Brazil's regulator now embeds features like a Board of Commissioners with political independence, a stand-alone enforcement program with a mandate, an enhanced tool-kit to combat serious wrongdoing, the possibility to negotiate settlements, and partnerships with the criminal justice authorities, the industry, and the international community.

Developments suggesting enhanced regulatory intensity include CVM's new enforcement program. Through specialized divisions—the *Superintendencia de Processos Sancionadores* and the *Procuradoria Federal Especializada*—this program introduced a new institutional design, combining CVM staff with federal attorneys and investigators. The latter half of the decade accordingly saw an increase in enforcement activity in terms of administrative actions and sanctions pursued and imposed by this new enforcement program. Also notable was the significant reduction in the time required to decide even the most complex administrative procedures. Moreover, serious wrongdoing, namely insider trading and market manipulation—which had been criminalized earlier in the decade—began to be more visibly targeted and sanctioned, not only administratively, but also through an older institution that had seldom been employed—the Collective Civil Action. A strong partnership with the criminal justice authorities also grew, capitalizing on the mentioned offenses. Tools for "real-time" enforcement, including the freezing of assets, subpoena powers, and injunctive orders, began to be deployed as well.

Additionally, the Committee for Settlements of Proceedings was established by CVM in order to identify and propose potential settlements and institutionalize the settlement negotiation process. Consequently, the latter half of the decade saw a striking rise in *Termos de Compromisso* settlements, an instrument that had been available to the regulator for years but that lacked legitimacy and use.

Revealing signs of a "multiple-enforcers" model, an enhanced Self-Regulatory Organization ("SRO") regime developed in both mandatory and voluntary fronts. On the statutory—thus, mandatory—dimension, CVM provided for a detailed legal framework of self-regulation for or-

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Helena dos Santos Fernandes de Santana. *See* CVM RELATÓRIO DE GESTÃO 2005 [ANNUAL REPORT 2005] 15–16 (2005) (Braz.), *available at* http://www.cvm.gov.br/port/relgest/RelGest2005.pdf.

ganized markets[15] that not only resulted in enhanced listing requirements, but also in practically outsourcing market surveillance to an autonomous non-profit organization with enhanced rule-making and enforcement powers, *BM&FBOVESPA Supervisão de Mercados* ("BSM"). On the voluntary front, the regulator provided incentives that resulted in firms listing in the market segments of the stock exchange that require higher corporate governance standards, including the Novo Mercado market.

Cooperation with other securities regulators, adherence to international principles, and sponsoring technical assistance workshops for improving enforcement, led by developed markets, became clear trends, too. The increase in enforcement activity was supported by a surge in budget and staffing resources during this period.

Perhaps the biggest hurdle faced by Brazil's securities enforcement system is in the private enforcement arena. The lack of specialized tribunals and judges trained in capital market matters has resulted in costly and stagnant procedures and in the practical nonexistence of private rights of action. There are, nonetheless, signs of judicial specialization, with an experiment involving a commercial court. In addition, communication and information and knowledge exchange regarding capital markets has increased between the regulator and the judiciary. CVM and the judiciary have made agreements to that effect, whereby the judiciary increasingly resorts to CVM for technical support on securities regulation.

These research findings showcase how a new corporate governance culture is permeating the Brazilian securities market, reshaping legal structures and institutional designs of enforcement in the global arena. The findings provide a story about how emerging global markets may shift toward enhanced enforcement as they become aware of its potential benefits for their development. Finally, they shed light on how legal systems undergo transformation, in view of the interplay between social change, legal cultures, and institutions.

Among other sources, the research draws from assorted data on enforcement activity and resources made available by CVM, published by its Ministry of Finance, and reported by the Latin American Corporate Governance Roundtable for Corporate Governance throughout the decade. Interviews with CVM's Chairperson, and its Attorney General, offer a reaction to the data, further illustrating the development and challenges of securities enforcement in Brazil.

The Paper unfolds as follows: Section I comments on the financial regulatory discourse and the potential benefits of securities enforcement,

15. Including over-the-counter ("OTC") and commodities and futures markets.

with a focus on Latin America. Section II identifies and comments on particular accounts of legal and institutional reform in Brazil's securities enforcement system during the past decade. It further discusses how this framework has been implemented, in light of preliminary evidence of enforcement activity. The Article then presents concluding remarks on how these newly adopted institutions and their implementation reflect enhanced regulatory intensity.

I. A WORD ON FINANCIAL REGULATORY INTENSITY AND THE PERCEIVED BENEFITS OF SECURITIES ENFORCEMENT IN LATIN AMERICA

Was there reason to believe that the emerging markets of Latin America would develop enhanced regulatory intensity in the enforcement of their securities laws by the end of the past decade? At the turn of the century, the answer might have likely been negative. Globalization, the rule of law, and legal convergence started to surface at the time in the region's securities markets. Countries joined the Organisation for Economic Co-operation and Development ("OECD") and, consequently, issued corporate governance codes. Best corporate practices even found their way into the formal legal systems of the region.[16] Yet, it would have been hard to believe that the incumbent players of the securities markets would give up their private benefits of control[17] and, in turn, give in to corporate governance, minority rights, and investor protection. It would have been difficult to imagine that strong regulatory frameworks governing the public firm would arrive and then be implemented and enforced effectively. After all, it remained highly questionable as to whether the basic preconditions of a strong capital market—property and contractual rights and their enforceability—were even in place.

Despite the region's historical reputation for being a difficult corporate environment,[18] investor protection ultimately gained considerable rele-

16. For example, as early as 2001, the Mexican Securities Market Law was reformed, introducing substantive corporate governance provisions that were originally in the voluntary Best Corporate Practices Code. This tendency followed with reforms to the same law in 2003 and with the creation of a new Securities Market Law in 2005.

17. *See* Rafael La Porta, Florencio López de Silanes & Guillermo Zamarripa, *Related Lending* 13–15 (Yale Int'l Ctr. for Fin. [ICF], Working Paper No. 02–19, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=302128 (discussing evidence of tunneling in Mexico's banking sector).

18. This refers to civil law jurisdictions with weak judiciaries, government corruption, and markets with concentrated ownership structures, in which the primary corporate governance concern is limiting self-dealing rather than reducing agency costs.

vance in the past decade. There was, no doubt, resistance by incumbent market participants opposing governance and disclosure. But there were also competing forces that countered this resistance and at times prevailed, even if it meant creatively avoiding the formal legal system and implementing corporate governance through self-regulatory regimes, as in the case of Brazil's Novo Mercado market segment.

Emerging markets' inclination to pursue a more stringent enforcement of their securities laws in the global marketplace might seem obvious today. Few would question that securities enforcement brings about investor protection and, consequently, capital market development and economic growth. Yet, these theories on the benefits of securities enforcement have only been empirically tested to a limited extent and the associations claimed are not all certain.

It is debatable which variables should be used as proxies for enforcement to explain development. Measuring enforcement in terms of regulators' powers may be a rather "law in books" approach that does not account for actual implementation. Regulators' resources might not translate into real market supervision efforts. Enforcement activity can be misleading as a variable, too. Enforcement action is, after all, a function of the underlying compliance. A jurisdiction with a low volume of securities enforcement activity may be one with a high level of compliance by market participants. Such jurisdiction might also be one in which regulation alone deters wrongdoing. More actions and sanctions do not necessarily reflect effective enforcement and/or higher regulatory intensity.

Moreover, these measures are not readily comparable across jurisdictions, given differences in the wrongdoing targeted, enforcement designs, and tool-kits, among many others. The benefits of enforcement, or lack thereof, vary across time and jurisdictions and are simply difficult to measure.[19]

Nevertheless, there appears to be widespread consensus among jurisdictions that corporate law and its enforcement matter. Perceptions on the importance of enforcement for their development may alone explain why Latin American markets undergoing convergence would shift toward enhanced enforcement in the global context, as well be influenced by enforcement-driven frameworks with multiple-enforcement channels and singular regulatory intensity, like the U.S. model. Enforcement may be perceived by these markets as a key piece of the financial and economic development puzzle that explains the leading position of devel-

19. *See* Jackson, *supra* note 6, at 256.

oped financial systems—a piece that yields benefits such as reducing informational asymmetry and a firm's cost of equity capital.[20] Such perceptions may speak to why investors are willing to pay a premium for the shares of an issuer that subjects itself to a particularly stringent regime. In the global arena, it may be considered a trigger to the "investor protection signaling" believed to attract cross-listings, decoding the *functional convergence* phenomenon behind the *bonding hypothesis*.[21]

On the assumption that enforcement makes a difference, and in spite of the challenges in measuring it, academic literature, economic development programs, and policy makers have continued to explore the intensity of jurisdictions' securities laws enforcement. Recent efforts have provided preliminary empirical evidence that begins to decipher regulatory intensity on the surface, and to associate it with the size and development of markets.

Comparisons across several jurisdictions have been made, in terms of both inputs, by way of resources allocated to public enforcement (for example, staffing and budget), as well as outputs, in the form of actual enforcement activity exerted.[22] Preliminary findings for these jurisdictions have reported that common law countries with more developed markets incur higher enforcement costs and enforcement activity volume than their civil law counterparts.[23] Regulators' resources allocated for market supervision have also been employed as enforcement proxies[24] and have associated public enforcement with robust markets.[25]

To provide an example, the literature has defined the "U.S. Model" as one that (1) pursues the enforcement of securities laws with singular in-

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20. *See* Coffee, *The Impact of Enforcement*, *supra* note 6, at 244–46 (suggesting that the U.S.'s greater emphasis on enforcement reduces informational asymmetry and provides for a lower cost of equity capital).

21. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 691–95 (1999). According to the bonding hypothesis set forth by Coffee, foreign firms opt into higher regulatory or disclosure standards, thereby committing (bonding) to more stringent governance standards than those of their domestic markets. Consequently, these firms have access to benefits such as raising equity capital and increasing shareholder value. Coffee further posits that, in seeking the mentioned benefits, firms may achieve functional convergence by simply listing on a foreign stock exchange and "renting" its higher governance standards, without having to rely on their respective local laws being reformed.

22. *See* Jackson & Roe, *supra* note 11, at 8.

23. *See* Jackson, *supra* note 6, at 256, 272.

24. *See* La Porta et al., *Securities Laws*, *supra* note 7, at 27–28.

25. *See* Jackson & Roe, *supra* note 11, at 32.

tensity,[26] and does so via (2) a dynamic blend of enforcement channels and enforcers. This "multiple-enforcers"[27] approach involves public enforcement by an "enforcement-driven" securities regulator in partnership with other equally active law enforcement agencies, coupled with an entrepreneurial private enforcement system of class and derivative litigation and a quasi-governmental self-regulatory regime in which markets are practically regulators.[28] Ongoing academic debate highlights the dynamics of this model by discussing whether private or public enforcement is more highly associated with robust markets ("private" vs. "public primacy" views),[29] and by exploring how the different enforcement modes fill each other's gaps or serve as supplements to one another (the "multiple mechanisms" view).[30] Regardless of whether the private, public, or multiple-mechanisms primacy views empirically come out ahead, one may expect to find an active interplay of each enforcement mode exerting remarkable regulatory intensity.

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26. *See* Coffee, *The Impact of Enforcement*, *supra* note 6, at 245; Jackson, *supra* note 6, at 281; Robert Litan, *Section III: Enforcement*, *in* INTERIM REPORT, *supra* note 10, at 71–92.

27. See James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CAL. L. REV. 115 (2012) providing a comprehensive analysis of the centralization debate revolving around the "multiple-enforcers" model characteristic of the United States' securities enforcement system.

28. Rob Baggott, *Regulatory Reform in Britain: The Changing Face of Self-Regulation*, 67 PUB. ADMIN. 435, 437 (1989). Considering self-regulation as a matter of degree, Baggott classifies it, among other criterion, with regards to its legal status. In essence, a self-regulatory regime would be governed by mere voluntary agreements. However, statutory law often backs these agreements, and it is not uncommon for governments to reserve powers for overseeing and enforcing self-regulation.

29. Ongoing academic debates highlight the dynamics of this model by, for instance, discussing whether private and/or public enforcement prevail in better explaining capital market development. *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. POL. ECON. 430, 443–52 (2008); La Porta et al., *Securities Laws*, *supra* note 7, at 2–3; WORLD BANK, INSTITUTIONAL FOUNDATIONS FOR FINANCIAL MARKETS 5–7 (2006), *available at* http://siteresources.worldbank.org/INTTOPACCFINSER/Resources/Institutional.pdf. For competing views, see Jackson & Roe, *supra* note 11, at 15–16 and Armour et al., *supra* note 11, at 722.

30. *See* Michael Klausner, Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis 6 (Feb. 23, 2010) (unpublished manuscript), *available at* http://www.law.upenn.edu/academics/institutes/ile/PNYUPapers/2010/Klausner_Are%20Securities%20Class%20Actions.pdf.

It might just be that "[t]he United States has the toughest administrative enforcement of securities laws in the world."[31] Annualized data from 2002–2004 suggests both the singular intensity and the "multiple-enforcers" at play—the SEC, the Department of Justice, the state regulators, and at the time, NASD and NYSE—yielding an impressive yearly average of 3,624 public actions resulting in $5,287,483,485 in penalties. Of these, 639 actions were imposed by the SEC, amounting to $2,164,666,667 in monetary sanctions (respectively, 17.6% and 40.9% of the total).[32]

Of course, the U.S. enforcement model could be considered an outlier. The high degree of regulatory intensity that it has presented in recent years may even border on "over-enforcement" (enforcement in excess of what is needed to deter and compensate), affecting capital market competitiveness and, consequently, development. The burden of excessive enforcement, namely extreme consequences for wrongdoing, may lead domestic firms to avoid raising capital through U.S. securities markets, let alone foreign issuers who simply stay away.[33] A healthy balance should be sought after by securities markets, and this concern has not gone unnoticed by Latin American jurisdictions.[34] However, if companies commonly cite U.S. enforcement as the most important reason why they avoid the U.S. market, it is arguably also one of the market's main strengths.[35] Moreover, the emerging markets of Latin America have likely not reached the point of over-enforcement yet. Any increase in regulatory intensity and enforcement at their earlier stages of capital market development would be perceived as a positive sign and a shift in the direction of competitiveness and investor protection.[36]

Yet, it is debatable whether emerging jurisdictions undergoing convergence should adopt the features that set the securities enforcement systems of developed markets apart. Emerging jurisdictions tend to have smaller markets with concentrated ownership structures, rather than

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31. Litan, *supra* note 26, at 71.

32. *See* Jackson, *supra* note 6, at 256, 272. All currency references depicted with a "$" shall refer to U.S. dollars.

33. Presumably rushed and political responses to crises during the past decade, as some have considered of both the Sarbanes-Oxley and Dodd-Frank Acts, could play into this phenomenon.

34. *See* Eugenio J. Cárdenas, *Mexican Corporations Entering and Leaving U.S. Markets: An Impact of the Sarbanes-Oxley Act of 2002?*, 23 CONN. J. INT'L L. 281, 296–97 (2008).

35. *See* Litan, *supra* note 26, at 72–81.

36. Conversation with Troy A. Paredes, Comm'r, U.S. S.E.C. (U.S. S.E.C., Washington, D.C., Oct. 2011).

deeper ones with dispersed shareholders. They normally suffer from weak judiciaries, government corruption, and low investor protection. Additionally, their primary corporate governance concern is usually limiting self-dealing, rather than focusing on reducing agency costs. They also belong to a different legal tradition,[37] and ongoing social change has led them to develop distinct *legal cultures*—attitudes and values with regard to law.[38] Hence, their needs, in terms of legal structures and institutional designs, are bound to vary accordingly. Nonetheless, many of the elements included in the enforcement "tool-kits" of developed markets could be beneficial to emerging markets and serve as an effective roadmap for them.[39] It is no wonder that Latin American regulators regularly request technical assistance on enforcement provided by regulators in developed markets, including the SEC and the Financial Industry Regulatory Authority ("FINRA").

In sum, one might expect that Latin American securities markets perceive securities enforcement as beneficial to their development and, hence, are focused on shifting toward enhanced regulatory intensity via the adoption of institutional designs employed by the more developed markets to the extent that it suits them. Selected instances regarding Brazil may reveal this shift in the section that follows.

II. A SHIFT IN THE DYNAMICS OF SECURITIES ENFORCEMENT IN BRAZIL

A. A New Wave in the Regulatory Evolution of Brazil's Securities Market

A third regulatory era in the evolution of Brazil's securities markets surfaced by the turn of the century, and continued through the past decade.[40] Characterized by a wave of legal and institutional corporate re-

37. Namely Civil Law, Common Law, and hybrid systems.

38. *See* LAWRENCE M. FRIEDMAN, THE LEGAL SYSTEM: A SOCIAL SCIENCE PERSPECTIVE 193–223 (1975).

39. *See* Z. Scott Birdwell, *The Key Elements for Developing a Securities Market to Drive Economic Growth: A Roadmap for Emerging Markets*, 39 GA. J. INT'L & COMP. L. 535, 543–44 (2011).

40. Maria Helena de Santana, CVM's Chair, identifies three stages in the regulatory evolution of Brazil's securities market. During the first stage (1964–1976) the financial system was structured. A Securities Market Law (Law 4.728 of 1965)—was enacted, and market discipline began to emerge. Lei No. 4.728, de 14 de Julho de 1965, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 16.7.1965 (Braz.). However, the absence of a securities regulator proved to be a shortcoming. Market supervision was in the hands of the Central Bank, to which investors were not of priority. Speculation due to lack of information and disclosure, market intermediaries and issuers without accountability, and poor oversight

form, this period was also defined by important signs of capital market development. Among other indicators, trading volume and market capitalization grew substantially,[41] as did initial public offerings.[42] The number of investment funds practically doubled.[43] The shift toward dispersed ownership became more evident too.[44]

To name just a few regulatory highlights, corporate governance reform found its way into the securities market early in the emergence period, if not as a matter of legislation at first, due to resistance by the incumbent

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and enforcement, among other factors, contributed to the stock market crisis of 1971 and 1972. A second stage (1976–2001) began with reaction to the crisis, aimed at legal reform to promote accountability and duties of market intermediaries and issuers. Based on the U.S. SEC model, a new securities market law (Law 6.385 of December 7, 1976) was enacted and, with it, the Brazilian CVM came to life as an autonomous regulator with regulatory, supervisory, and sanctioning powers. *See* Lei No. 6.385, de 7 de Dezembro de 1976, D.O.U. de 09.12.1976 (Braz.). CVM's enforcement powers were, however, shared with the National Monetary Council and penalties were relatively insignificant. Brazil's Corporations Law (Law No. 6.404) was also enacted, defining a legal framework for the public firm, aimed at enhancing investor confidence and protection. *See* Lei No. 6.404, de 15 de Dezembro de 1976, D.O.U. de 17.12.1976 (Braz.). Among other features, the law provided for officer and director accountability, and for specific minority rights, enhancing disclosure, and imposing compulsory dividends. Still, the reform was not considered to have much impact in market development. Inefficient management could not be replaced through takeover activity, and firm expropriation ("tunneling") was not properly dealt with. Brazil lacked the desired capital market culture and faced economic problems, such as the inflationary environment that deterred long-term investment during the 1980s. It was not until 1997 that the Securities Market Law (Law 6.385) underwent reform, boosting enforcement of the regulator, by increasing penalties and allowing settlement agreements. *See* Lei No. 6.385, de 14 de Julho de 1965, D.O.U. de 16.7.1965, *redação dada pela* Lei No. 9.457, de 5 de Maio de 1997, D.O.U. de 6.5.97 (Braz.). However, real implementation of these enforcement mechanisms did not materialize until the turn of the century, during the third stage (2001–present) described above. For more details, see Santana, *supra* note 12.

41. Alexandre Pinheiro dos Santos, *Mitigating the Impact of Financial Crises on the Brazilian Capital Market*, *in* 3 WORLD BANK LEGAL REVIEW: INTERNATIONAL FINANCIAL INSTITUTIONS AND GLOBAL LEGAL GOVERNANCE 337 (Hassane Cissé et al. eds., 2012). Market capitalization increased from $225 billion in 2000 to $1.5 trillion in 2010. The daily average trading of shares increased from $348 million to over $3 billion.

42. Public offerings of equities totaled $133 billion in 2010, doubling the amount of 2009. Regarding IPOs, the total amount reached $2.1 billion in the first quarter of 2011. *Id.*

43. During the past decade—to over 10,000. *Id.*

44. *Id.* at 335, 337.

regime, through self-regulation.[45] Sweeping legal reform included changes to the Corporations Law No. 6.404,[46] providing for a series of clearly specified minority shareholder rights.[47] An impressive array of rules on financial disclosure was issued on an ongoing basis, particularly in the latter part of the decade.[48] Additionally, active coordination among financial governing bodies, focused on improving policy and regulation,[49] became a clear trend, as did convergence with international standards.[50]

Nonetheless, developments in the realm of enforcement of Brazil's securities market deserve the most attention. Early in this recent regulatory phase, important foundations in the area of market surveillance were laid down for Brazil's regulatory and institutional framework. Among others,

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45. *See id.* at 338. Via the Novo Mercado, established in 2000 as a listing segment of the, then, Sao Paulo Stock Exchange, today BM&BOVESPA S.A.-Securities, Commodities and Futures Exchange.

46. *See* Lei 10.303, de 31 de Outubro de 2001, D.O.U. de 01.11.2001 (Braz.) (altering and adding provisions to Law No. 6.404, governing corporations, and Law No. 6.385, governing the securities market).

47. Among other provisions introduced were tag-along rights; the right of preferential (non-voting) shareholders to appoint a board member, initial public offerings ("IPOs") for the case of increase in control; and the reduction of the limit of non-voting shares issued. *See id.*

48. *See* Pinheiro dos Santos, *supra* note 41, at 339–40. Examples of substantive rules issued by CVM, following the 2008 global financial crisis, may be cited. These include improving information disclosed by issuers on financial and derivative instruments (Instrução CVM No. 475, de 17 de Dezembro de 2008, D.O.U. de 22.12.2008 (Braz.)); disclosure regarding corporate governance practices, risk management controls, issuers' compensation and stock option plans (Instrução CVM No. 480, de 7 de Dezembro de 2009, D.O.U. de 11.12.2011 (Braz.)); and the regulation of public requests by management for the exercise of voting rights via proxy, including the disclosure of information to be made electronically available prior to a shareholders' meeting (Instrução CVM No. 481, de 17 de Dezembro de 2009, D.O.U. de 02.02.2010 (Braz.)).

49. Examples include the Capital Markets Working Group—established as an ongoing joint effort of the different sectors of the financial system to produce policy on capital market development. Led by the Minister of Economic Policy, it is conformed by CVM, the Central Bank, SUSEP, SPC, the Ministry of Finance and the IRS. The Committee for Regulation and Supervision of Financial markets, Capital, Insurance, and Private Pension Plans ("COREMEC"), created in 2006 and aimed at reaching bilateral agreements on financial regulation and enforcement. Conformed by the President and the Director of each of the following bodies: Central Bank, CVM, SPC and SUSEP.

50. Examples include CVM signing the IOSCO Multilateral Memorandum of Understanding for Cooperation and Assistance in 2009. *See* Int'l Org. of Sec. Commissions [IOSCO], Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information [MMoU] (May 2002), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf.

the Securities Act underwent significant reform in 2001, strengthening the organization and structure of Brazil's CVM.[51] The agency was given exclusive oversight over securities markets, which it previously shared with the National Monetary Council, granted administrative and budgetary independence aimed at political independence, and provided with a wider scope of supervision, including oversight of investment funds, collective investment vehicles, and the derivatives, commodities, and futures markets. Serious corporate wrongdoings, including insider trading and market manipulation, were criminalized,[52] and tools, like the ability to settle cases, were made available to the securities regulator as well.

Nevertheless, implementation of this enforcement framework did not become prominent until the latter half of the decade. There may be multiple explanations for the sudden surge in enforcement activity, particularly given that Brazil's securities market was increasingly growing in the global context, in the midst of the global financial crisis of 2008.[53] The number of market participants and wrongdoing likely grew as well, a scenario in which regulatory reaction and enforcement would have made sense. However, a catalyst for the enhancement of regulatory intensity actually began in 2005: a shift in policy by Brazil's CVM, making enforcement its primary area of priority. CVM evolved into an ex-post enforcement-driven agency, somewhat resembling enforcement systems of developed markets, both in light of the adoption and implementation of new institutions and enforcement practices, and the revival of old ones. Accordingly, there was a rise in enforcement activity.

The following section identifies and discusses selected accounts that may suggest this enhanced regulatory intensity in the enforcement of Brazil's securities laws, both in terms of institutional enforcement design and its implementation.

B. Enhanced Regulatory Intensity in Brazil's Securities Market?

Drawing from particular guidelines of a regulatory model to effective enforcement for emerging markets may contribute to identifying the developments of securities enforcement in Brazil during the past decade.[54] This regulatory system roadmap focuses mainly on the securities regulator, but also on the partnerships that it develops with the industry and

51. *See* Lei 10.303, de 31 de Outubro de 2001, D.O.U. de 01.11.2001 (Braz.).
52. Including insider trading and market manipulation. *See id.*
53. *See* Pinheiro dos Santos, *supra* note 41, at 337–39.
54. *See* Birdwell, *supra* note 39, at 543–44.

other law enforcement agencies. The steps of this roadmap that I particularly select for the purposes of this study—to assess Brazil—are:

1. Political independence of the securities regulator
2. A stand-alone enforcement program with a mandate
3. The capacity to identify, target, and sanction serious securities violations (i.e. financial disclosure fraud, insider trading, market manipulation)
4. Comprehensive compulsory investigative authority (i.e. to obtain bank records, telephone and online records, witness statements)
5. A tool-kit to engage in real-time enforcement (i.e. asset freezing and financial intelligence units)
6. Recourse to an effective judiciary with specialized tribunals
7. Access of the regulator to efficient and effective civil action and remedies in the first instance
8. The ability to settle cases
9. Developing a partnership with the criminal authorities
10. Developing a partnership with the industry through a self-regulatory model
11. Developing partnerships with the international community to maximize cooperation

The analysis that follows further explains and details these guidelines, and evaluates how they have played out in light of recent developments in Brazil's securities enforcement system.

1. Public Enforcement

a. Political Independence and Boosted Resources?

An essential aspect of this roadmap is the political independence of the regulator.

A capital market regulator should be structured by law as an independent regulatory and law enforcement agency. It should be empowered with the discretion to regulate, investigate, and bring enforcement proceedings to protect investors and to keep the capital market clean and honest, all while free of political influence.[55] This element is one of the principles established by the International Organization of Securities Commissions ("IOSCO").[56]

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55. *Id.* at 552–56.

56. IOSCO, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 3–4 (2010), *available at* http://www.compliance-exchange.com/governance/library/ioscoprinciples2010.pdf.

Unfortunately, Latin American securities regulators have traditionally been under the umbrella of the executive power. Finance ministries appoint and remove the heads of agencies,[57] and also approve of personnel hiring. The executive branches also have control over the budget, and may authorize proposed rules and exercise enforcement powers. This breadth of executive control has affected the operational and budgetary autonomy of regulators across the region for years.

During the past decade, Brazil's CVM has adopted this important cornerstone of the enforcement wish list, setting an important precedent for the region. In a significant institutional change during the wave of reform that swept Brazil in the past decade,[58] the Securities Act was amended in 2001,[59] declaring CVM an independent government agency, endowed with administrative autonomy, and free from the restraints of hierarchic subordination. In addition, it was also granted financial and budgetary autonomy.[60]

Moreover, the reform provided a fixed mandate for each of the five members of the Board of Commissioners. Following the SEC model,[61] CVM's commissioners, including the Chair, are appointed by the President of the Republic and ratified by the Senate[62] for five-year terms, with one new member elected each year on a staggered basis. In addition, commissioners may only be removed if they are convicted of a serious crime. This should, in theory, provide for stability and political independence of the Board of Commissioners, allowing them decision-making freedom and effective action.

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57. For example, Mexico's Minister of Finance may discretionally appoint and remove the head of the agency. Brazil appears to be leading this tendency, which other markets have followed as well, including Colombia.

58. *See* Fifth Meeting of the Latin American Corporate Governance Roundtable, Rio de Janeiro, Braz., Oct. 8–9, 2004, *The Legal, Regulatory and Institutional Framework for Enforcement Issues in Latin America*: *A Comparison of Argentina, Brazil, Chile, Colombia and Peru* 2 (2004) (by Daniel Blume), *available at* http://www.oecd.org/dataoecd/32/30/34254149.pdf.

59. Through the enactment of Law 10.411 of February 26, 2002. Lei No. 10.411, de 26 Fevereiro de 2002, D.O.U. de 27.02.2002 (Braz.).

60. *See id.* art. 1.

61. *See* Santana, *supra* note 12.

62. Lei No. 6.385, art. 6, de 7 de Dezembro de 1976, D.O.U. de 09.12.1976, *redação dada pela* Lei No. 9.457, de 5 de Maio de 1997, D.O.U. de 6.5.97 (Braz.).

The law, however, provides that CVM is linked to Brazil's Ministry of Finance.[63] In principle, this link should not pose a threat to the agency's independence, but rather allow for accountability—an element that should characterize securities regulators.[64] In fact, Congress and the Ministry of Finance,[65] through its Department of Internal Control, oversee CVM's activities.[66]

Nevertheless, the law in action reveals particular shortcomings. For instance, CVM does not actually have the financial and budgetary autonomy that is provided for by law. The budget is centrally managed through Brazil's treasury department and an amount is allocated to the agency every year. CVM does not manage its own revenue, and the income that it generates—via fines, settlements, and an "enforcement tax"[67] paid by market participants, goes directly to the central government for distribution.[68] As a result, a significant surplus has been reported in recent years, with CVM's revenues being much in excess of the amount that it receives from the annual budget.[69] The agency has not received the desired budget to carry out its operations, mainly due to government focus in other priority areas.[70]

One illustration involves the 2009 approval of 165 new staff positions for CVM. Other government priorities have prevented CVM from hiring these allocated employees. This impingement on CVM's financial autonomy also extends to its administrative and operational independence, not only because it involves the hiring of personnel, but also be-

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63. *See* Lei No. 10.411, art. 1, de 26 Fevereiro de 2002, D.O.U. de 27.02.2002, amending Lei No. 6.385, art. 5, de 7 de Dezembro de 1976, D.O.U. de 09.12.1976 (Braz.).

64. *See* Birdwell, *supra* note 39, at 555.

65. Lei No. 6.385, art. 5, de 7 de Dezembro de 1976, D.O.U. de 09.12.1976, *redação dada pela* Lei No. 10.411, art. 1, de 26 Fevereiro de 2002, D.O.U. de 27.02.2002 (Braz.).

66. CVM undergoes several audits each year which result in a report with recommendations on its activities. Brazil's Court of Public Account also revises CVM's activities. *See, e.g.*, CVM RELATÓRIO DE GESTÃO 2005, *supra* note 14.

67. CVM's 2005 Annual Report noted that 91% of the income came from these alternative sources. *Id.* In 2007, this tax was reported to have amounted $60 million. CVM RELATÓRIO DE GESTÃO DO EXERCÍCO DE 2009 [ANNUAL REPORT 2009] 29 (2009) (Braz.) [hereinafter CVM RELATÓRIO DE GESTÃO 2009], *available at* http://www.cvm.gov.br/port/relgest/RelatóriodeGestãoCVM2009.pdf. According to 2009 report the amount of fines totaled $29 million in 2007, but totaled $65.5 million in 2006. *Id.*

68. CVM RELATÓRIO DE GESTÃO 2009, *supra* note 67, at 15.

69. *Id.*

70. Telephone Interview with María Helena dos Santos Fernandes de Santana, Chair of CVM & IOSCO's Exec. Comm. (Oct. 10, 2011) [hereinafter Santana Interview].

cause a significant number of these new employees were to be allocated to enforcement and surveillance efforts.[71]

However, since 2005, after CVM's management decision to prioritize enforcement, the central government has strived to provide the agency with increased resources.[72] Data reported by the Latin American Corporate Governance Roundtable reveals that CVM's budget, which amounted to $25.8 Million in 2004, increased to $77.2 million in 2007 and $90.67 million in 2008, a significant rise of 84.6% (in terms of adjusted local currency).[73] However, as shown in the following table, the increase during the mentioned time period is not nearly as impressive after normalizing the budget in relation to the size of the market, in terms of market capitalization.

Moreover, to what extent these resources were actually allocated to enforcement is difficult to determine, but a breakdown of CVM's budget provides a fairly accurate snapshot.[74] A significant percentage of CVM's budget was allocated to an account described as Capital Market Development, which at least indirectly is aimed at investor protection. However, it appears that only a relatively small percentage of that account

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71. *Id.*

72. *Id.*

73. *See* Tenth Meeting of the Latin American Corporate Governance Roundtable, Santiago, Chile, Dec. 1–2, 2008, *The Legal, Regulatory and Institutional Framework for Enforcement Issues in Latin America: A Comparison of Argentina, Brazil, Chile, Colombia, Panama and Peru* 3 (2009) (by Andreas Grimminger et al.) [hereinafter *2009 Framework for Enforcement Issues*], *available at* http://www.oecd.org/dataoecd/0/15/44138533.pdf.

74. Annual National Budgets of Brazil 2004–11. *See* Lei No. 10.837, de 16 de Janeiro de 2004, Orçamento Anual de 2004 [Annual Budget], Janeiro 2004 (Braz.), *available at* http://sidornet.planejamento.gov.br/docs/lei2004/index.htm; Lei No. 11.100, de 25 de Janeiro de 2005, Orçamento Anual de 2005 [Annual Budget], Janeiro 2005 (Braz.), *available at* http://sidornet.planejamento.gov.br/docs/lei2005/index.htm; Lei No. 11.306, de 16 de Maio de 2006, Orçamento Anual de 2006 [Annual Budget], Maio 2006 (Braz.), *available at* http://sidornet.planejamento.gov.br/docs/lei2006/; Lei No. 11.451, de 07 de Fevereiro de 2007, Orçamento Anual de 2007 [Annual Budget], Fevereiro 2007 (Braz.), *available at* http://www.planejamento.gov.br/secretarias/upload/Legislacao/Leis/070207_lei_11451.pdf; Lei No. 11.647, de 24 de Março de 2008, Orçamento Anual de 2008 [Annual Budget], Março 2008 (Braz.), *available at* http://www.planejamento.gov.br/secretarias/upload/Legislacao/Leis/080324_lei_11647.pdf; Lei No. 11.897, de 30 de Dezembro de 2008, Orçamento Anual de 2009 [Annual Budget], Dezembro 2008 (Braz.), *available at* http://www.planejamento.gov.br/secretarias/upload/Arquivos/sof/orcamento_09/loa09/Loa_2009.pdf; Lei No. 12.214, de 26 de Janeiro de 2010, D.O.U. de 27.01.2010 (Braz.); Lei No. 12.381, de 9 de Fevereiro de 2011, D.O.U. de 10.02.2011 (Braz.).

(4.9% annualized average) was actually designated for Market Supervision, Regulation, and Investor Protection.

CVM Budget 2004–2011[75]

("$" Indicates Brazilian Currency in Millions, Decimals Reflect Percentages)

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
I. Total Financial System Budget (Nominal Value)	$8,614	$10,146	$10,340	$13,119	$14,342	$19,862	$19,219	$19,702
Real Value (Adj. to inflation)	$12,221	$13,620	$13,458	$16,346	$16,874	$22,403	$20,468	$19,702
Normalized to Market Capitalization	0.98158	0.91825	0.68269	0.54152	1.03462	0.85642	0.74639	0.86051
A. Total CVM Budget (Nominal Value)	$75.40	$79.40	$94.00	$140.20	$162.90	$201.90	$191.20	$267.40
Real Value (Adj. to inflation)	$106.98	$106.59	$122.35	$174.69	$191.66	$227.73	$203.63	$267.40
Normalized to Market Capitalization	0.00859	0.00719	0.00621	0.00579	0.01175	0.00871	0.00743	0.01168
% of Financial System Budget	0.88	0.78	0.91	1.10	1.40	1.00	1.00	1.40
1. Capital Market Development	$59	$66.40	$77.50	$98.10	$99.60	$101	$124.30	$134.60
Real Value (Adj. to inflation)	$84	$89.14	$100.87	$122.23	$117.18	$114	$132.38	$134.60
Normalized to Market Capitalization	0.00672	0.00601	0.00512	0.00405	0.00719	0.00435	0.00483	0.00588
% of CVM's Budget	78.00	83.60	82.50	70.00	61.00	50.00	65.00	50.30
a. Market Supervision, Regulation & Investor Protection	$4.11	$3.22	$2.99	$7.73	$9.53	$3.61	$6.60	$6.90
Real Value (Adj. to inflation)	$2.48	$2.74	$4.76	$9.04	$8.92	$4.83	$6.82	$6.90

75. Author's compilation. Budget collected from Brazil's Annual National Budgets 2004–2011 (see *supra* note 74), was adjusted for inflation (real value in terms of 20011 BRCy) based on Brazil's Consumer Price Index ("CPI")—Calculated from annualized data on inflation obtained at: INFLATION, http://www.inflation.eu (last visited May 29, 2012), and normalized in relation to Market Capitalization of BM&FBOVESPA stock

Normalized to Market Capitalization	0.00033	0.00022	0.00015	0.00026	0.00058	0.00014	0.00024	0.00030
% of Capital Market Development	4.90	3.60	3.00	6.30	8.00	3.20	5	5
i. Investor Protection & Assistance	$1.10	$0.81	$0.71	$1.30	$1.40	$1	$1.40	$1.40
Real Value (Adj. to inflation)	$1.56	$1.09	$0.92	$1.62	$1.65	$1	$1.49	$1.40
Normalized to Market Capitalization	0.00013	0.00007	0.00005	0.00005	0.00010	0.00004	0.00005	0.00006
ii. Market Supervision	$0.80	$0.80	$0.80	$2.50	$3.30	$9.30	$1.20	$2.00
Real Value (Adj. to inflation)	$1.14	$1.07	$1.04	$3.11	$3.88	$10.49	$1.28	$2.00
Normalized to Market Capitalization	0.00009	0.00007	0.00005	0.00010	0.00024	0.00040	0.00005	0.00009
iii. Information Dissemination & Regulation	$1.10	$0.81	$0.80	$2.40	$3.40	$1.30	$3.50	$3.50
Real Value (Adj. to inflation)	$1.56	$1.09	$1.04	$2.99	$4.00	$1.47	$3.73	$3.50
Normalized to Market Capitalization	0.00013	0.00007	0.00005	0.00010	0.00025	0.00006	0.00014	0.00015

With regards to staff, the Commission also showed an upward trend during the decade. The number of employees increased from 363 in 2004 to 500 in 2008.

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exchange—end of year market capitalization data from 2004–2011 obtained at: WORLD FEDERATION OF EXCHANGES, http://www.world-exchanges.org/ (last visited June 7, 2012). The market capitalization data was converted from U.S. Dollars to Brazilian Currency using the end of the year exchange rate (Dec. 31) obtained at: *Historical Exchange Rates*, OANDA, http://www.oanda.com/currency/historical-rates/ (last visited May 29, 2012).

CVM Staff 2001–2007[76]	
2001 (January)	327 employees
2003 (Aug.)	371 employees
2004∗	363 employees
2005 (Sep)	500 employees
2006 (Aug)	487 (451 staff / 36 Federal Attorneys)
2007	489 (459 Staff / 30 Federal Attorneys)
2008∗	500 employees

A significant increase occurred in 2005, reflecting CVM's strategic decision that year to prioritize on enforcement.[77] CVM has since continued its efforts to increase staff. As mentioned above, new employee positions were approved in 2009, but to date are on hiatus given budgetary constraints.

Moreover, as a result of CVM establishing a centralized enforcement division in 2008, it also began hiring more specialized staff to conduct investigations and pursue cases. In 2009, the department had a staff of thirty, composed of twenty-two inspectors, and eight federal prosecutors.[78] In addition, the Inspections Department, responsible for external inspections, had a staff of forty-two. CVM's new enforcement division is detailed in the section that follows.

b. A Beefed-Up Enforcement Program and Increased Action

In the roadmap to effective enforcement, a fundamental step involves the regulator establishing a "stand-alone enforcement program with a mandate."[79] Among other features, the program should have an enforcement division vested with the responsibility and statutory capacity to investigate and prosecute serious corporate wrongdoing. It should be able to compel evidence and prosecute, employing tools such as stopping ongoing fraud via injunctive orders and asset freezes, and to bring enforcement actions with demonstrable consequences. The program should have both investigative and prosecutorial functions, and its investigative staff

76. *2009 Framework for Enforcement Issues*, *supra* note 73, at 7–8; ROBERT PRINGLE, HOW COUNTRIES SUPERVISE THEIR BANKS, INSURERS AND SECURITIES MARKETS 2010 (Risk Books 2009).

77. Santana Interview, *supra* note 70.

78. *See 2009 Framework for Enforcement Issues*, *supra* note 73, at 3.

79. *See* Birdwell, *supra* note 39, at 552.

should include not only lawyers, but also accountants and personnel with experience in prosecuting cases.[80]

As is the case with most Latin American jurisdictions, Brazil's securities regulator did not have an enforcement department prior to 2008. Each of CVM's eleven divisions, or *Superintendencias*,[81] supervised, investigated, and proposed penalties regarding their areas of expertise for the Board of Commissioners to decide on. That system has advantages and continues to be implemented to this date, particularly given the in-depth technical expertise of each division. However, with its shift in policy to prioritize enforcement, CVM established a centralized enforcement program in 2008 aimed at unifying and accelerating enforcement activity.[82] Enforcement is jointly carried out by two divisions: the *Superintendencia de Processos Sancionadores* ("SPS") and the *Procuradoria Federal Especializada* ("PFE").[83]

This enforcement program's institutional design entails a unique model of administrative enforcement. Investigations are carried out by the managers and staff of SPS and PFE in collaboration with specialized federal attorneys and investigators assigned to CVM. This design reportedly resulted in increased and more focused enforcement activity, targeting serious and sophisticated wrongdoing.[84] Moreover, the length of even the most complex procedures has been reduced to an average of ten months.[85]

Carrying on with the roadmap, the ability to settle administrative matters is also an essential feature of an enforcement program and a useful part of its tool-kit.[86] Unique among the regulators of the region, CVM has had this power since 1997, inspired by the SEC settlement.[87] Known as *Termos de Compromiso*, these settlements halt an administrative proceeding if the accused party agrees to end the unlawful conduct and to correct the wrongdoing, in addition to indemnifying the corresponding loss.

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80. *Id.* at 553–54.

81. With the same hierarchical level, and headed by a Directors or *Superintendentes*. *See* Pinheiro dos Santos, *supra* note 41, at 343–44.

82. *See 2009 Framework for Enforcement Issues*, *supra* note 73, at 4.

83. *See id.*

84. Telephone Interview with Alexandre Pinheiro dos Santos, CVM Att'y Gen. (Gen. Counsel) & Head of CVM Legal Dept. (Procuradoria Federal Especializada) (Oct. 13, 2011) [hereinafter Pinheiro Interview].

85. Pinheiro dos Santos, *supra* note 41, at 343.

86. *See* Birdwell, *supra* note 39, at 575–76.

87. Pinheiro dos Santos, *supra* note 41, at 343.

However, these settlements had seldom been used until the second half of the decade. Aimed at deploying this potentially useful tool, CVM established the *Committee for Settlements of Proceedings* in 2005. This committee is led by CVM's Chief Executive Officer and includes the Superintendents of each of CVM's eleven divisions. Its role broadly involves identifying and negotiating potential settlements of administrative cases and delivering opinions on proposals for settlement made by defendants or people under investigation. Proposed settlements are subject to review and approval by CVM's Board of Commissioners.

The committee has played an active role in institutionalizing the negotiations and settlement process, providing for its legitimacy. Market participants involved get to actively engage in the negotiations, which has resulted in a more open and transparent process. CVM's Board of Commissioners usually, though not always, accepts the terms proposed, which also speaks to the authority of the process.[88] Moreover, the reduction in the length of administrative procedures and investigations may also explain why market participants prefer to reach a settlement, rather than wait for a decision by CVM's Board of Commissioners. Further, the Enforcement Division has been bringing more cases, resulting in increased settlements.[89] Another aspect that may be appealing to both regulators and market participants is that these settlements are not subject to approval by the courts.

Preliminary data may speak to the increase in enforcement activity by CVM, regarding administrative action pursued via its new centralized enforcement division and settlements. Surveys conducted by the Latin American Roundtable for Corporate Governance both before and after CVM's shift in policy prioritizing enforcement reflect the contrast in enforcement between the first and second half of the decade.[90]

There is an upward trend in the number of administrative sanctions imposed by Brazil's securities regulator, resulting from administrative procedures. These amounted to 542 between the period from 2006 to July 2009, of which 448 were fines and 94 were suspensions.[91] This was an increase from the 319 sanctions imposed during the 2001–2003 period, which featured 313 fines and 6 suspensions.[92] Even more striking is the difference in the amount of fines imposed during the 2006–2009 period, which totaled $279.5 million, versus a much lower $81.7 million

88. Santana Interview, *supra* note 70.
89. *Id.*
90. *See 2009 Framework for Enforcement Issues*, *supra* note 73, at 3–5.
91. *Id.* at 8.
92. *Id.*

for the 2001–2003 period.[93] During the recent period, the highest individual fine was also significantly higher, amounting to $38.5 million, compared to $22.5 million in the earlier period.[94]

CVM Administrative Sanctions 2001–2003 / 2006–2009[95]			
	Number of Fines	**Amount of Total Fines (U.S. millions)**	**Highest Fine in period (U.S. millions)**
2001	131	–	$22.5
2002	55	–	
2003	127	–	
Total	**313**	**$81.7**	
2006	184	$65.5	$38.5
2007	105	$29	
2008	103	$185	
Jul. 2009	56	–	
Total	**448**	**$279.5**	

Administrative sanctions are not always final, however.[96] Of the 448 fines imposed between 2006 and July 2009, a very high number, 313 (over 70%) were subject to appeals processes.[97]

93. *Id.* at 7.

94. *Id.*

95. *Id.* at 7–8.

96. Final decisions of CVM relating to enforcement may be appealed before the *Conselho de Recursos do Sistema Financeiro Nacional—CRSFN*, an administrative body composed of representatives of CVM, the Central Bank of Brazil, the Finance Ministry, and regulated agents. There is no possibility of appeal before the judiciary. *See id.* at 8.

97. *Id.* at 6–8.

CVM Administrative Sanctions 2006–2009[98]			
	Number of Fines	**Number of Fines Appealed**	**Appeals Status In 2004 (for the 2003–2006 fines) / In 2009 (for the 2006–2009 fines)**
2001	131	114	74 upheld / 13 reversed
2002	55	66	14 upheld / 7 reversed
2003	127	87	0 upheld / 0 reversed
Total	**313**	**267**	**90 upheld / 20 reversed / 108 modified / 49 pending**
2006	184	134	4 upheld / 10 dismissed / 120 pending
2007	105	81	4 upheld / 77 pending
2008	103	84	1 upheld / 83 pending
2009 (1st semes-ter)	56	19	0 upheld / 0 dismissed / 19 pending
Total	**448**	**318**	**19 processed / 280 pending**

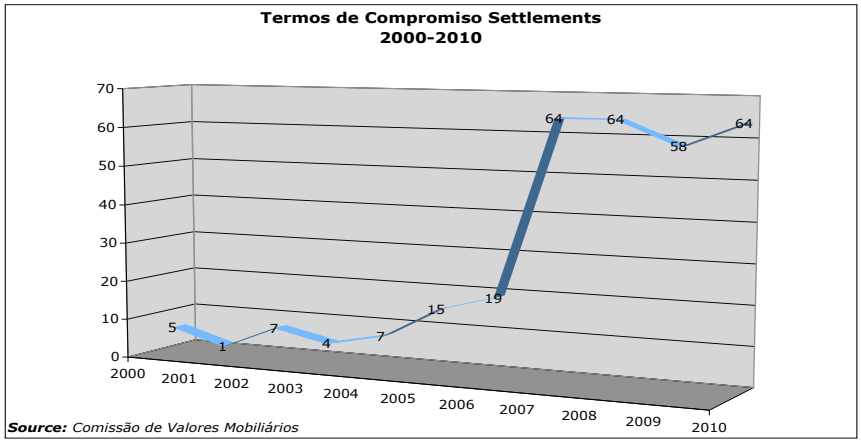
For the 2001–2003 period, most of the appeals were processed by the end of the three-year period, that is, 218 of the total 267 appeals.[99] Though a considerable number were upheld, and there were only a few reversals, 108 cases were modified.[100] What is of more concern is that for the 2006–2009 period, of the 313 appeals only 19 (6%) were actually processed by the end of that period.[101]

Since 2005, there has been increased focus on more sophisticated wrongdoing, particularly insider trading. Although relatively few administrative cases have been decided regarding this misconduct, they concern a considerable number of defendants. These figures reflect that enforcement activity is now visible in this area, and speak to CVM's efforts to bring action in this front.[102]

98. *Id.* at 7–8.
99. *Id.*
100. *Id.*
101. *Id.*
102. Pinheiro Interview, *supra* note 84.

Insider Trading Cases Judged by CVM			
Year	**Number of administrative cases judged and/or with *Termo de Compromisso***	**Number of defendants**	**Charged as Guilty or Closed with celebration of Termo de Compromisso**
2005	4	14	2
2006	5	21	17
2007	4	40	22
2008	7	36	19
2009	3	4	2
2010	10	33	29
2011	2	3	3
Total	**35**	**151**	**94**
Source: Comissão de Valores Mobiliários			

The *Termos de Compromiso* settlements have witnessed a significant increase too, as shown in the following graph. Not surprisingly, this rise began after 2005, following the establishment of the Committee for the Settlement of Procedures.



The number of settlements skyrocketed from nineteen in 2006 to over sixty in the years that followed. As shown in the table below, the number of defendants entering into the agreements surged as well, as did the total amount paid as a result. Significant amounts were paid per settlement too, with the lowest settlement signed in 2008 amounting to almost $10,000, the average to $53,026, and the highest to over $3 million. In contrast, the average fine that year amounted to almost $1.5 million, and

the highest imposed was $38.5 million.[103] This considerable difference may explain not only why most administrative decisions (which impose fines) are appealed, but also why market participants increasingly consider settling.

TERMOS DE COMPROMISO			
Year	**Number**	**Number of defendants**	**Amount Paid (R$)**
1998	2	4	$2,679.87
1999	3	5	$0.00
2000	5	30	$3,347,001.77
2001	1	3	$266,414.48
2002	7	31	$520,000.00
2003	4	7	$10,000.00
2004	7	23	$254,407.97
2005	15	51	$17,529,100.00
2006	19	96	$1,911,986.28
2007	64	159	$46,054,291.88
2008	64	112	$10,660,927.80
2009	58	84	$11,045,731.74
2010	64	141	$57,502,975.77
2011	36	70	$170,469,222.67
Total	349	816	$319,574,740.23
Source: CVM's Procuradoria Federal Especializada (PFE)			

Yet another step toward effective enforcement entails developing a partnership with the criminal justice authorities. To that end, during the latter half of the past decade, CVM actively cooperated with the Brazilian Federal Police Department and the Federal Prosecutor's Office. This joint action was the result of an inter-institutional relationship that has deepened over the past six years, which has already led to the signing of cooperation agreements among the three institutions.[104] This collaboration has resulted in the use of more sophisticated tools that have allowed CVM to engage in real-time enforcement. This has included the freezing of assets on a considerable number of occasions during recent years.

As previously mentioned, a series of offenses were criminalized early in the decade, including insider trading and market manipulation. Though that was an important achievement, it was not until these col-

103. *See 2009 Framework for Enforcement Issues*, *supra* note 73, at 7.

104. Pinheiro Interview, *supra* note 84.

laborations began that real implementation has materialized. For instance, in 2011, CVM and the Federal Prosecutors Office were able to obtain the first criminal conviction in Brazil for insider trading, in the *Sadia* case.[105] This active interplay among enforcers might be a reflection of Brazil moving toward a "multiple-enforcers" model.

CVM and the Federal Prosecutors office have also joined together to revive the Collective Civil Action. Though it dates back to 1989, it had not been employed until very recently, as a result of CVM's recent enforcement efforts. Unlike U.S. class actions, the remedy is not available for market participants to file directly, but CVM and the Federal Prosecutors Office may do it on their behalf. CVM has increasingly been filing these actions on behalf of numerous market participants. The compensation obtained is then sent back to a fund to pay people who incurred losses. This process is an important instrument that is gaining relevance and momentum, though CVM is very selective in its use. Although there are not many cases to date, CVM set important precedents in recent years, particularly regarding insider trading.[106] One deterrent to wider use of this instrument, however, is the judiciary's lack of expertise in capital markets matters.

Finally, in terms of maximizing its capacity to engage in international cooperation, CVM's policy on enforcement has led it to reach out to the global community in order to improve its enforcement practices and exchange information with securities regulators around the world. Securities enforcement in Brazil follows the IOSCO Objectives and Principles of Securities Regulation. This commitment is reflected in CVM's signing the IOSCO Multilateral Memorandum of Understanding for Cooperation and Assistance in 2009, aimed at international cooperation among regulators for pursuing the increasing amount of securities violations having international dimensions.[107] A more recent example of this international interplay among regulators was a technical assistance workshop on enforcement practices hosted and sponsored by CVM in May 2011, to

105. Two former officers of Sadia, S.A. were convicted by a court and sentenced to prison and a fine. J.F.S.P., Crim. No. 2009.61.81.005123-4, 16.02.2011, 182 Diário do Judiciário Eletrônico [D.J.e.], 02.10.2009, 234 (Braz.) (on file with the author).

106. Pinheiro Interview, *supra* note 84.

107. MMoU, *supra* note 50. The fact that CVM's chair is also the current Chair of IOSCO's Executive Committee further reflects Brazil's commitment with the international community regarding collaboration among regulators in terms of global market surveillance.

which the Office of International Affairs of the SEC substantially contributed through its Technical Assistance Program.[108]

2. Self-Regulation—Toward a Multiple-Enforcers Model?

A securities authority needs to develop a partnership with the industry via a self-regulatory regime.[109] Brazil has strong foundations in self-regulation dating back to before the turn of the century. The Brazilian Corporate Governance Institute ("IBGC") was established in 1995 to guide qualifying directors and senior officers of companies in the application of corporate governance principles. In 1998, the National Investment Bank Association ("ANBID") launched its self-regulatory code for public offerings of securities, imposing stricter standards than those of the legislation of the time. In 2000, the stock exchange launched the Novo Mercado and Corporate Governance Levels II and III listing segments, involving corporate government standards and requirements that also went further than the law.

CVM has supported and capitalized on these self-regulatory developments, ultimately designing an SRO regime that is both mandatory and voluntary. The mandatory dimension is of a statutory nature and involves, as legal conditions to operate, requirements to issuers. An important step came in 2007, when the Sao Paulo Stock Exchange ("BOVESPA")[110] and the Brazilian Mercantile & Futures Exchange ("BM&F")[111] demutualized, launched their IPOs, and merged, resulting in BM&FBOVESPA.[112] Practically in tandem, and foreseeing potential conflicts of interest, CVM issued Instruction No. 461/07,[113] providing for a detailed legal framework of self-regulation for stock exchanges and other organized markets.[114]

Under this framework, organized securities markets must be structured, maintained, and inspected by "managing entities" authorized by CVM,

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108. CVM & BM&FBOVESPA, Bilateral Enforcement Program with Brazilian Regulators and Prosecutors (May 2–6, 2011), *available at* http://www.sec.gov/about/offices/oia/oia_emergtech.shtml.

109. *See* Birdwell, *supra* note 39, at 579.

110. The company that actually launched the IPO was BOVESPA Holding Group, of which the Sao Paulo Stock Exchange was a subsidiary. This took place on October 26, 2007.

111. BM&F's IPO took place on November 30, 2007.

112. Brazil's only stock exchange, and the third largest in the world.

113. Instruçao CVM No. 461, de 23 de Outubro de 2007, D.O.U. de 24.10.2007 (Braz.) [hereinafter CVM Instruction No. 461].

114. Including OTC and commodities and futures markets.

organized as associations or stock corporations.[115] These managing entities are responsible for the preservation and self-regulation of the securities markets they manage, and it is their legal duty to maintain the balance between their own interests and the public interests to be served.[116] In turn, to perform the self-regulatory supervision and enforcement, managing entities may either (1) form an association, controlled entity, or entity under common control, or (2) outsource the task to an independent third-party.

BM&FBOVESPA is the managing entity responsible for Brazil's securities markets. Unlike the U.S. exchanges, BM&FBOVESPA has not yet outsourced its market surveillance and oversight activities to a third-party enforcer like FINRA. However, it did establish a functionally autonomous and financially independent non-profit subsidiary with considerable rule-making and enforcement powers to perform the task: BM&FBOVESPA Supervisão de Mercados ("BSM").[117]

A specific example of the interplay of public enforcement with self-regulation is provided by Instruction 461/07,[118] which establishes that in relation to penalties for violations of rules under its jurisdiction, CVM may deduct penalties that have already been imposed under mandatory self-regulation, including penalties imposed by BSM. In that respect, CVM is reported to be reasonable, and it capitalizes on this division of labor, which has reportedly proved successful in recent years and contributes to CVM's prioritizing of its resources.[119]

The other self-regulatory dimension is of a non-statutory nature, which CVM has promoted via regulatory incentives. These have included fast-track securities (debenture) offerings (avoiding paperwork and costs) after complying with best corporate practices, such as those established by the Investment Bank Association ("ANBID") Code regarding public offerings. Another example is CVM Instruction 471 of 2008, which offers a fast track for offerings that have been reviewed by a self-regulatory entity under an agreement with CVM.[120] In addition to enhancing investor confidence through disclosure practices, this has allowed CVM to save and focus its resources on other priorities.

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115. CVM Instruction No. 461/07, art. 9.

116. *Id.* art. 14.

117. BSM started operating on October 1, 2007.

118. CVM Instruction No. 461, art. 49, para. 5.

119. Santana Interview, *supra* note 70.

120. Instruçao CVM No. 471, de 8 de Augusto de 2008, D.O.U. de 11.08.2008 (Braz.) [hereinafter CVM Instruction No. 471].

As a result of these developments, Brazil's securities market may be further shifting toward a "multiple-enforcers" model.

3. Private Rights of Action—Are They on the Way?

So far Brazil's securities enforcement system appears to satisfy several of the guidelines considered to contribute to effective enforcement. However, there is one important instrument that it does not yet offer: recourse to an effective judiciary with specialized tribunals that have the capacity to entertain capital markets matters.[121]

Private enforcement of securities markets violations is rare in Latin America, and Brazil is not an exception.[122] Market participants may resort to the Brazilian court system, but seldom do in practice. In part, this may be due to the lack of specialized judges trained in capital markets and securities regulation.[123] The courts also present other problems, such as lengthy procedures that become expensive. In turn, most of the cases related to corporate and securities law often result in settlement agreements, so there is even less incentive to use the courts.[124]

Another potential explanation involves the perception by the market that CVM is quite efficient and able to deal with very complex legal issues. This further preempts the judiciary from being activated.[125] If, in fact, CVM is bringing more actions, this may trigger the involvement of the courts in the foreseeable future. This scenario might provide incentives to challenge or delay a ruling by CVM, and may ultimately result in further specialization of the judiciary to handle these matters.[126]

Another factor worth noting is that a good number of issuers are listed in Level II of the Novo Mercado market, and accordingly are obliged to adhere to an arbitration procedure rather than resort to the courts. Unfortunately, illustrating a shortcoming of self-regulation, arbitration has not

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121. Birdwell, *supra* note 39, at 576–77.

122. *See* Nelson Eizirik, Concept Paper Presented at the Harvard Law School First Annual Symposium on Building the Financial System of the 21st Century: An Agenda for Latin America and the United States: Insider Trading Law in Brazil: Recent Developments 83, 83–89 (June 13–15, 2008), *available at* http://www.law.harvard.edu/programs/about/pifs/symposia/brazil/2008-latam/08lafinalreport.pdf.

123. Santana Interview, *supra* note 70.

124. *Id.*

125. *Id.*

126. *Id.*

been used by market participants, as it is often considered too expensive.[127]

A related step in the roadmap involves the access of a regulator to civil remedies in order to instigate action in the first instance.[128] Regulators in Brazil have access to civil action. However, civil remedies, as with private rights of action, are often not pursued in practice and CVM prefers to proceed administratively. Moreover, as opposed to market participants, CVM does not have the option of resorting to the state courts, which have more experience in dealing with private commercial matters than the federal courts.

The upside is that there are signs of improvement that may lead Brazil to include private rights of action in its emerging multiple-enforcers model. Judges have reportedly been receptive to this in recent matters. In what might be the most relevant collective civil action to date, CVM reportedly did not face major difficulties in presenting the matter thoroughly to the court.[129] Other efforts have involved collaboration agreements between CVM and the judiciary to increase communication and exchange of information concerning Brazil's capital market. During the last two to three years, CVM has designed programs for judges to participate in, yielding positive results.[130] CVM has also increased its interactions with the courts via amicus briefs and expert opinions regarding conflicts among market participants.

Finally, there has been a tendency toward specialization. One innovation is a specialized commercial court in Rio de Janeiro. This is still a preliminary experience that lacks institutionalization. Among other issues, problems arise when a judge is promoted and needs to be replaced. A system to keep the judges educated and specialized in the field of capital markets is needed.[131] More resources should also be directed toward Brazil's judiciary to establish "commercial courts . . . in the cities with stronger business activities," and to invest in specialized training.[132]

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127. *Id.*

128. Birdwell, *supra* note 39, at 568. Considering that it may be easier to pursue serious wrongdoing via the civil procedure, as it usually provides simpler standards of proof than the criminal path.

129. Pinheiro Interview, *supra* note 84.

130. *Id.*

131. Santana Interview, *supra* note 70.

132. *See* Isabella Saboya, Partner, Investidor Professional, Address at the Fifth Meeting of the Latin Am. Corp. Governance Roundtable: Legal, Regulatory and Institutional Framework for Enforcement—State of Play and Key Challenges (Oct. 8, 2004), *available at* http://www.oecd.org/dataoecd/48/42/33940873.pdf.

CONCLUDING REMARKS

These preliminary findings indicate that, within the global context and during a period of ongoing legal and institutional corporate reform dating back to the turn of the century, Brazil has shifted toward enhanced regulatory intensity in the enforcement of its securities laws. The research identifies a series of developments in institutional design and implementation that reflect this shift.

This transformation in Brazil's securities enforcement system followed a 2005 change in policy whereby CVM made enforcement its main priority. Consequently, CVM became an enforcement-driven agency, embodying characteristics reminiscent of regulators in developed securities markets like the United States. This transformation involved both the development and implementation of new enforcement institutions and practices, and the resurgence of older ones that had been in place but had seldom been engaged.

Key developments suggesting enhanced regulatory intensity included the establishment of a new stand-alone enforcement program within CVM that includes a centralized enforcement program aimed at enhancing enforcement activity via two specialized divisions: the *Superintendencia de Processos Sancionadores* and the *Procuradoria Federal Especializada*. This enforcement mandate was created with a unique design, combining federal attorneys and staff with prosecutorial and investigative functions. A surge in enforcement activity, particularly regarding administrative action, penalties, and settlements, became clear after this enforcement program came into play in the second half of the decade. Other signs of improvement included swifter administrative procedures and a focus on more serious misconduct, namely insider trading and market manipulation.

In addition to administrative action, the enforcement team diversified toward both civil and criminal actions. This resulted in the revival of the Collective Civil Action, a class-action type remedy that had not been employed before, which led to an increased use of the courts. Further, a collaboration with the criminal justice authorities allowed for the successful prosecution of wrongdoing that had been criminalized earlier in the decade, and triggered the use of a more sophisticated tool-kit, including the freezing of assets and injunctive orders.

Moreover, to spark the use of an important tool that had lacked legitimacy and use—the power to settle cases—CVM created the Committee for Settlements of Proceedings. This new institution legitimized a negotiations process that resulted in a striking rise in *Termos de Compromisso* settlements, yet another sign of enhanced enforcement activity.

CVM further developed a strong partnership with the industry, establishing a self-regulatory regime with both mandatory and voluntary dimensions. On the mandatory (statutory) side, a detailed legal framework of self-regulation for organized markets was set in place, including both enhanced listing requirements for public firms and the effective outsourcing of market surveillance to a quasi-regulator SRO with enhanced rule-making and enforcement powers. On the voluntary front, significant incentives led firms to adopt higher corporate governance standards that went beyond the law.

Additional trends included international cooperation and assistance with other securities regulators of the world, the adoption of international principles involving enhanced enforcement practices, and reaching out to developed markets for technical support in order to improve market surveillance.

A surge in the resources of the securities regulator during this period, both in budget and staffing, also suggests increased focus on enforcement. However, challenges in this area became apparent, revealing limited administrative and budgetary autonomy of the regulator, restricting its access to the resources and personnel needed for market surveillance and enforcement.

Another shortcoming is the lack of specialized tribunals and judges trained in capital market matters. This may explain why private rights of action are practically null, and why procedures are sluggish and costly. It may also explain why CVM does not instigate civil action in the first instance but, rather, proceeds administratively. There are, however, tendencies that might make way for increased involvement of the courts, including attempts to establish specialized commercial courts, and recent collaboration and exchanges of information between the securities regulator and the courts.

To what extent do all these developments speak to globalization of securities enforcement and the influence of developed markets in the evolution of emerging securities enforcement systems? There are interesting indicators in light of the Brazilian example. These include, with regards to the securities regulator, (1) the adoption of a policy to prioritize enforcement; (2) modeling its structure after the SEC's "sole-entity" model,[133] including an independent Board of Commissioners; (3) undergoing a transformation into an enforcement-driven agency; (4) achieving considerable political independence; (5) establishing a stand-alone enforcement program with a mandate; (6) having access to an enhanced

133. *See* Santana, *supra* note 12.

tool-kit to combat serious corporate wrongdoing in "real-time"; (7) the ability to settle; and (8) active partnerships with the criminal justice authorities; (9) with the industry; and (10) and with the international community.

These partnerships also speak to the development of a "multiple-enforcers" model reminiscent of developed markets. Despite the practical absence of private rights of action, the securities regulator has come to rely on collaboration with other law enforcement agencies, and has engaged in an active interplay with a sophisticated self-regulatory regime, sharing the burden of market surveillance with a quasi-governmental FINRA-like SRO.

Brazil's recent experience with securities enforcement could well be a reflection of the path that lies ahead for emerging capital markets in today's global arena.

WHY DO SHAREHOLDER DERIVATIVE SUITS REMAIN RARE IN CONTINENTAL EUROPE?

Martin Gelter[*]

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* Associate Professor, Fordham Law School, and Research Associate, European Corporate Governance Institute. For helpful comments, I thank Pierre-Henri Conac, Luca Enriques, Francesca Giannoni-Crystal, Kristoffel Grechenig, Federico Mucciarelli, Mathias Siems, the participants of the Fordham Law Alumni Association European Chapter meeting that took place at LUISS Guido Carli University, Rome, Italy, in July 2011, and the participants of the October 2011 Symposium on the Globalization of the US Litigation Model at the Dennis J. Block Center for the Study of International Business Law at Brooklyn Law School.

"Happy families are all alike; every unhappy family is unhappy in its own way."

LEO TOLSTOY, ANNA KARENINA (1878)

INTRODUCTION

The objective of this symposium piece is to explore why shareholder derivative suits are rare in Continental Europe. I mainly focus on Germany, France, and Italy, and further provide less extensive references regarding derivative suits in Austria, Belgium, the Netherlands, Spain, and Switzerland. In doing so, I compare the Continental European situation with the one in the United States and Japan, where derivative suits are important mechanisms of corporate governance enforcement. It is sometimes thought that shareholder litigation and litigiousness in general are cultural features of U.S. society.[1] In Japan—where shareholder derivative suits have also become common since the early 1990s—cultural theories gave way to theories emphasizing economic incentives that were more strongly supported by the evidence, as no discernible cultural shift occurred when suits became widespread.[2] I also emphasize economic incentives set by the legal framework to explain the scarcity of derivative suits in Continental Europe. This explanation, similar to the explanation provided for Japan, is also only cultural as far as legal and structural constraints setting these incentives are part of the respective culture. The two points I seek to make are summarized under the headings of the "Anna Karenina Principle" and "The Path of Least Resistance."

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1. *See, e.g.*, Scott H. Mollett, *Derivative Lawsuits Outside of Their Cultural Context: The Divergent Examples of Japan and Italy*, 43 U.S.F. L. REV. 635, 654 (2009); Mathias M. Siems, *Private Enforcement of Directors' Duties: Derivative Actions as a Global Phenomenon*, *in* COLLECTIVE ACTIONS: ENHANCING ACCESS TO JUSTICE AND RECONCILING MULTILAYER INTERESTS? 4 (Stefan Wrbka, Steven Van Uytsel & Mathias Siems eds., forthcoming 2012), *available at* http://ssrn.com/abstract=1699353 (both discussing cultural explanations of derivative litigation).

2. Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436, 1439–41 (1994) [hereinafter West, *Pricing Shareholder Derivative Actions in Japan & U.S.*] (criticizing cultural explanations).

In his Pulitzer Prize-winning book *Guns, Germs and Steel*, geographer and biologist Jared Diamond popularized the "Anna Karenina Principle" based on the first line of Leo Tolstoy's classic novel. Tolstoy suggested that happy families share a number of core characteristics that must all be present to ensure happy family life. Diamond varies the idea to explain that an animal species needs to meet a list of criteria, including diet, social behavior, and breeding habits, to be susceptible to domestication by humans.[3] The relatively small number of domesticable species can thus be explained by the observation that if even one criterion on the list is not met, the species would be too onerous to employ for human purposes. Likewise, only the United States and Japan seem to "get it right" with respect to all necessary criteria to make derivative litigation a successful model for shareholders. By contrast, no single factor suffices to account for the scarcity of derivative litigation in Continental Europe—or even a single country. I survey the available and some additional explanations, and suggest that several criteria have to be met to make derivative suits attractive.

The small number of derivative suits in Continental Europe is often seen as a reason why corporate law is considered underenforced in these jurisdictions.[4] While I do not attempt to disprove this claim, I suggest that there is a significant degree of enforcement through channels of corporate law, beyond enforcement derived from derivative suits. If a legal system discourages derivative suits, disgruntled shareholders will take the "Path of Least Resistance," and resort to other enforcement mechanisms. I, therefore, address other ways in which shareholders of European corporations can seek judicial recourse that do not take the shape of derivative litigation. While this does not imply that there is the same quality and quantity of enforcement in Europe as in the United States, we can identify at least a limited range of partial functional equivalents.

The article proceeds as follows: Part 1 begins by discussing the basics: Part 1.1 defines the scope of the investigation and establishes some comparative fundamentals. While European legal systems distinguish between two legal forms, namely the public company[5] and the private

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3. JARED DIAMOND, GUNS, GERMS AND STEEL 157–75 (1997).

4. *E.g.*, Gérard Hertig, *Western Europe's Corporate Governance Dilemma*, *in* CORPORATIONS, CAPITAL MARKETS, AND BUSINESS IN THE LAW 265, 280 (Theodor Baums, Klaus J. Hopt & Norbert Horn eds., 2000).

5. This includes the German, Austrian, and Swiss *Aktiengesellschaft*; the French, Swiss, and Belgian *société anonyme*; the Italian *società per azioni*; the Spanish *sociedad anónima*; and the Dutch and Belgian *Naamloze vennootschap.* A firm incorporated as a

company,[6] I discuss only the former (derivative suits tend to be easier in the latter category). Section 1.2 describes the general issue all corporate law systems have to deal with, namely the tradeoff between effective enforcement of corporate law and prevention of abusive lawsuits that are used to divert resources to plaintiffs. Part 1.3 gives a brief overview of the various European models of shareholder litigation. Part 2 discusses possible reasons for the absence of derivative suits in Continental Europe. Some of the arguments have been discussed frequently, such as minimum ownership thresholds and the distribution of litigation risk through litigation cost rules. Others have received less or no attention, such as limits to the information available to defendants, and limits to who can be sued derivatively. Part 3 suggests that the absence of derivative suits may not be as detrimental as one might think at first glance by showing that derivative litigation is not the only possible avenue for private corporate law enforcement. Without attempting to provide a complete picture, I look at three Continental European enforcement models, as follows: Part 3.1 investigates rescission (nullification) suits, which are common in several countries, but subject to a particularly intense debate in Germany, where it is often argued that they can be abused by "predatory shareholders"; 3.2 discusses criminal enforcement under French law, on which shareholders are able to "piggyback"; and 3.3 looks at the Dutch model, where derivative suits are not available and the unique "inquiry proceedings" are the chosen method for resolution of many corporate conflicts of interest. The larger theoretical point is that shareholders will seek the "path of least resistance" in litigation. If derivative litigation does not provide a good option, maybe another legal mechanism (such as the ones described in Part 3) will. Finally, the Conclusion summarizes and concludes.

1. THE BASICS

1.1. The Significance of Derivative Suits

Robert Clark emphasizes that the American derivative suit was originally conceived as a combination of two suits: "The plaintiff (1) brought

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public company does not necessarily have to be publicly traded (the majority of firms are not).

6. The German, Austrian, and Swiss *Gesellschaft mit beschränkter Haftung*; the French, Swiss, and Belgian *société à responsabilité limitée*; the Italian *società a responsabilità limitata*; the Spanish *Sociedad de responsabilidad limitada*; and the Dutch and Belgian *Besloten vennootschap* are therefore not discussed, as well as newer "hybrid" forms such as the French *société par actions simplifiée.*

a suit in equity against the corporation seeking an order compelling it (2) to bring a suit for damages or other relief against some third person."[7] Derivative suits were—and are—typically brought against directors or officers of the corporation.[8] While litigation on behalf of the corporation is normally one of the tasks within the wide range of the board's powers,[9] the board is unlikely to bring a suit against one of its members or against an officer, whom the board appointed and who works under the board's supervision.[10] Against this conflict of interests, the derivative suit provides a safety valve by allowing shareholders to push the corporation into litigation.[11] Much of Delaware case law revolves around the circumstances under which directors can avoid a suit. Even when shareholders have good intentions and their claims are likely to succeed, these suits may not be in the best interest of the corporation.[12]

There is strong evidence that the number of derivative suits in the United States is quite large, however, the suits are outnumbered by shareholder class actions—which are brought for *personal* claims of all shareholders[13]—and by securities class actions. For example, Thompson and Thomas report that, in 1998 and 1999, 824 class actions, 87 individual direct actions, and 137 derivative actions were brought in Delaware based on alleged violations of fiduciary duty.[14] Nevertheless, the niche for derivative actions remains sizeable.[15]

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7. ROBERT C. CLARK, CORPORATE LAW 639 (1987); *see* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

8. Anne Tucker Nees, *Who's the Boss? Unmasking Oversight Liability within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 214 n.56 (2010).

9. *See* DEL. CODE ANN. tit. 8, § 141(a) (2011).

10. *See* Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 397 (2008); Agostino v. Hicks, 845 A.2d 1110, 1116 (Del. Ch. 2004) ("[D]irectors and officers of a corporation may not hold themselves accountable to the corporation for their own wrongdoing.").

11. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981); Taormina v. Taormina Corp., 78 A.2d 473, 475 (Del. Ch. 1951) ("[T]he action is brought as a class action . . . on behalf of all other stockholders of the Corporation similarly situated.").

12. *See, e.g.*, *Maldonado*, 430 A.2d at 779–85.

13. Delaware uses the Tooley test to distinguish between derivative and direct suits (which include class actions) on the basis of whether (1) the corporation or shareholders allegedly suffered harm, and (2) who would receive the benefit of the remedy. Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004).

14. *E.g.*, Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 168–69 (2004).

15. As shown by Mark West, Japan is the one country that seems to have adopted the U.S. practice of the derivative suit on a large scale. Mark D. West, *Why Shareholders*

The European evidence is fragmentary, but commentators that discuss individual countries uniformly confirm that the number of suits is very low.[16] In the United Kingdom, an investigation by Armour et al., spanning 2004 through 2006, brought to light only twenty-six suits in which directors were named as the defendants.[17] I am not aware of any systematic evidence for Continental Europe. Cheffins and Black report only two suits against German supervisory board members before 1997 in which

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Sue: The Evidence from Japan, 30 J. LEGAL STUD. 351, 351 (2001) [hereinafter West, *Why Shareholders Sue*].

16. *E.g.*, Kristoffel Grechenig & Michael Sekyra, *No derivative shareholder suits in Europe: A model of percentage limits and collusion*, 31 INT'L REV. L. & ECON. 16, 16 (2011) (suggesting a general absence of derivative litigation in Europe). For specific countries, see, for example, Lukas Glanzmann, *Die Verantwortlichkeitsklage unter Corporate-Governance-Aspekten* [*The Liability Action under Corporate Governance Aspects*], 119 ZEITSCHRIFT FÜR SCHWEIZERISCHES RECHT [ZSR] 137, 174–75 (2000) (Switz.) (noting the small significance of shareholder litigation in Switzerland); YVES GUYON, 1 DROIT DES AFFAIRES—DROIT COMMERCIAL GÉNÉRAL ET SOCIÉTÉS [BUSINESS LAW—COMMERCIAL LAW AND ASSOCIATIONS] ¶ 462 (2003) (Fr.) (stating that the "*action sociale ut singuli*" is rarely exercised); Dominique Schmidt, *De quelques règles procédurales régissant l'action en responsabilité civile contre les dirigeants de sociétés « cotées » in bonis* [*About severel procedural rules regarding the civil liability action against the directors of publicly traded companies*], *in* ÉTUDES DE DROIT PRIVÉ. MELANGES OFFERTS À PAUL DIDIER 383, 391 (Michael Germain & Jean Foyer eds., 2008) (Fr.) (noting that the number of suits in France is insignificant); Paolo Giudici, *Representative Litigation in Italian Capital Markets: Italian Derivative Suits and (if ever) Securities Class Actions*, 6 EUR. COMPANY & FIN. L. REV. 246, 249 (2009) ("[T]he Italian derivative action exists on paper, but not in the real world"); Dario Latella, *Shareholder Derivative Suits: A Comparative Analysis and the Implications of the European Shareholders' Rights Directive*, 6 EUR. COMPANY & FIN. L. REV. 307, 319 (2009) ("At present, there are no suits exerted in Italy and, therefore, no data available."); Marcus Lutter, *Zur Durchsetzung von Schadenersatzansprüchen gegen Organmitglieder* [*The Enforcement of Compensation Claims against Board Members*], *in* FESTSCHRIFT FÜR UWE H. SCHNEIDER ZUM 70. GEBURTSTAG 763, 764–65 (Ulrich Burgard, Walther Hadding, Peter O. Mülbert, Michael Nietsch & Reinhard Welter eds., 2011) (Ger.) [hereinafter FESTSCHRIFT FÜR UWE H. SCHNEIDER] (noting that neither "predatory shareholders" not plaintiffs bringing legitimate suits have appeared since the 2005 reform of shareholder litigation in Germany); Klaus Ulrich Schmolke, *Die Aktionärsklage nach § 148 AktG*, [*The Shareholder Action under § 148 AktG*], 40 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [ZGR] 398, 402–03 (2011) (Ger.) (explaining that there were only three relatively insignificant cases of derivative suits in Germany have been reported since the 2005 reform).

17. John Armour, Bernard Black, Brian Cheffins & Richard Nolan, *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687, 699 (2009).

damages were awarded at trial.[18] Ulmer reports only two published German cases awarding damages on the basis of a submission by shareholders between 1965 and 1999.[19] Pierre-Henri Conac, Luca Enriques, and I began to compile a database of published French, German, and Italian cases decided between 2000 and 2007 where self-dealing by controlling shareholders is alleged. While this can provide us only with a limited (and maybe not even the main) subset of derivative suits, it is still interesting to note that we have so far found only two such suits in Germany (one of which related to a GmbH, roughly the equivalent of an LLC), two in Italy, and one in France.[20] There is, however, very good data on rescission suits in Germany.[21]

1.2 The Tradeoff between Enforcement and Abuse

Are the effects of shareholder litigation beneficial? Intuitively, corporate law requires an enforcement mechanism. Directors and officers who do not expect sanctions for violating duties of care, loyalty, or good faith have little reason to comply with these duties. Generally the decision to bring a lawsuit is within the competence of a corporation's directors,[22] who are unlikely to bring a lawsuit on behalf of the corporation and name themselves as defendants.[23] Without derivative suits, enforcement would be highly improbable, except after a change of the management team, e.g. because ownership of the corporation changed or because the

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18. *See* Brian R. Cheffins & Bernard S. Black, *Outside Director Liability across Countries*, 84 TEX. L. REV. 1385, 1424 (2006).

19. Peter Ulmer, *Die Aktionärsklage als Instrument zur Kontrolle des Vorstands- und Aufsichtsratshandelns* [*The Shareholder Action as an Instrument to Control Executive and Supervisory Board Actions*], 163 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT [ZHR] 290, 295 n.19 (1999) (Ger.).

20. In fact, in most of the cases in our database judicial recourse was not sought through a derivative suit, but in other ways. *See infra* Section 3.1.

21. *See infra* Section 3.1.

22. For France, see, for example, PHILIPPE MERLE & ANNE FAUCHON, DROIT COMMERCIAL. SOCIÉTÉS COMMERCIALES [COMMERCIAL LAW: BUSINESS ASSOCIATIONS] ¶ 409 (13th ed. 2009) (Fr.); for Germany, see UWE HÜFFER, AKTIENGESETZ [STOCK CORPORATION ACT] § 147, ¶ 1 (9th ed. 2010) (Ger.) (explaining that normally the management board and supervisory board act on behalf of the company).

On shareholders' power to pass a binding resolution to litigation, *see infra* note 50 and accompanying text. In Spain and Belgium, the law simply states that the shareholder meeting decides about liability suits, apparently without explicitly providing for a suit to be brought by directors. *See* LEY DE SOCIEDADES ANÓNIMAS art. 134.1 (B.O.E. 1989, 1564) (Spain); CODE DES SOCIÉTÉS [COMPANY CODE] art. 561 (Belg.).

23. *E.g.*, Arad Reisberg, *Funding Derivative Actions: A Re-Examination of Costs and Fees as Incentives to Commence Litigation*, 4 J. CORP. L. STUD. 345, 367 (2004).

old board was forced to resign after a scandal or the company's insolvency.[24] Boards of directors are typically not inclined to sue officers of the corporation, even if the officers are not members of the board.

The same holds in two-tier board models such as the German model. Under German law, the supervisory board represents the corporation vis-à-vis members of the management board.[25] While the separation of the two boards is intended to avoid conflicts of interest resulting from an overlap between the management and oversight functions, lawsuits against incumbent boards are still not frequent. The obvious reasons are that the supervisory board is also responsible for the appointment of management board members,[26] and that supervisory directors at least appear to be indirectly responsible for decisions of the management organ they are expected to monitor.[27] Decisions that give rise to litigation are, therefore, likely to shed a bad light on the supervisory board and may even lead to liability for poor oversight.[28] The same applies when the potential defendant is a supervisory board member, in which case management, representing the company, is equally unlikely to bite the hand that feeds it.[29] Interlocking directorates and inevitable social relationships between directors further widen the enforcement gap.[30]

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24. *See* Giudici, *supra* note 16, at 248–49 (recounting that liability against directors was largely unheard of outside of insolvency before Italy introduced derivative suits in 1998); Michel Germain, *Les droits des minoritaires (droit français des sociétés)* [*Minority Rights (French Company Law)*], 54 REVUE INTERNATIONALE DE DROIT COMPARÉ [RIDC] [INTERNATIONAL JOURNAL OF COMPARATIVE LAW] 401, 409 (2002) (Fr.) (pointing out that liability suits are usually only brought after a change at the helm).

25. *See* Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BUNDESGESETZBLATT, TEIL I [BGBL. I] at 1089, last amended by Gesetz [G], Dec. 22, 2011, BGBL. I at 3044, § 112 (Ger.). Regarding representation in the case of litigation against members of the management board, see, for example, Mathias Habersack, *in* 2 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ [MUNICH COMMENTARY ON THE STOCK CORPORATION ACT], § 112, ¶ 17 (Wulf Goette & Mathias Habersack eds., 3d ed. 2008).

26. AktG § 84 (Ger.).

27. *See* AktG § 111(1) (Ger.); Hans C. Hirt, *The Review of the Role and Effectiveness of Non-Executive Directors: A Critical Assessment with Particular Reference to the German Two-tier Board System: Part 1*, 14 INT'L COMPANY & COM. L. REV. 245, 254 (2003) [hereinafter Hirt, *The Review of the Role and Effectiveness of Non-Executive Directors*] (describing structural interdependence of the two boards).

28. *E.g.*, HANS C. HIRT, THE ENFORCEMENT OF DIRECTORS' DUTIES IN BRITAIN AND GERMANY 274–75 (2004).

29. *See* Hans C. Hirt, *The Enforcement of Directors' Duties pursuant to the Aktiengesetz: Present Law and Reform in Germany: Part 1*, 16 INT'L COMPANY & COMM. L. REV. 179, 185 (2005) [hereinafter Hirt, *The Enforcement of Directors' Duties*].

30. *See* Hirt, *The Review of the Role and Effectiveness of Non-Executive Directors*, *supra* note 27, at 253–54; Susanne Kalss, *Shareholder Suits: Common Problems, Differ-*

Shareholder derivative litigation is one possible way of filling this gap. The individual shareholder's incentive to sue, however, is weak. A potential plaintiff will only benefit from a successful suit in proportion to his share in the company, while the remaining benefits accrue to other shareholders. The plaintiff has to bear the time investment of dealing with a suit and possibly the cost. Derivative suits are, therefore, often said to produce a public good, the production of which may need to be subsidized if derivative suits are thought to have beneficial effects.[31]

Shareholder litigation, however, may not always be in the interest of the corporation or shareholders as a group. Even if there is a possible basis for liability, the likelihood of success and the potential award may be too small to make spending money and the executives' time worthwhile for the corporation.[32] Furthermore, a suit may create negative publicity that reduces sales or causes skepticism among suppliers and customers. Weighing the pros and cons against each other, the decision to litigate looks very much like other business decisions usually taken by management. Boards typically possess superior information, in comparison to shareholders, as to whether a suit would be advisable. This is why one can arguably consider the choice to bring a lawsuit a business decision—one that warrants the protection of the business judgment rule—at least as long as the decision maker is not subject to a conflict of interest. U.S. corporate law developed the "demand requirement" to strike a balance between the business judgment inherently required in the decision to litigate and conflicts of interest arising from the fact that potential defendants are directors.[33] A potential plaintiff in a derivative suit must

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ent Solutions and First Steps towards a Possible Harmonization by Means of a European Model Code, 6 EUR. COMPANY & FIN. L. REV. 324, 336–37 (2009).

31. *E.g.*, Reisberg, *supra* note 23, at 345, 347–48 (discussing incentives to sue and free-riding); Anne van Aaken, *Shareholder Suits as Technique of Internalization and Control of Management*, 68 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT [RABELSZ] 288, 289 (2004) (Ger.) (discussing the public good character of derivative suits).

32. *See, e.g.*, Reinier Kraakman, Hyun Park & Steven Shavell, *When are Shareholder Suits in Shareholder Interests?* 82 GEO. L.J. 1733, 1738 (1994) (discussing litigation cost). Besides these costs on the individual level, shareholder litigation may also make it more expensive for firms to hire managers. *Id.* In this case, other shareholders might react to a suit by selling.

33. *See* Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000); *see, e.g.*, DEL. CH. CT. R. 23.1 (West 2012); N.Y. BUS. CORP. LAW § 626(c) (McKinney 2003).

show that the plaintiff requested that the board of directors bring a suit or had a good reason not to do so.[34]

It is conceivable that a suit can be entirely abusive.[35] For example, a criticism that is sometimes raised in the United States is that derivative suits primarily benefit plaintiff law firms[36]—since the first shareholder bringing the suit controls the suit, law firms may engage in a race to the courthouse in order to win the prize of controlling the suit.[37] The ulterior motive of the firm, however, is to receive a contingency fee.[38] Most cases do not actually go to trial, but instead result in a settlement.[39] Under the "substantial benefits" test, plaintiff lawyers receive a contingency fee not only as a percentage of damages awarded or agreed upon as a settlement, but also on the basis of other consequences of the suit. These sometimes include corporate governance changes agreed upon with the corporation's management, such as the appointment of independent directors to the board (the financial benefits of which, if there are indeed any, are

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34. *See* FED. R. CIV. P. 23.1(b)(3) and equivalent rules under state law, such as MODEL BUS. CORP. ACT § 7.42 (1984). The complaint has to "state with particularity" the efforts the plaintiff made "to obtain the desired action from the directors" or the reasons why the plaintiff failed to do so. Under Delaware law, courts will assume that by making a demand, plaintiffs concede that demand was not futile. *See* Speigel v. Buntrock, 571 A.2d 767, 775 (Del. 1990). Since directors will typically conclude that a suit is not advisable, demand is rarely made. *See* James D. Cox & Randall S. Thomas, *Common Challenges Facing Shareholder Suits in Europe and the United States*, 6 EUR. COMPANY & FIN. L. REV. 348, 352 (2009). Litigation often revolves around the disinterestedness of directors' decision not to sue. *See* Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave*, 1832 PLI/CORP 163, 209–14 (2010). Under the Aronson-Levine test, plaintiffs thus either have to show that the current board "could not reach a disinterested decision with respect to plaintiff's demand," or that "there was reasonable doubt about whether the board then exercised reasonable business judgment with respect to the challenged transaction." *See* Aronson v. Lewis, 473 A.2d 805, 805, 814 (Del. 1984); *Brehm*, 746 A.2d at 256.

35. *See* Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 5–6 (1999).

36. *See id.* at 2, 5–6.

37. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 692 (1986) [hereinafter Coffee, *Understanding the Plaintiff's Attorney*].

38. *See* Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 86 (2008); *see also* Loewenstein, *supra* note 35, at 6 (discussing the motivating force behind filing a derivative action).

39. James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3 (1999).

nearly impossible to measure).[40] Litigation may therefore often commence without merit and be entirely characterized by litigation agency cost.[41] The controlling law firm has an incentive to settle the case in the way not necessarily most beneficial for shareholders, but rather to maximize the firm's own benefit.[42]

But even in light of this problem, one could argue that litigation without merit in the specific case may create beneficial general deterrence. Managers and directors will have stronger incentives to shy away from anything that remotely resembles a violation of corporate law because it *could* lead to a suit, and consequently negative publicity and the hassle of legal proceedings. Contingency fees—or any other reward obtained by an "abusive" lawyer or plaintiff—could be seen as a reward needed to incentivize possible plaintiffs to monitor corporate actions. Abusive lawsuits might actually be socially valuable because only they create a sufficient deterrent effect.

1.3 Continental European Models of Derivative Litigation

Despite the general perception that derivative suits are rare in Continental Europe, they are, in principle, available in all countries surveyed here with the exception of the Netherlands.[43] (Dutch law has developed another enforcement model that will be discussed in Part 3.3.) Admittedly, some countries were relative latecomers to the concept. Belgium only introduced derivative litigation in 1991,[44] and Italy did so for listed firms only as part of a securities law reform in 1998.[45] The Italian

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40. *See* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 392 (1970).

41. *See* Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 37, at 679–80.

42. *See In re* Revlon, Inc. S'holders Litig., 990 A.2d 940, 959 (Del. Ch. 2010); Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 37, at 690.

43. STEVEN R. SCHUIT, BARBARA BIER, LEONARD G. VERBURG & JAN A. TER WISCH, CORPORATE LAW AND PRACTICE OF THE NETHERLANDS 155 (Steven R. Schuit ed., 2d ed. 2002).

44. The relevant section of the law today is CODE DES SOCIÉTÉS art. 562 (Belg.). The suit was first introduced with the *Lois coordonnées sur les sociétés commerciales* [Belgian Company Code] art. 66bis, of July 26, 1991, MONITEUR BELGE [M.B.] [Official Gazette of Belgium] (Belg.). Alexia Bertrand & Arnaud Coibion, *Shareholder Suits against the Directors of a Company, against other Shareholders and against the Company itself under Belgian Law*, 6 EUR. COMPANY & FIN. L. REV. 270, 282–83 (2009) (discussing reasons for the introduction).

45. Decreto Legislativo 24 febbraio 1998, n. 58 (It.); TESTO UNICO IN MATERIA DI INTERMEDIAZIONE FINANZIARIA [T.U.I.F.] [RULES AND REGULATIONS CONCERNING STOCK MARKET TRADING] art. 129, D. Lgs. n.58 (It.). The corporation could settle lawsuits un-

mechanism was expanded to all stock corporations—or *società per azioni*—including those that are not publicly traded, in 2003. Elsewhere, derivative suits or very close equivalents have been around for much longer. For example, France was the trailblazer and introduced the so-called *action sociale ut singuli* in 1867,[46] while Germany's slightly different minority enforcement mechanism followed suit in 1884.[47]

The litigation models of France and Switzerland, where the derivative suit is seen as an individual shareholder right and the law simply states that a corporate liability suit can be brought by a shareholder on behalf of the corporation,[48] are probably the closest to the United States' model. In Austria, Belgium, Germany, Italy, and Spain, enforcement is a collective right of shareholders that can be imposed on the corporation by a binding shareholder resolution.[49] The power of the majority is compromised by the right of a qualified minority to set litigation in motion with court approval.[50] The Belgian, Italian, and Spanish enforcement mechanisms can

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less a minority of 5% objected in the shareholder meeting. Article 129 has been eliminated in consequence of the introduction of the derivative suit in corporate law.

46. Loi du 24 juillet 1867 sur les Sociétés [Law of July 24, 1867 on Companies], arts. 17, 39 (Fr.) (permitting a minority of 5% to bring a derivative suit). In spite of the 5% threshold, the courts soon found that this provision did not limit the individual shareholders right to bring a derivative suit; it merely set out limitations to the circumstances under which a group of shareholders could collaborate to sue jointly (in order to save cost). *See* C. HOUPIN & H. BOSVIEUX, 2 TRAITÉ GÉNÉRAL DES SOCIÉTÉS CIVILES ET COMMERCIALES ET DES ASSOCIATIONS ¶ 1431 (6th ed. 1929) (citing a list of cases beginning with Cass., 7 maie 1872, Dal. 72, I, 273 (It.)).

47. *See* Hirt, *The Enforcement of Directors' Duties*, *supra* note 29, at 184.

48. *See* CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] art. L. 225-252 (Fr.); OBLIGATIONENRECHT [OR] [CODE OF OBLIGATIONS] Mar. 30, 1911, as amended, art. 756 (Switz.). Germany follows this model only in the law of corporate groups. *See infra* notes 185–84 and accompanying text. In France, it is usually assumed that the derivative suit can only be brought if the corporation failed to sue, even though there is no formal demand requirement. *See* Hans de Wulf, *Direct shareholder suits for damages based on reflective loss*, *in* 1 FESTSCHRIFT FÜR KLAUS J. HOPT ZUM 70. GEBURTSTAG AM 24. AUGUST 2010, 1537, 1558 (Stefan Grundmann et al. eds., 2010).

49. Depending on the respective board structure, shareholders that do not fulfill the standing requirements to sue can of course alert the board, supervisory board, or board of auditors of possible wrongdoing, although this will of course not help much in many cases. *See, e.g.*, CODICE CIVILE [C.C.] art. 2393(3) (It.) (permitting the board of auditors to sue).

50. *See* C.C. arts. 2393(1), 2364(4) (It.); AktG § 147(1) (Ger.); CODE DES SOCIÉTÉS art. 561 (Belg.); AKTIENGESETZ [AKTG] [STOCK CORPORATION ACT] § 134(1) (Austria); Ley de Sociedades Anónimas art. 134.4 (B.O.E. 1989, 1564) (Spain) (providing that a minority of 5% can ask for the convocation of a shareholder meeting to decide about a liability suit, and can bring the suit if (1) the board does not convene the shareholder

be qualified as providing for actual derivative suits, even though Belgian and Italian laws require that shareholders must appoint representatives (of plaintiff shareholders).[51] The same is true for the German model introduced with the Business Integrity Act of 2005,[52] which for the first time permits a "real" derivative suit in which shareholders personally enforce a claim.[53] The old German model, which is still available as an alternative,[54] and the equivalent Austrian provisions, only create a right for a qualified minority to petition a court to appoint a special representative of the corporation to pursue liability claims against directors.[55] The

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meeting, (2) the company does not bring a suit in spite of a decision in the shareholder meeting within a month, or (3) shareholders decide not to bring a suit).

The right to enforce claims is only one of a whole range of rights that qualified minority shareholders have in many Continental European jurisdictions. The role of minimum ownership requirements will be discussed in Part 2.1. While fiduciary duties or equivalent doctrines applying to controlling shareholders are generally recognized, I am not aware of litigation that would allege a breach for a controlling shareholders' failure to vote in favor of a liability suit. *See* Pierre-Henri Conac, Luca Enriques & Martin Gelter, *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 EUR. COMPANY & FIN. L. REV. 491, 500–02 (2007).

51. CODE DES SOCIÉTÉS art. 565 (Belg.) (requiring that plaintiffs unanimously elect a representative to pursue the suit who can be a "shareholder or not"); C.C. art. 2393-bis(4) (It.) (requiring that plaintiffs elect one or more representatives by a majority vote). In Italy, shareholders also control the suit, since the law allows them to abandon or settle the claim. C.C. art. 2393-bis(6) (It.); *see* Luca Enriques & Federico M. Mucciarelli, *L'azione sociale di responsabilità da parte delle minoranze* [*Derivative Action brought by a Minority*], *in* 2 IL NUOVO DIRITTO DELLE SOCIETÀ [THE NEW CORPORATE LAW] 861, 878–79 (Pietro Abadessa & Giuseppe B. Portale eds., 2006) (It.) (criticizing that a majority shareholder could inhibit litigation by suing separately and electing a compliant representative).

52. AktG § 148 I, as amended by Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts [UMAG], Sept. 22, 2005, BGBL. I at 2802 (Ger.).

53. Regarding additional procedural hurdles, *see infra* notes 65–67 and accompanying text.

54. *See* AktG § 147(2) (Ger.).

55. Regarding the requirement to first push for the enforcement of the claim in the meeting, see UWE HÜFFER, AKTIENGESETZ [STOCK CORPORATION ACT] § 147, ¶ 4 (6th ed. 2004); Henning Schröer, *in* 4 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 147, ¶ 32 (Bruno Kropff & Johannes Semler eds., 2d ed. 2004) (Ger.). Before 1998, a minority of 10% or a stated capital of €1 million could request the appointment of a special representative. Gesetz zur Kontrolle und Transparenz im Unternehmensbereich [KonTraG] [Control and Transparency Act], Mar. 3, 1998, BGBL. I Nr.24 S. 786 (Ger.), reduced the ownership threshold to 5%/€500,000 for cases where petitioners were able to establish facts indicating dishonesty or serious violations of the law or the corporate charter (AktG §147 III (Ger.) (old version)) and for the first time permitted the minority right to be exercised directly without first having to go through the shareholder meeting. Shareholders could

new German framework, for the first time, gives shareholders control over the suit,[56] although the corporation can decide to take over a pending suit at any time.[57] It is also the only Continental European country to adopt the demand requirement from the United States' model.[58]

2. THE ANNA KARENINA PRINCIPLE: EXPLANATIONS FOR THE ABSENCE OF SUITS

I focus on four issues to explain the scarcity of derivative litigation in spite of its availability in principle. In analogy to the Anna Karenina principle, countries need to "get it right" in at least four dimensions to allow shareholder suits to proliferate. The four dimensions are as follows: there must be favorable standing requirements that do not include a minimum ownership threshold (Section 2.1); the litigation risk must be allocated favorably to overcome minority shareholders' rational apathy (Section 2.2); potential plaintiffs must have sufficient access to information to litigate (Section 2.3); and the enforcement model must make it possible for shareholders to derivatively sue potential wrongdoers, which not only includes directors, but also controlling shareholders (Section 2.4).

2.1 Minimum Share Ownership Requirements

A number of Continental European jurisdictions require that shareholders (or groups of shareholders) hold a qualified percentage of the company's shares or a specified amount of capital to bring a derivative suit. Percentage limits can be rationalized as a screening mechanism against abusive lawsuits on the grounds that the incentive for a shareholder with a small amount of shares to bring a legitimate suit is very likely small. Given that any shareholder's benefits from the results of a successful suit consist only of a proportionate share in the rise of the value of the corporation, it seems hard to imagine why a shareholder

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also vote to appoint a special representative, presumably to pursue the claim more effectively. AktG § 147 II (Ger.). Currently, the appointment of a special representative can be requested by a 10% /€1 million minority.

Austrian law, which shares a historical origin with German law because of the introduction of the 1937 AktG in Austria, still provides essentially the same in AKTG § 134 (Austria).

56. Hirt, *The Enforcement of Directors' Duties*, *supra* note 29, at 188.

57. AKTG § 147(3) (Austria).

58. *See* AktG § 148(1)(2) (Ger.).

with only a few shares would sue for a legitimate reason.[59] For a small investor, a suit would seem to be rational only when the investor can somehow coerce management into an abusive settlement that constitutes an effective bribe to make the investor go away, i.e., the litigation equivalent of greenmail.[60] Theory cannot explain what particular percentage should provide the cutoff, which could be set at 1%, 5%, 10%, or any other number with almost equal justification. A plaintiff's motives are presumably legitimate when the benefits of the lawsuit, multiplied by the probability of its success, exceed the costs of litigation, including nonmonetary cost. Any percentage limit is, to some extent, arbitrary and can preclude some legitimate suits. The requirement to retain a relatively large number of shares while the suit is pending may act as a further deterrent.[61]

Grechenig and Sekyra suggest that percentage limits are to blame for the absence of derivative suits in Continental Europe.[62] Their mathematical model captures a simple intuition: in order to avoid a lawsuit, potential defendant managers only need to deal with those shareholders above the applicable threshold. In order to "bribe" these large shareholders, managers would have to offer these shareholders an advantage that exceeds their losses from managerial wrongdoing. Large shareholders, therefore, do not monitor management, but become accomplices of management in actions exploiting investors whose share is below the threshold.[63]

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59. *E.g.*, Kalss, *supra* note 30, at 341 ("The *function* of a minimum share stake requirement is to impose part of the financial risk to be borne by the company on the claimant and, therefore, to reduce the economic motivation for suits brought for purposes of extortion."); Schmolke, *supra* note 16, at 425. The assumption implicit in this argument is that there are significant, non-reimburseable costs that do not increase in the plaintiff's share in the firm.

60. Relatedly, it is sometimes argued that small shareholders are mere investors without a long-term interest in the firm, who have no entrepreneurial interest and can express their dissatisfaction by selling his share. *See* Mathias M. Siems, *Welche Auswirkungen hat das neue Verfolgungsrecht der Aktionärsminderheit?*, 104 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFT [ZVGLRWISS] 376, 385 (2005) (Ger.) (criticizing this argument).

61. Giudici, *supra* note 16, at 251 (discussing the Italian case).

62. *See* Grechenig & Sekyra, *supra* note 16, at 16–17.

63. *See also* Alexander Stremitzer, *Plaintiffs Exploiting Plaintiffs* 11–12 (Yale Law & Econ. Research Paper, 2010), *available at* http://ssrn.com/abstract=1085282 (reaching practically the same result under different assumptions about bargaining power between managers and minority shareholders). One could imagine that managers permit large shareholders to engage in harmful self-dealing transactions, while these shareholders will allow managers to obtain illicit private benefits. This assumption seems to be in line with

In recent years, Germany and Italy have reduced minimum ownership thresholds. The traditional German enforcement mechanism required a qualified minority of 10% or DM 2,000,000 until 1998, when it was lowered to 5% or €500,000 for cases where shareholders could establish facts indicating dishonesty or serious violations of the law or the corporate charter.[64] The derivative suit introduced in 2005 requires only 1% or €100,000.[65] To prevent abusive litigation, the German legislature introduced a special judicial "lawsuit admission procedure," or *Klagezulassungsverfahren*, during the course of which plaintiffs must show that they demanded that directors bring the suit.[66] Shareholders have to establish facts indicating dishonesty or serious violations of the law or the corporate charter, and the court must determine whether litigation would be in the interest of the company before allowing it to proceed beyond this stage.[67]

In 1998, when derivative suits were introduced, Italian law started out with a 5% threshold.[68] Since the mechanism was never used,[69] the 2003 reform eliminated the six month ownership requirement and extended it to unlisted stock corporations. In unlisted corporations, the suit is restricted to shareholders owning at least 20%, unless the corporate charter provides an even higher threshold of up to 33.3%.[70] For publicly traded

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anecdotal evidence about financial scandals. In concentrated ownership systems, blockholders tend to be involved in wrongdoing. John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OX. REV. ECON. POL'Y 198 (2005). In a dispersed ownership firm where all stakes are below the threshold, there will be no suits unless shareholders are able to coordinate.

64. AktG § 147 III (Ger.) (old version). In other words, the burden of proof was more severe for smaller shareholders.

65. AktG § 148 I, as amended by UMAG (Ger.).

66. AktG § 148 II, as amended by UMAG (Ger.). Among other things, it must be shown that the firm failed to bring a suit within a reasonable period after demand was made by shareholders. A "reasonable" period seems to be about two months. *See* HÜFFER, *supra* note 22, § 148, ¶ 7.

67. To be precise, the court must determine whether there are indications that the company suffered damages from dishonesty or from serious violations of the law or the charter, and whether a suit would be contrary to the preponderating interest of the company AktG § 148 II, as amended by UMAG (Ger.). The corporation can at any time decide to pick up the suit. AktG § 148 III (Ger.).

68. Marco Ventoruzzo, *Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, 2 EUR. COMPANY & FIN. L. REV. 207, 246–47 (2005). The law also stipulated a minimum ownership period of six months. *Id.*

69. *Id.* at 247.

70. C.C. art. 2393bis(1) (It.).

firms, the threshold was reduced from 5% to 2.5% in 2006,[71] again because derivative suits failed to emerge in practice.[72]

Whereas Belgian law also only requires 1% or a nominal capital share of €1,250,000 for a derivative suit,[73] the thresholds are higher in Spain (5%)[74] and Austria (10%).[75] Table 1 provides a summary.

Country	Minimum ownership	Enforcement model	Additional notes
Austria	10%	enforcement by special representative of the corporation	5% if special audits revealed incriminating information
Belgium	1% or €1,250,000	derivative suit with mandatory shareholder representative	
France	none	derivative suit	groups of shareholders and shareholder associations need to pass thresholds to bring joint suits
Germany	1% or €100,000	derivative suit	demand requirement and judicial "admission procedure" shareholders have to establish facts indicating cases of dishonesty or serious violations of the law or the corporate charter
	10%	enforcement by special representative of the corporation	***special rules for corporate groups (see section 2.4)
Italy	2.5% (listed) or 20%	derivative suit with mandatory shareholder representative	
The Netherlands	10% or €225,000	no derivative suit, but "inquiry proceedings" (see section 3.3)	
Spain	5%	derivative suit	
Switzerland	none	derivative suit	

Table 1: Minimum ownership thresholds for minority enforcement of directors' liability in Continental European jurisdictions

71. C.C. art. 2393bis(2), as modified by Legge 28 dicembre 2005, n. 262 (It.).

72. *See* Giudici, *supra* note 16, at 250.

73. CODE DES SOCIÉTÉS art. 562 (Belg.).

74. Ley de Sociedades Anónimas art. 134(4) (B.O.E. 1989, 1564) (Spain) (referring to art. 100).

75. AKTG § 134(1) (Austria).

The percentage limit theory cannot explain the cases of France and Switzerland, where—as in the United States and Japan—individual shareholders can enforce liability claims against directors without holding a minimum stake. These laws also do not have the additional procedural hurdles of German law, such as the demand requirement and admission procedure.[76] The German situation is not well explained by the theory, since there is a special derivative mechanism available to every shareholder in the law of corporate groups, but the mechanism has also failed to produce litigation.[77] French law does not provide an ownership threshold for individual plaintiffs, but does so for groups of shareholders suing jointly[78] and for qualifying shareholder associations.[79] In these cases, the threshold amounts to at least 0.5% or 1%, respectively.[80] The collective mechanisms are preferable to the individual suit for reasons of litigation costs,[81] but the advantage is not big enough to overcome the problems set by the threshold and the lack of incentives for small shareholders to sue.

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76. Giudici, *supra* note 16, at 252, 253 n.38. Japan also never had a threshold, and still suits appeared only in the 1990s. West, *Why Shareholders Sue*, *supra* note 15, at 352 (describing the emergence of derivative suits in Japan).

77. *See infra* Section 2.4.

78. *See* C. COM. art. L. 225-169 (Fr.). The exact threshold is computed by taking 4% of the first €750,000 of the firm's capital, 2.5% of the amount between €750,000 and €7,500,000, 1% of the amount between €7,500,000 and €15,000,000, and 0.5% for anything above that. Thus, the larger the firm's capital, the smaller the required percentage.

79. Qualifying associations can collectively exercise the certain shareholder rights, such as the convocation of the shareholder meeting, putting items on the agenda, demand the resignation of auditors, submit questions to directors, and, most interestingly for us, bring suits against directors/administrators. *See id.* art. L. 225-120, I (Fr.); ANNE CHAVÉRIAT, ALAIN COURET & BRUNO ZABALA, MÉMENTO PRATIQUE FRANCIS LEVEBVRE: SOCIÉTÉS COMMERCIALES 2010, ¶ 17903 (Francis Lefebrvre ed., 41st ed. 2009).

80. *See* C. COM. arts. L. 225-252 & L. 225-120 (Fr.). The members of a qualifying association must own a minimum number of shares depending on the firm's legal capital. *See id.* art. L. 225-120. If the firm's capital is below €750,000, the required amount is 5%; between €750,000 and €4,500,000 it is 4%, between €4,500,000 and €7,500,000 it is 3%, between €7,500,000 and €15,000,000 it is 2%, and above that it is 1%. *See id.* French law does not have a demand requirement. *See* de Wulf, *supra* note 48, at 1558.

81. Since several shareholders suing in parallel cannot delegate a member of their group as a joint representative ("nul ne plaid par procureur"), court fees are effectively multiplied by the number of suing shareholders. Groups of shareholders or shareholder associations can allows spreading cost across shareholders. *See* RAPHAËL CONTIN, LE CONTRÔLE DE LA GESTION DES SOCIÉTÉS ANONYMES ¶ 526 (1975) (Fr.); GUYON, *supra* note 16, at 496; Germain, *supra* note 24, at 409; *see also* MAURICE COZIAN, ALAIN VIANDIER & FLORENCE DEBOISSY, DROIT DES SOCIÉTÉS ¶ 619 (22d ed. 2009); MERLE & FAUCHON, *supra* note 22, ¶ 410; CHAVARÉT ET AL., *supra* note 79, ¶ 2404.

In spite of these doubts, policymakers regularly obsess about percentage thresholds.[82] Given the highly dispersed ownership structure in the United States, it is likely that even a small percentage threshold would kill most suits in publicly traded firms. It is equally unlikely that eliminating ownership thresholds would result in derivative litigation spreading across the European continent. A non-trivial ownership threshold seems to be an exclusionary criterion that will prevent the emergence of a culture of derivative litigation, but the absence of one does not guarantee its spread.

2.2. Costs and the Allocation of Litigation Risk

2.2.1. Law Firm Driven Litigation in the United States

Besides ownership thresholds, the most frequently discussed reason for the scarcity of derivative litigation is the absence of incentives to bring derivative suits.[83] In most publicly traded U.S. firms, which usually have dispersed share ownership, one would expect individual shareholders to have little, if any, incentive to sue given that they only draw a very small advantage while being burdened with a potentially substantial cost.[84] The "American Rule" in civil procedure, which requires that each party pays its own cost regardless of the outcome, could in theory deter some prospective suits that have a high probability of success.[85] Losers are only required to pay winners in rare cases where courts believe that bringing a suit was clearly abusive.[86]

The high frequency of derivative (and other shareholder) litigation is typically credited to the entrepreneurial and specialized plaintiff bar. This bar actually has quite a strong incentive to bring derivative suits given that contingency fees resulting from an award or settlement could be as high as one third of the amount.[87] Even when the settlement does not contain a monetary award, and only requires changing the firm's corporate governance practices (e.g., more independent directors), the law firm can receive a considerable award under the "substantial benefits" doc-

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82. *See, e.g.*, Giudici, *supra* note 16, at 250 (reporting that the Italian legislator of 2006 thought that 5% was too high); Cheffins & Black, *supra* note 18, at 1425 (considering the former German 10% threshold as a reason for the absence of litigation).

83. Erickson, *supra* note 38, at 100.

84. *See id.*

85. *See* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 391 (1970).

86. *E.g.*, Cox & Thomas, *supra* note 34, at 355.

87. *See* Erickson, *supra* note 38, at 101.

trine.[88] Specialized law firms therefore only need to find a suitable plaintiff and sometimes actually hold a stock portfolio to be able to sue once they hear about a possible claim.[89] This situation may result in a "race to the courthouse" between law firms since, traditionally, the first firm to file is assigned the role of lead counsel in the case and thus receives most of the fee.[90] However, since about the year 2000, Delaware courts have begun to rely on a variety of factors to determine lead counsel, including the size of the plaintiff's stake and the quality of the pleadings filed.[91] While this may marginally diminish suits or induce plaintiffs to take cases out of Delaware, this further illustrates that the incentive to sue rests almost entirely with the law firm.[92]

2.2.2. The "Loser Pays" Principle

European countries generally apply what in the United States is often called the "English Rule": the losing party has to reimburse the winning party for litigation costs.[93] Since the outcome of a lawsuit is rarely certain, it is often suggested that the most important factor deterring derivative suits is that shareholders will not be willing to take the risk of having

88. Fletcher v. A.J. Indus., Inc., 266 Cal. App. 2d 313, 320 (1968); *see also Mills*, 396 U.S. at 395–96 (noting that "an award of counsel fees, regardless of whether the benefit is pecuniary in nature" may be justified from a derivative suit where the corporation received a "substantial benefit"); Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162, 1165 (Del. 1989) (discussing the term "corporate benefit"). Note that the Delaware courts were long known to be more generous to plaintiff's attorneys than other courts, who often relied on the "lodestar" approach, which is based on the number of hours invested multiplied by the lawyer's hourly fee and adjusted by a factor depending on various characteristics of the case, like risk. *In re* Oracle Sec. Litig., 852 F. Supp. 1437, 1449 (N.D. Cal. 1994); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 22 (1991). There is evidence that Delaware has started to act more parsimoniously recently and has hence lost market share in litigation. *See* John Armour, Bernard Black & Brian Cheffins, *Delaware's Balancing Act* 31–35 (Univ. Cambridge Legal Studies Research Paper Series, Paper No. 10-04, 2011), *available at* http://ssrn.com/abstract=1677400 (discussing attorney's fees in Delaware).

89. Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 37, at 682.

90. *See id.* at 692.

91. *See* Armour et al., *supra* note 88, at 35–43.

92. *E.g.*, Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 37, at 669.

93. *E.g.* ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE], Dec. 5, 2005, BGBL I S. 3202, § 91 (Ger.); CODE DE PROCÉDURE CIVILE [C.P.C.] [CODE OF CIVIL PROCEDURE] art. 696 (Fr.); Codice di Procedura civile [C.p.c.] art. 91 (It.); SCHWEIZERISCHE ZIVILPROZESSORDNUNG [C.P.C.] [SWISS CODE OF CIVIL PROCEDURE] art. 106(1) (Switz.); ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE] § 41(1) (Austria); CODE JUDICIAIRE [C.JUD.] § 1017 (Belg.).

to pay for the defendants' fees.[94] The argument appears persuasive at first glance. Fees often depend on the complexity of the case, which is high if it involves intricate business issues. Moreover, to the extent that fees depend on the amount in dispute, court fees will also be very high in a derivative suit given the high value at stake in such suits.[95]

From a theoretical perspective, the argument is not entirely persuasive. The obvious objection is that the effects of the English Rule cut both ways; a plaintiff not only bears the risk of having to reimburse the defendant if the suit fails, but also benefits from being reimbursed in the case of success. Thus, the rule's overall effect is to increase the dollar amount subject to litigation risk. Instead of receiving an amount between zero and the sum sought in the suit, the plaintiff's potential payoff varies from the negative amount of the defendant's cost to the sum sought plus the plaintiff's own cost. With the greater spread in possible payoffs, the effect of the English Rule is to dilute "the value of low-probability-of-prevailing cases" and enhancing "the value of high-probability-of-prevailing cases."[96] Winners' cost reimbursement favors plaintiffs who know for sure that they have a clear-cut case over those who are unlikely to prevail. The rule should, therefore, deter frivolous shareholder litigation, while encouraging meritorious suits.

Moreover, European reimbursement systems are often closer to the American Rule in practice than in theory. In several countries, including Germany and Italy, reimbursement is limited to court fees plus expenses for lawyers, according to the official tariff promulgated by the bar association.[97] Reimbursement by the loser is even more limited in France;[98]

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94. *E.g.*, Luca Enriques, *The Comparative Anatomy of Corporate Law*, 52 AM. J. COMP. L. 1011, 1024 (2004) (reviewing REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (2004)) [hereinafter Enriques, *The Comparative Anatomy of Corporate Law*]; Reisberg, *supra* note 23, at 348–49 ("[T]he American treatment of fees in such actions provides significantly lower disincentives to prospective plaintiffs than does the English Rule."); Cheffins & Black, *supra* note 18, at 1425; Cox & Thomas, *supra* note 34, at 357.

95. *E.g.*, Lutter, *supra* note 16, at 765 (criticizing that a high amount in dispute may deter German shareholders from suing). Technically, the court has some discretion in setting the amount in dispute under German law. Gerichtskostengesetz [GKG] [Court Fees Act], Aug. 4, 2009, BGBL. I at 2491, § 53.

96. Kathryn E. Spier, *Litigation*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 259, 301 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

97. For Germany, see Martin Giebel, *in* 1 MÜNCHENER KOMMENTAR ZUR ZIVILPROZESSORDNUNG § 91, ¶ 49 (Thomas Rauscher & Peter Wax eds., 3d ed. 2008) (Ger.); ZPO § 91 II (Ger.) (first sentence). For Italy, see Giudici, *supra* note 16, at 253–54 (noting that the Italian civil procedure code applies the English rule for legal expenses). For Austria, see ZPO § 41(2) (Austria).

while court fees are usually reimbursed, lawyers' fees normally are not. These are automatically borne by the losing party only when retention of an attorney is mandatory,[99] which is generally not the case in commercial courts, where corporate cases are litigated.[100] French judges can grant lawyers' fees to the winning party under equitable considerations,[101] but, if fees are granted in practice, the amount tends to be much lower than what lawyers actually charged.[102]

Several jurisdictions have special rules regarding litigation costs for shareholder derivative suits, all of which slightly improve the position of plaintiff shareholders compared to the basic "loser pays" principle. For example, under the post-2005 German law,[103] the minority shareholder's risk is initially cabined to the cost of the special judicial procedure deciding the admission of the derivative suit. At this stage, the amount in dispute is capped at €500,000, which usually limits court fees to a four-digit figure.[104] Moreover, the corporation bears the cost if the petition is denied for reasons "in the interest of the company" about which the shareholder could not know, but which the corporation could have disclosed to the shareholder. If the petition actually proceeds to the stage of a derivative suit, the English Rule applies in principle. However, if the suit is not successful or is only partially successful, the corporation has to reim-

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98. *See* Bernard Grelon, *Shareholders' Lawsuits against the Management of a Company and its Shareholders under French Law*, 6 EUR. COMPANY & FIN. L. REV. 205, 212 (2009) (explaining that a winning plaintiff shareholder is not fully reimbursed).

99. C.P.C. art. 696(7) (Fr.).

100. *Id.* art. 853.

101. *Id.* art. 700.

102. *E.g.*, Daniel Landry, *Les frais irrépétibles* [*The Irrecoverable Costs*], 2010 LA SEMAINE JURIDIQUE ÉDITION GÉNÉRALE [JCP-G] 1288 (Fr.); Raymond Martin, *Avocats—Obligations et prérogatives* [*Lawyers—Duties and Prerogatives*], *in* JURISCLASSEUR PROCÉDURE CIVILE 83–84, ¶ 43 (2011) (Fr.).

103. Before 2005, liability claims initiated by minority shareholders were pursued by a court-appointed special representative, who was an agent of the corporation and thus paid by it. AktG § 147 III (Ger.), before KonTraG (1998); AktG § 147 II, as amended by KonTraG (1998–2005). However, the petitioning minority shareholders had to compensate the corporation when litigation cost exceeded the award, and even had to bear court fees if the suit was entirely unsuccessful. AktG § 147 IV (Ger.) (until 2005).

104. GKG § 53 (Ger.); *see* Martin Peltzer, *Das Zulassungsverfahren nach § 148 AktG wird von der Praxis nicht angenommen! Warum? Was nun?*, *in* FESTSCHRIFT FÜR UWE H. SCHNEIDER, *supra* note 16, at 956–57 (discussing the amount of court fees); *see also* Carsten A. Paul, *Derivative Actions under English and German Corporate Law—Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference*, 7 EUR. COMPANY & FIN. L. REV. 81, 102 (2010) (suggesting that fees hardly ever exceed €12,000).

burse the plaintiff, unless the plaintiff passed the first stage of judgment review by claiming false facts and in doing so acted intentionally or with gross negligence.[105] As a result, a good faith plaintiff should bear little risk.

In most other countries, cost rules are also slightly tweaked in favor of plaintiffs. In Italy, the corporation is not only required to pay the victorious plaintiff's litigation expenses, but also the cost of ascertaining the facts that form the basis of the suit.[106] In Switzerland and France, the court generally has the discretion to diverge from the English Rule in the case of an unsuccessful good-faith plaintiff.[107] In Belgium, the court *can* require losing shareholders to pay damages to the defendants, but *must* order the company to reimburse damages if the suit is successful.[108] In Austria, the minority can be required to pay the litigation cost incurred by the special representative only if the minority acted intentionally or with gross negligence in the pursuit of frivolous litigation.[109]

Given these theoretical doubts and the economics of the English Rule, it appears that the idea of the English Rule's deterrent power is based on the assumption that shareholder suits have a low probability of winning. If that is the case, maybe the United States only has vibrant derivative litigation because strike suits are not deterred. Moreover, the increased risk created by the English Rule may be hard to absorb for shareholder plaintiffs who tend to be worse risk-bearers than large corporations and wealthy directors with deep pockets. This issue is likely exacerbated by the reality that lawyers' fees are often not reimbursed beyond a certain basic amount, since cases with a complicated corporate fact pattern are hard to handle for non-specialized counsel. In spite of ostensively shareholder-friendly rules, often open-ended standards with respect to cost put

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105. AktG § 148 VI (Ger.).

106. C.C. art. 2393-bis(5) (It.); *see also* Enriques & Mucciarelli, *supra* note 51, at 887 (pointing out that Italian law also eliminates the plaintiff's additional risk that the defendants are judgment proof and therefore cannot reimburse them).

107. C.P.C. art. 107(b) (Switz.). The official legislative report explicitly encourages judges to do so in cases of derivative suits. SCHWEIZERISCHEN EIDGENOSSENSCHAFT, BOTSCHAFT ZUR SCHWEIZERISCHEN ZIVILPROZESSORDNUNG 7297, June 28, 2006, *available at* http://www.admin.ch/ch/d/ff/2006/7221.pdf (Switz.) (mentioning the case of a small shareholder bringing a derivative suit a possible case where the court may use this discretion). Before the enactment of a uniform Swiss Code of Civil Procedure in 2009, there was an explicit rule in corporate law. OR, former art. 756(2) (Switz.). In France, the court has the same equitable power under C.P.C. art. 696 (Fr.), although this happens extremely rarely, and no specific reference to shareholder litigation is made.

108. CODE DES SOCIÉTÉS art. 567 (Belg.).

109. *See* AKTG § 135(4)–(5) (Austria).

plaintiffs at the mercy of the courts by making reimbursement uncertain. Peltzer suggests that, regarding Germany, the cost risk of an admission procedure is still too big for small shareholders, in particular when several shareholders have to coordinate to surpass the 1% threshold, in which case they are jointly and severally liable for cost.[110] In the Italian context, Giudici criticizes that the court has too much discretion in determining what costs were necessary to establish the facts and are therefore reimbursable.[111] Similar arguments can be made for other laws that rely on the plaintiff's good faith or degree of negligence to allocate litigation risk.

Overall, the purported negative effects of the loser pays principle seem to be rather an issue of how easy it is to bring a claim, specifically what burden of proof needs to be met to survive early stages of litigation or to obtain reimbursement with reasonable certainty. In order to facilitate derivative litigation, it may be more promising for European legislatures to facilitate information gathering by shareholders instead of switching to the American Rule, even if it slightly encourages more risky lawsuits.[112]

2.2.3. No Contingency Fees

Besides the "English Rule," the other classic difference that could explain the rarity of derivative suits in Europe is the absence of contingency fees. In contrast to the United States, contingency fees are uncommon and often illegal. Contingency fees have traditionally been rejected because they are thought to distort the incentives of lawyers to represent clients' interests.[113] Although the cultural aversion to a more entrepreneurial view of the legal profession may be receding, this has not yet resulted in the emergence of a plaintiff bar comparable to the American one.

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110. Peltzer, *supra* note 104, at 956–57.

111. *See* Giudici, *supra* note 16, at 254.

112. The issue will be addressed in Section 2.3.

113. *See, e.g.*, Samuel Issacharoff & Geoffrey P. Miller, Essay, *Will Aggregate Litigation Come to Europe?*, 62 VAND. L. REV. 179, 197–99, 199 n.57 (2009) (describing resistance against derivative litigation and mentioning that England and Wales allowed conditional fees since the early 1990s); Tiffany Chieu, Note, *Class Actions in the European Union?: Importing Lessons Learned from the United States' Experience into European Community Competition Law*, 18 CARDOZO J. INT'L & COMP. L. 123, 148 (2010) ("[W]ith the exception of England and Wales, contingency fees are prohibited in EU Member States.").

Contingency fees could conceivably kindle desirable litigation, which has not eluded the attention of policymakers, scholars, and courts.[114] In France, the 1996 Marini Report on corporate law discussed the possible adoption of contingency fees in the context of class actions, but ultimately did not recommend the introduction of either instrument.[115] In Germany, the Constitutional Court declared the former blanket prohibition unconstitutional in 2006.[116] Therefore, the law regulating lawyers' fees in Germany had to be amended to permit contingency fees in restricted circumstances, specifically when a plaintiff would otherwise be prevented from pursuing the plaintiff's rights for economic reasons.[117] However, lawyers in Germany are not permitted to use contingency fees as a general strategy,[118] but only to permit indignant plaintiffs to pursue claims.[119] In July 2006, Italy took some steps towards results-based compensation for lawyers.[120] The Italian law governing lawyers' ethics now permits lawyers' fees to be made dependent on the achievement of specified goals,[121] and the former prohibition in the civil code has been elimi-

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114. *See, e.g.*, Gerard Hertig & Joseph A. McCahery, *Company and Takeover Law Reform in Europe: Misguided Harmonization Efforts or Regulatory Competition?*, 4 EUR. BUS. ORG. L. REV. 179, 193 (2003) (suggesting that contingency fees could improve corporate law enforcement in the EU).

115. PHILIPPE MARINI, LA MODERNISATION DU DROIT DES SOCIÉTÉS [THE MODERNIZATION OF CORPORATE LAW] 93–94 (1996), *reprinted in* COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS M-113 (Klaus J. Hopt & Eddy Wymeersch eds., 1997). The legal basis for the prohibition in France is Loi 71-1130 du 31 décembre 1971 portant réforme de certaines professions judiciaires et juridiques [Reforming Certain Judicial and Legal Professorions], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], art. 10(3) (Fr.).

116. Entscheidungen des Bundesverfassungsgerichts [BVerfG] [Federal Constitutional Court] Dec. 12, 2006, 1 BvR 2576/04, NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 878, 2007 (Ger.) (requiring the legislature to amend the law by June 30, 2008).

117. Rechtsanwaltsvergütungsgesetz [RVG] [Attorney Fees Act] § 4a, as amended by Gesetz zur Neuregelung des Erfolgshonorars, July 1, 2008, BGBL. I at 1001, art. 2, § 4a (Ger.).

118. *See* Joachim Teubel, *in* RECHTSANWALTSVERGÜTUNGSGESETZ § 4a, ¶ 24 (Hans-Joachim Mayer & Ludwig Kroiß eds., 4th ed. 2009) (Ger.).

119. *Id.* § 4a, ¶¶ 30–34 (explaining that contingency fees may not be used to let suits go forward that would otherwise not be brought because of the plaintiff's risk aversion and a small probability of success); *see also* Schmolke, *supra* note 16, at 409 (explaining that contingency fees are not permissible in this context).

120. *See* Decreto Legislativo 4 luglio 2006, n. 223, in G.U. 4 luglio 2006, n. 153, as modified by D. Lgs. 4 agosto 2006, n. 248, in G.U. 11 agosto 2006, n. 186 (It.).

121. Codice deontologico forense [Bar Code of Conduct] art. 45 (It.)

nated.[122] However, another section of the civil code still prohibits the assignment of rights and claims contested in litigation to lawyers involved in it.[123] While the law thus allows fees that are (partly) conditional on success, it is not permissible to assign a percentage of the claim to the lawyer.

By itself, however, the contingency fee prohibition does not seem to explain the absence of derivative litigation either. Hertig and McCahery suggest that contingency fees already are "a common but concealed practice throughout Europe."[124] The new Italian law seems to allow at least conditional fees, and derivative suits still have not emerged as a prominent factor.[125] This is illustrated by the emergence of derivative suits in Japan in the early 1990s. Two-part tariffs consisting of a fixed retainer and a fee conditional on success—either in the form of a judgment or a settlement—were seemingly enough to encourage derivative litigation.[126] For Japanese firms representing shareholders, retainers tend to be low and success fees high.[127]

Hence, it appears that the legality of a conditional fee arrangement should suffice to encourage some litigation. The foregoing discussion establishes that some kind of reward is needed for possible plaintiffs to overcome the collective action/free rider problem that is inherent to the corporate structure. Favorable lawyers' fee arrangements, however, are not necessarily the only mechanism that creates incentives either on lawyers or on shareholders to engage in corporate litigation. As I discuss in Part 3, there are other mechanisms of shareholder litigation that have widespread use without derivative litigation, particularly nullification suits in Germany, where the plaintiff's risk is also low compared to the personal benefit. Furthermore, even with high-powered contingency fees in place, there must be a reasonable chance of winning or settling favorably to make the suit worthwhile ex ante for the lawyer. If courts are strongly biased against plaintiffs or plaintiffs have little access to infor-

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122. C.C. art. 2233(3) (It.) (now only requiring a written agreement between lawyers and clients and no longer prescribing fees based on outcome of litigation).

123. C.C. art. 1261 (It.).

124. Hertig & McCahery, *supra* note 114, at 193.

125. *See* Enriques, *The Comparative Anatomy of Corporate* Law, *supra* note 94, at 1024 (suggesting that the "loser pays" rule has been more important in preventing the emergence of an entrepreneurial plaintiff bar in Europe).

126. *See* West, *Why Shareholders Sue*, *supra* note 15, at 365.

127. *See id.* at 368–72 (noting that, "in practice, many derivative-suit attorneys reduce their retainers").

mation forming the basis for evidence of wrongdoing, suing will still be difficult.

2.2.4. Requirement to Advance Court Fees

The last element of litigation cost that could deter derivative suits is the high up-front fees that a plaintiff has to pay to the court in order to commence the suit. If the amount is high enough, fees of this type will make it difficult to finance a suit. Even a shareholder with a considerable stake might be tempted to reconsider if he is not sure about the action's chance of success. Mark West argued that Japanese derivative litigation was triggered by a 1993 court decision that did away with the previous practice of computing the filing fee as a percentage of the damages sought and replaced it with a relatively modest flat one of only ¥8200.[128] He further suggested that the Japanese courts' practice of frequently requiring plaintiffs to post security for suits allegedly brought in bad faith and led to further deterrence.[129]

A superficial look at the complexities of litigation cost in Europe indicates that the above explanation is plausible in some cases, but does not provide a universal explanation for the scarcity of derivative suits. For example, German courts generally only serve a suit if the fee for the trial is paid.[130] The amount of the fee indeed depends on the amount in dispute, and can generally reach an amount of tens of thousands of Euros if the amount in dispute is several million. For the "lawsuit admission procedure" introduced in 2005, the amount in dispute is usually capped at €500,000, which corresponds to an amount of a few thousand Euros.[131]

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128. West, *Pricing Shareholder Derivative Actions in Japan & U.S.*, *supra* note 2, at 1463–65; West, *Why Shareholders Sue*, *supra* note 15, at 353. *But see* Dan W. Puchniak & Masafumi Nakahigashi, *Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation*, 45 VAND. J. TRANSNAT'L L. 1, 48–50, 54–56 (2012) (criticizing this explanation because derivative suits apparently began before the change in the fee rules, and suggesting that suits were brought initiated by activist attorneys with non-monetary motivations).

129. West, *Pricing Shareholder Derivative Actions in Japan & U.S.*, *supra* note 2, at 1465–66.

130. GKG § 12(1) (Ger.).

131. The base fee for an amount in dispute of €500,000 is €2,956, with an additional €150 in fees for every additional €50,000. GKG § 34(1) (Ger.) and GKG Anlage 2 (providing a table for the amount of one "value unit" of fees depending on the amount in dispute). In the case of a "normal" lawsuit, this amount is multiplied by 3. GKG Anlage 1, no. 1210 (providing that court fees generally amount to three "value units"), GKG Anlage 1, no. 1640 (establishing a multiplier of 1.0 for an admission procedure under AktG § 148).

In spite of the limit, the amount may be high enough to deter "casual" suits by portfolio shareholders.[132] Furthermore, once the suit has been admitted by the court, fees on the basis of the actual amount in dispute apply, which may result in a substantially larger upfront payment (unless the corporation decides to take over the suit).[133] By contrast, in France, derivative suits are not even hindered by a minimum ownership level, and courts only charge a nominal fee comparable to those in Japan.[134] However, it has been suggested that plaintiffs may be required to advance case-specific cost, e.g., for collecting evidence or for expert witnesses, which may also create a deterrent effect.[135] Nevertheless, as an explanation for the French case, legal fees are much less persuasive. Overall, it is probably safe to say that court fees are a possible deterrent factor, but they are not the only restrictive feature in Germany.[136]

2.3. Access to Information

As discussed in the preceding section, whether the law creates a structure that overcomes the free rider problem inherent in representative litigation depends on how cost rules allocate litigation risk between plaintiffs, firms, and defendants. This other compounding factor is what risk there is, i.e., whether a suit is likely to be successful or not. If meeting the burden of proof is extremely difficult for shareholder plaintiffs, the best incentives set by litigation cost rules may not be enough to encourage suits.

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132. Peltzer, *supra* note 104, at 955 n.7 (reporting that admission procedures are very rare based on a telephone survey among judges), and *id.* at 957 (arguing that fees will deter shareholders that do not hold a substantial stake).

133. *See* AktG § 148(3) (Ger.); Peltzer, *supra* note 104, at 959–60 (arguing that this possibility further discourages potential plaintiffs). By contrast, in France the courts have found that this is not possible. Cass com. 12-12-2000, 2001 REVUE DES SOCIÉTÉS 323 (Fr.); Germain, *supra* note 24, at 409.

134. *See, e.g.*, *Tarifs des activités judiciaires* [*Rates of Judicial Activities*], GREFFE DU TRIBUNAL DE COMMERCE DE PARIS [REGISTRY OF THE COURT OF COMMERCE OF PARIS] (July 1, 2011), http://www.greffe-tc-paris.fr/judiciaire/tarifs.htm (Fr.) (listing fees for various types of suit in the Paris commercial court). For comparison, the Delaware Chancery Court currently charges a fee of $600 for a derivative suit. *See Court of Chancery Court Fees or Charges*, DEL. STATE COURTS, http://courts.delaware.gov/help/fees/chanceryfees.stm (last visited Apr. 11, 2012).

135. Schmidt, *supra* note 16, at 391.

136. Under some U.S. state laws, plaintiffs can be required to post security for the defendant's expenses. *E.g.*, N.Y. BUS. CORP. L. § 627 (McKinney 2003) (establishing such a requirement for plaintiffs holding less than 5% and shares less than $50,000); *see also* CLARK, *supra* note 7, at 652–55 (discussing how these statutes were introduced to curb abusive litigation).

In some cases, the burden of proof creates particular problems. For example, in Germany, Peltzer has argued that the requirement for plaintiffs to show *dishonesty* or *serious* violations of the law in order to pass the judicial admission procedure and the firm's defense that a suit would not be in the interest of the company create considerable difficulty for plaintiffs.[137] Standards such as the German one or the French requirement to show a "management mistake" are vague and thus create uncertainty while, at least in the German case, leaving a lot of room for the directors to claim spurious reasons why the suit would be harmful.[138] Generally, the main problem seems to be plaintiff's difficulty in obtaining the evidence needed to make a plausible claim, which will typically require the plaintiff to have access to the company's internal documents. Other than in the United States,[139] shareholders normally do not have access to the company's books and records and are limited to the right to ask questions in the shareholder meeting.[140]

More importantly, in the United States, plaintiffs with a thin basis of evidence can avail themselves of pretrial discovery, in the course of which the defendant is required to disclose pertinent information to the plaintiff.[141] Once the suit passes the demand requirement on the basis of relatively limited notice pleading, plaintiffs may rely on information gathered in discovery to coerce the defendant to settle or go to trial.[142] In Europe, a party to a civil suit must generally identify specific documents and ask the court to order the other party to produce them; furthermore, it must explain why these documents are necessary and where they are lo-

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137. Peltzer, *supra* note 104, at 962–63.

138. Lutter, *supra* note 16, at 765; *see also* Peltzer, *supra* note 104, at 957–58; GUYON, *supra* note 16, at 493 (describing the French "management mistake" standard as vague and unclear).

139. *See, e.g.*, DEL. CODE ANN. tit. 8 § 220 (2011); REVISED MODEL BUS. CORP. ACT [RMBCA] §§ 16.02, 16.03 (1984) (entitling shareholders to inspect and copy corporation's books and records for a proper purpose).

140. Cox & Thomas, *supra* note 34, at 355–56; Paul, *supra* note 104, at 102–03; Giudici, *supra* note 16, at 254.

141. *See* FED. R. CIV. P. 26; Guido A. Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement* 50–51 (Eur. Corp. Gov. Inst., Working Paper No. 40, 2005), *available at* http://ssrn.com/abstract=730403 (explaining that U.S. discovery rules are so far-reaching that they typically shock Continental European lawyers); Frank H. Easterbrook, *Discovery As Abuse*, 69 B.U. L. REV. 635, 636 (1989) (generally discussing the potential abuse in discovery).

142. *See generally* Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 37, at 701–02 (discussing an explanation for the cost differential between plaintiffs and defendants).

cated.[143] The absence of a wide-ranging discovery procedure is often thought to make derivative suits, particularly strike suits, more difficult in Europe.[144] Fishing expeditions are typically not permitted, while "the opponent's obligations to cooperate are usually strict and quite restrictive."[145] A motion to produce a general class of documents will normally not be granted.[146] Mark West reports that in Japan, where U.S.-style discovery also does not exist, shareholders are sometimes able to avoid the information problem by piggybacking on the information brought to light in public enforcement actions.[147]

Is there a Continental European functional equivalent that makes up for this "information gap"? While there is no obvious or complete one, a mechanism that is sometimes brought up by Continental European observers is the appointment of a "special auditor" by a court upon application by minority shareholders.[148] The auditor, who will typically be an accounting professional or other certified expert, is tasked with reviewing problematic or suspicious management activities and subsequently submits a report at the shareholder meeting. The information compiled by the auditor can—at least in theory—form the basis for a lawsuit.

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143. 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); *see also* Ferrarini & Giudici, *supra* note 141, at 51–52 (discussing the difference between notice pleading in the United States and fact pleading in Italy, and its implications for shareholder litigation).

144. Enriques, *The Comparative Anatomy of Corporate Law*, *supra* note 94, at 1024; Schmidt, *supra* note 16, at 391 (pointing out that directors control what information the corporation discloses in a French derivative suit); Ferrarini & Giudici, *supra* note 141, at 51, 53; John W. Cioffi, *Adverserialism versus Legalism: Juridification and Litigation in Corporate Governance Reform*, 3 REG. & GOV. 235, 245 (2009).

145. Rolf Stürner, *Transnational Civil Procedure: Discovery and Sanctions against Non-Compliance*, 6 UNIFORM L. REV. 871, 876 (2001).

146. "Only in more exceptional cases, when a party has no exact knowledge of facts and means of evidence in the sphere of its opponent and shows a good cause for an alleged fact . . . the court may order the production and inspection of a category of documents or tangible things." *Id.*

147. West, *Why Shareholders Sue*, *supra* note 15, at 380–81. On a similar process in France, see *infra* Section 3.2.

148. *See* Paul, *supra* note 104, at 103–04 (emphasizing the connection between the purpose of the special audit and the derivative suit).

The corporate laws of all countries discussed here, except Spain, provide for a minority right of this type.[149] The exact procedure and the necessary factual basis vary, but generally there has to be some indication of wrongdoing, and petitioners have to meet a certain minimum ownership threshold. In both France and Germany, the threshold was reduced in recent years, namely from 10% or €1,000,000 to 1% or €100,000 to petition for the appointment of a *Sonderprüfer* in the German 2005 reform,[150] and from 10% to 5% in France in 2001 to initiate an *expertise de gestion*.[151] Belgium also has a 1% (or €1,250,000) threshold,[152] while in Italy (10% and 5% in publicly traded firms),[153] Austria (10%),[154] and Switzerland (10%/CHF 2,000,000) thresholds are relatively high.[155]

(*See table on next page*.)

149. *See* Kalss, *supra* note 30, at 342 ("All legal systems except Spain and England provide for a special audit.") (internal citation omitted). The more far-reaching Dutch inquiry proceedings are discussed in Section 3.3 *infra*.

150. The so-called AktG § 148 I, as amended by UMAG (Ger.); AktG § 142 II (Ger.); *see also* Conac et al., *supra* note 50, at 512 (discussing the threshold reduction). The usual 10% for forcing the corporation into litigation is reduced to 5% if a special audit that brought results to light that indicate liability claims. AKTG § 134(1) (Austria).

Interestingly, there is no such threshold in a German *de facto group*, which allows individual shareholder to ask for an appointment. However, the circumstances when this is possible are fairly limited: either the firm's statutory auditor must have found accounting irregularities, the supervisory board found irregularities with the management's report on group relations, or management board must have declared that disadvantageous transactions were not compensated. *See* AktG § 315 (Ger.).

151. *See* C. COM. art. L. 225-231 (Fr.).

152. CODE DES SOCIÉTÉS art. 168 (Belg.).

153. C.C. art. 2409(1) (It.).

154. *See* AKTG § 130(2) (Austria).

155. OR art. 697(b), para. 1 (Switz.).

Country	Minimum ownership	Note
Austria	10%	
Belgium	1% or €1,250,000	
France	5%	
Germany	1% or €100,000	
Italy	10% 5%	not publicly traded Publicly traded
The Netherlands	10%	more far-reaching "inquiry proceedings" (see section 3.3)
Spain	N/A	
Switzerland	10% or CHF 2,000,000	

Table 2: Minimum ownership thresholds for the appointment of a special auditor

As a true functional equivalent to discovery, special audits seem to fail by and large. The instrument is relatively popular in France, partly because the minority right can be exercised by a shareholder association.[156] Furthermore, under the general law of civil procedure, individual shareholders can also ask the court to appoint an expert even before a trial to establish facts.[157] Elsewhere, special auditors are not appointed frequently, although appointments happen occasionally.[158] Both in Germany and Italy, requirements to show "serious" irregularities put a heavy bur-

156. Holger Fleischer, *Aktienrechtliche Sonderprüfung und Corporate Governance*, 46 RECHT DER INTERNATIONALEN WIRTSCHAFT [RIW] 809, 810–11 (2000) (Ger.) (comparing the frequency of court-appointed audits in France and Germany). Regarding the extensive case law regarding when an appointment is permissible, see MERLE & FAUCHON, *supra* note 22, ¶ 523. In Switzerland, the effectiveness of the instrument is hindered by a statute of limitations, which prohibits derivative suits six months after a shareholder meeting in which the majority approved the "discharge" of the board of directors. OR art. 758, para. 2 (Switz.). This applies even to shareholders who voted against the resolution. This may not leave enough time for an audit to be performed thoroughly. Glanzmann, *supra* note 16, at 175.

157. C.P.C. art. 145 (Fr.); *see* Conac et al., *supra* note 50, at 512 (pointing out that in this case the cost is not borne by the corporation).

158. For Germany, see, for example, Michael Nietsch, *Klageinitiative und besondere Vertretung in der Aktiengesellschaft*, 40 ZGR 589, 592–95 (2011) (Ger.) (discussing the HVB and IKB cases in both of which a special auditor was appointed by a court).

den of proof on the petitioner, which rules out fishing expeditions.[159] In Italy, the court's ability to order the petitioning minority shareholders to provide a deposit to cover cost for the *ispezione giudiziale* may act as a further deterrent.[160] Moreover, since the 2003 reform in Italy, the court can suspend the inspection if the majority replaces the directors and the members of the board of auditors, or *collegio sindacale*, with members who profess to take action to ascertain the alleged violations and eliminate them.[161] Since minority shareholders have no way of forcing the continuation of the outside audit, the majority is in a relatively good position to abort an inspection by replacing the current directors with "friendly" ones who will not allow a suit to proceed.[162]

In general, the minimum threshold seems to be a major hurdle since the percentage required is generally higher than the percentage requirement for a derivative suit.[163] Even France and Switzerland, which allow derivative suits without providing for a minimum threshold, require one for the initiation of a special audit. The higher thresholds for the appointment of the auditor clearly inhibit the effectiveness of this tool for gathering information for a derivative suit.[164]

2.4. Limitations Regarding Potential Defendants

Besides the factors already discussed, it is important to point out that, compared to the United States, derivative actions in Europe are limited in scope, which further reduces their attractiveness for potential plaintiffs who will resort to other instruments. This aspect seems not to have been discussed in the literature yet. In the United States, anyone can be sued derivatively. While the defendant is "usually an officer, director or other

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159. Schröer, *supra* note 55, § 142, ¶ 10; OBERLANDESGERICHT STUTTGART [OLG Stuttgart] [Stuttgart Higher Regional Court] June 15, 2010, 15 UF 85/10 (Ger.). For Italy, see C.C. art. 2409(1) (It.).

160. C.C. art. 2409(2) (It.).

161. *Id.* art. 2409(3).

162. I thank the participants of the Rome Fordham Alumni Meeting for pointing out this issue to me.

163. *See* Glanzmann, *supra* note 16, at 175–76 (also pointing out that petitioners bear a significant risk of having to pay for the audit); Grechenig & Sekyra, *supra* note 16, at 20 (suspecting that the scarcity of derivative suits in Switzerland may be based on "a percentage limit for initiating an investigation essential for bringing a lawsuit[]").

164. *See* Glanzmann, *supra* note 16, at 175 (suggesting that the shareholders' individual right to launch a derivative suit may be toothless given that they are unlikely to have enough information to form the basis of a suit); Kalss, *supra* note 30, at 342 (arguing that the minimum thresholds for both types of minority rights should be the same).

fiduciary of the corporation," this is by no means a legal prerequisite.[165] The applicable section of the Federal Rules of Civil Procedure—equivalent statutes exist in state law—simply refers to "a right that the corporation or association may properly assert but has failed to enforce,"[166] but says nothing about the defendant or the nature of the suit.[167] Legally, a derivative suit can be any type of suit.

In all of the countries surveyed here, the legal basis for derivative suits is, in all cases, found in a section of the respective corporate law governing directors' liability. This fact has two important consequences. First, derivative suits are only available for claims to damages. The French courts, for example, found that derivative actions are not available for injunctions.[168] The potential of derivative litigation to prevent harmful corporate behavior ex ante and to put pressure on those actually in control of the corporation is therefore low. Of course, this does not imply that shareholders cannot, given the appropriate circumstances, seek judicial recourse to block corporate actions. German courts, for example, recognize, without any specific statutory basis, an individual shareholder's right to enjoin actions taken by the board that infringe in the decision-making power of the shareholder meeting.[169] When the board dutifully sought shareholders' approval, a single shareholder can sue to rescind the decision taken in the shareholder meeting if it is in violation

165. CLARK, *supra* note 7, at 639.

166. FED. R. CIV. P. 23.1(a).

167. Corporate statutes also accept that derivative suits are available against anyone. *E.g.*, DEL. CODE ANN. tit. 8 § 145 (2011), which governs the corporation's power to indemnify for litigation expenses, lawsuits, and settlements. Specifically subsection (b) speaks of suits "in the right of the corporation" and permits that "any person who was or is a party or is threatened to be made a party" can be indemnified under certain circumstances if that person acted as that corporation's fiduciary. *Id.* Thus, the statute implicitly recognizes the derivative suit against anyone. And in fact, experience shows that defendants in many much-publicized important suits (that appear in casebooks) are in fact controlling shareholders (who are alleged to be in violation of their duty of loyalty).

168. *See* Benjamin Mojuyé, *French Corporate Governance in the New Millennium: Who watches the board in corporate France*, 6 COLUM. J. EUR. L. 73, 102, 102 n.94 (2000).

169. Bundesgerichtshof [BGH] [Federal Court of Justice], June 25, 1982, 83 ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN [BGHZ] 122, 1982 (Ger.); *see* Von Johannes Adolff, *Zur Reichweite des verbandsrechtlichen Abwehranspruch des Aktionärs gegen rechtswidriges Verwaltungshandeln*, 169 ZHR 310 (2005) (Ger.). *Cf.* Katz v. Bregman, 431 A.2d 1274 (Del. Ch. 1981) (granting a shareholder an injunction against the sale of substantially all assets in a direct suit).

of the law.[170] Rescission suits, which will be discussed in Part 3.1, are quite popular across the Continent partly because they allow shareholders to block significant corporate action. In comparison, derivative litigation is not terribly relevant.

Second, possible defendants in Continental European derivative suits are limited to directors (including supervisory board members),[171] and in some cases corporate officers,[172] auditors,[173] or the founders of the corporation.[174] The opportunity to engage with controlling shareholders is therefore limited.[175] True, sometimes controlling shareholders may be sued because they are also directors, and in rare cases a director can be successfully sued for failing to prevent illicit self-dealing by controlling shareholders; the limitation may still, however, prevent litigation that would otherwise be brought.

A possible exception can arise when a controlling shareholder is qualified as a *de facto director* (i.e., a person managing the company and acting like a director without formally having been appointed). This seems to happen occasionally in Italy and France. Consequently, the rules on derivative suits apply.[176] There are, however, considerable limitations. In

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170. This includes violations of the controlling shareholders' duty of loyalty and the actionable abuse of majority power where applicable.

171. CODE DES SOCIÉTÉS art. 562 (Belg.); Ley de Sociedades Anónimas art. 134(1) (B.O.E. 1989, 1564) (Spain) (speaking of "liability suits against directors"). In France and Italy, the limitation is implicit since the legal basis for derivative suits (or their equivalents) is in the respective statutory section governing director's liability. C.C. arts. L. 225-249 through 225-257 (Fr.) govern the civil liability of directors and promoters of the corporation. For Italy, see C.C. arts. 2393, 2393bis (It.); ALESSANDRO DE NICOLA, SHAREHOLDER SUITS 177 (2006) (pointing out that only directors, managers, and auditors can be sued derivatively in Italy).

172. Swiss law includes "persons involved in management." OR art. 754, para. 1 (Switz.).

173. *Id.* arts. 754–56; C.C. arts. 2393, 2393bis (It.); Ley de Sociedades Anónimas art. 211 (Spain) (referring to the provisions regarding suits against directors).

174. *See* AktG § 147(1) (Ger.) and AKTG § 134(1) (Austria) (both listing only members of the supervisory and management boards and promoters of the company as potential defendants).

175. *See, e.g.*, Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955); *In re* S. Peru Copper Corp. S'holder Derivative Litig., 30 A.3d 60 (Del. Ch. 2011); Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010) (derivative suits where the defendant is a shareholder). Derivative suits against shareholders also tend to be easier in private companies. *See, e.g.*, C.C. art. 2476(7) (It.) (providing that shareholders who intentionally approved acts harmful to the corporation are personally liable in an Italian s.r.l.).

176. For Italy, see, for example, FRANCESCO GALGANO & RICCARDO GENGHINI, 1 IL NUOVO DIRITTO SOCIETARIO [THE NEW COMPANY LAW] 483 (2006) (It.); for France, see

Italy, such shareholders can only be sued for actions taken in their capacity as directors, but not for votes cast in the shareholder meeting, etc.[177] In France, courts have permitted suits of this type where the shareholder acted with the intention to harm.[178] Moreover, it may be difficult to qualify a corporate shareholder as a de facto director. In France, where corporations can be appointed as directors,[179] banks have sometimes been qualified as de facto directors even in their role as creditors.[180] However, such a doctrinal move is likely more difficult in the majority of other jurisdictions, where only natural persons can become directors. In any event, proving that a large shareholder qualifies as a de facto director may be hard for an outside investor. Any lawsuit would, therefore, require the plaintiff to overcome another evidentiary hurdle that creates an obstacle for shareholder litigation.

The German law on corporate groups[181] provides a special basis for suits against certain controlling shareholders. Substantively, this law provides that a "controlling undertaking" in a *de facto group* may not instruct a controlled firm to enter into disadvantageous transactions unless the latter is compensated for any disadvantages in the same financial year.[182] In contrast to general corporate law, a minority shareholder can

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COZIAN ET AL., *supra* note 81, ¶ 262; for Switzerland, see Bundesgericht [BGer] [Federal Supreme Court] Dec. 12, 1991, 117 ENTSCHEIDUNGEN DES SCHWEIZERISCHEN BUNDESGERICTS [BGE] II 570, 571 (Switz.) (finding that the defendants were not de facto directors in this specific case, but implying the possibility of a derivative suit if they were).

177. Conac et al., *supra* note 50, at 510.

178. *Id.*

179. In this case, it has to delegate a specific individual to perform the function on its behalf.

180. MERLE & FAUCHON, *supra* note 22, ¶ 412; COZIAN ET AL., *supra* note 81, ¶ 262; for Switzerland, see Glanzmann, *supra* note 16, at 162–63.

181. The 1965 German *Aktiengesetz* pioneered the idea that corporate groups required special statutory recognition and special mechanisms protecting shareholders and creditors of subsidiaries. AktG §§ 291–328 (Ger.). For a general description, see, for example, Peter Hommelhoff, *Protection of Minority Shareholders, Investors and Creditors in Corporate Groups: The Strengths and Weaknesses of German Corporate Group Law*, 2 EUR. BUS. ORG. L. REV. 61 (2001) (providing an overview of the AktG and its impact on German corporate groups).

182. AktG § 311 (Ger.). The management board of the controlled company is required to prepare a report on relations with other group firms within the first three months of the year, in which all intra-group transactions of the firm are described and compensation received is discussed. This "dependency report" (*Abhängigkeitsbericht*) must be audited by the statutory auditor and the supervisory board, which reports to the shareholder meeting. *See id.* §§ 313, 314. Note that shareholders do not have access to the dependency report.

sue the controlling entity as well as directors of both the controlling firm and the controlled subsidiary on behalf of the corporation.[183] The law neither provides for a percentage limit nor a demand requirement or judicial pre-screening procedure.[184]

There are a number of problems with this model. First, this only applies when the controlling shareholder qualifies as an "undertaking" (*Unternehmen)* that practically controls the dependent firm and where business connections go beyond mere share ownership, thus establishing a *de facto group* that includes both the controlling shareholder and the firm.[185] It is not entirely clear why minority shareholders require stronger protection in this case, as opposed to the situation where a firm is controlled by a private individual or a family.[186] Second, the law has been criticized for actually making it easier for the controlling shareholder to harm the subsidiary, since it explicitly allows disadvantages to the controlled firm as long as there is compensation.[187] Third, it may be difficult to determine what exact advantages and disadvantages resulted from coordinated group policies.[188]

In spite of the procedural advantages, shareholder litigation under the law of corporate groups has remained exceptionally rare. Ulmer, writing in 1999, summarized the state of affairs by saying that the suit had remained "completely without any function in 30 years of its existence."[189] Again, a major reason seems to be the financial risk created by litigation cost.[190] In the absence of a special statute for this type of suit, a plaintiff

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183. *Id.* §§ 317 III, 318.

184. *Id.* §§ 309 III, IV & 310 IV, 317 IV & 318 IV (all referring to § 309 III to V). The historical reason for the absence of a percentage limit was the impression that it is likely difficult for the required threshold to be met if there is a controlling undertaking. BRUNO KROPFF, AKTIENGESETZ 405 (1965) (Ger.). Holger Altmeppen, *in* 5 MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ § 309, ¶ 121 (Wulf Goette & Mathias Habersack eds., 3d ed. 2010) (Ger.).

185. HÜFFER, *supra* note 22, § 15, ¶ 8.

186. *See, e.g.*, Ulrich Wackerbarth, *Die Abschaffung des Konzernrechts*, 9 DER KONZERN 562–63 (2005) (arguing that the conflict of interests is the same).

187. *Id.* at 564–65.

188. Susanne Kalss, *Alternativen zum deutschen Aktienkonzernrecht*, 171 ZHR 146, 188–89 (2007).

189. Ulmer, *supra* note 19, at 300; *see also* Hirt, *The Enforcement of Directors' Duties*, *supra* note 29, at 191–92 (discussing the experience with shareholder action and its significance in application since its introduction).

190. Altmeppen, *supra* note 184, § 317, ¶ 57. The legislative report on the act also points out that the concern about abusive suits was thought not to be considerable when the law of corporate group was introduced, given that the plaintiff shareholder bears the

shareholder would need to potentially bear court fees computed on the basis of an amount in dispute, which, since the latter amount is usually a damages claim by the corporation, will typically add up to many millions.[191] Even the fee that the plaintiff must pay before the court will serve the suit could, therefore, easily amount to tens of thousands of Euros.[192]

Italy introduced a German-inspired law on corporate groups in 2003.[193] Corporations and other legal entities[194] incur liability by harming subsidiaries whose activities they "direct and coordinate" while acting in their own entrepreneurial interest. Shareholders have a direct but not a derivative claim under Italian law.[195] Again, the burden of proof seems to be a major issue. Ventoruzzo argues that the various elements of the claim are hard to prove, such as the requirement to act in an entrepreneurial interest and to violate the "principles of good management."[196] Furthermore, the rule does not specifically look at the harm done to the firm, but only to the harm to shareholders created by a lower share value (or lost profitability) and losses incurred by creditors if the firm became insolvent.[197]

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risk of having to reimburse the firm for its cost. KROPFF, *supra* note 184, at 405; Altmeppen, *supra* note 184, § 309, ¶ 121.

191. It is sometimes suggested that AktG § 247(2) (Ger.), which allows the court to reduce the amount in dispute to protect indignant plaintiffs in a nullification suit, should apply by analogy. Altmeppen, *supra* note 184, § 309, ¶¶ 126–28.

192. *See supra* note 131 and accompanying text. Commentators have therefore often argued that the procedures forcing the corporation to bring the suit described above (either under the pre- or the post-2005 law) could be used to enforce claims under the law of corporate groups to lighten the burden resulting from cost risk. *E.g.*, Karsten Schmidt, *Verfolgungspflichten, Verfolgungsrechte und Aktionärsklagen: Ist die Quadratur des Zirkels näher gerückt? Gedanken zur Reform der §§ 147-149 AktG vor dem Hintergrund der Juristentagsdiskussion des Jahres 2000*, 2005 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT [NZG] [NEW JOURNAL OF CORPORATE LAW] 796, 802 (Ger.); Altmeppen, *supra* note 184, § 317, ¶¶ 63–68 (both arguing that §§ 147 & 148 should apply). However, this theory has never been tested in the courts.

193. C.C. art. 2497 *et seq.* (It.). For an overview, see Paola Fasciani, *Groups of Companies: The Italian Approach*, 4 EUR. COMPANY & FIN. L. REV. 195 (2007).

194. It is not clear whether a natural person can also be sued under this provision. *E.g.*, Fasciani, *supra* note 193, at 223 (discussing the controversy). Ventorozzo points out that many Italian firms are controlled by individuals, which renders the rule somewhat irrelevant. Ventoruzzo, *supra* note 68, at 251.

195. *See* Guido Ferrarini, Paolo Guidici & Mario Stella Richter, *Company Law Reform in Italy? Real Progress,* 69 RABELSZ 659, 694 (2005) (Ger.).

196. Ventoruzzo, *supra* note 68, at 252.

197. Ferrarini et al., *supra* note 195, at 695.

3. THE PATH OF LEAST RESISTANCE: DO WE NEED DERIVATIVE LITIGATION?

The previous section illustrates that there are at least four different obstacles to shareholder derivative litigation in Continental Europe. Addressing a single one of them would likely not suffice to encourage this type of litigation. Hence, based on the sparse use of derivative suits in Continental Europe, one may conclude that corporate law is inadequately enforced in Continental Europe. From the American perspective, the scarcity is startling, since in the United States the derivative suit is a major enforcement mechanism for corporate law. In this Section, I suggest that this situation is not quite as bad as one might believe. Other mechanisms at least partly make up for this shortfall in enforcement and possibly create at least some deterrence against wrongdoing by managers and controlling shareholders. However, it would be premature to conclude that there are effective functional equivalents in all cases. Without attempting to provide a complete picture, the following subsections explore three enforcement mechanisms. Part 3.1 discusses the nullification suit, which is common across the European continent and has been discussed with particular intensity in Germany, given that it is often claimed that many of these suits are abusive. Part 3.2 looks at the role of criminal investigations using the example of France, where criminal investigations play a particularly important role. Part 3.3 discusses the Dutch "inquiry proceedings," an instrument standing between public and private enforcement, where shareholders can induce a court to investigate managerial wrongdoing.

3.1. Rescission Suits

The private instruments of choice in much of Continental Europe are suits permitting shareholders to rescind or nullify decisions made in the shareholder meeting, and sometimes those of the board, because these decisions violate the law—including the majority shareholder's duty of loyalty—or the company's articles.[198]

The rescission, or nullification, suit is of considerable significance in several Continental European countries given the frequency of share-

198. For the legal basis of these lawsuits see AktG §§ 241–57 (Ger.); C. COM. art. L. 235-1 (Fr.); C.c. arts. 2377–79 (It.); OR arts. 706, 708 (Switz.); Ley de Sociedades Anónimas art. 115 (B.O.E. 1989, 1564) (Spain); CODE DES SOCIÉTÉS art. 178 (Belg.); BURGERLIJK WETBOEK [BW] [CIVIL CODE] arts. 2:13–2:16 (Neth.); AKTG §§ 195–202 (Austria). Laws often explicitly distinguish between resolutions that are void and those that can be avoided.

holder votes. Shareholders generally need to vote on more issues than their American counterparts. Like in the United States, European shareholders vote on election and removal of directors,[199] mergers,[200] and changes to the articles.[201] Changes to the articles include increasing the company's capital, which is necessary to issue new shares,[202] and reductions of capital.[203] Furthermore, shareholders vote on the waiver of preemptive rights[204] and the election of the company's auditor.[205] In France, Belgium, Italy, Switzerland, the Netherlands, and Spain, shareholders also vote on the approval of financial statements,[206] and in Germany and Austria, shareholders do so in the case of a disagreement between the

199. AktG § 103 (Ger.); C. COM. art. L. 225-18 (Fr.); AKTG § 87 (Austria); Ley de Sociedades Anónimas arts. 123, 131 (Spain); C.C. art. 2364(2) (It.); CODE DES SOCIÉTÉS art. 518(2), (3) (Belg.); BW arts. 2:132, 2:134 (Neth.).

200. Umwandlungsgesetz [UmwG] [Reorganization Act], Oct. 28, 1994, BGBL. I at 3210, §§ 13, 65 (Ger.) (requiring a supermajority of three quarters); C. COM. art. L. 236-2 (Fr.); AKTG § 221 (Austria); FUSIONSGESETZ [FUSG] [MERGER ACT] Oct. 3, 2003, arts. 18(a), 43, 64(a) (Switz.) (requiring a two thirds supermajority); Ley 3/2009 de 3 de abril sobre modificaciones estructurales de las sociedades mercantiles arts. 8, 40 (B.O.E. 2009, 3) (Spain); C.C. art. 2365 (It.); CODE DES SOCIÉTÉS art. 699 (Belg.); BW art. 2:317 (Neth.).

201. *See* AktG § 179 (Ger.); C. COM. art. L. 225-96 (Fr.); AKTG § 145 (Austria); OR art. 647 (Switz.); Ley de Sociedades Anónimas art. 144 (Spain); C.C. art. 2365 (It.); CODE DES SOCIÉTÉS art. 558 (Belg.); BW art. 2:121 (Neth.).

202. *See* AktG §§ 182, 192, 202 (Ger.); C. COM. arts. L. 225-129, L. 225-130 (Fr.); AKTG §§ 149, 159, 169 (Austria); OR art. 650, 651, 653, para. 1 (Switz.); Ley de Sociedades Anónimas art. 152.1 (Spain); CODE DES SOCIÉTÉS art. 581 (Belg.); BW art. 2:96 (Neth.); Council Directive 77/91, art. 25, 1976 O.J. (L 26) 1, 8 (EC).

203. *See* AktG §§ 222, 229, 237 (Ger.); C. COM. art. L. 225-204 (Fr.); AKTG § 175 (Austria); OR art. 732 (Switz.); Ley de Sociedades Anónimas art. 164.1 (Spain); CODE DES SOCIÉTÉS art. 612 (Belg.); BW art. 2:99 (Neth.).

204. *See* AktG § 186(3) (Ger.); C. COM. art. L. 225-135 (Fr.); AKTG § 153(3) (Austria); OR art. 652b (Switz.) (permitting the shareholder meeting to waive the preemptive right for an important reason); Ley de Sociedades Anónimas art. 159.1 (Spain); C.C. art. 2441 (It.); CODE DES SOCIÉTÉS art. 596 (Belg.); BW art. 2:96a(6) (Neth.).

205. HANDELSGESETZBUCH [HGB] [COMMERCIAL CODE], Oct. 15, 1897, REICHSGESETZBLATT [RGBL] 219, as amended Dec. 22, 2011, BGBL. I 3044, § 318 (Ger.); C. COM. arts. L. 225-228, L 823-1 (Fr.); UNTERNEHMENSGESETZBUCH [UGB] [BUSINESS ENTERPRISE CODE], Oct. 15, 1897, RGBL. 219 (Ger.) (as HGB), introduced in Austria, Dec. 24, 1938, RGBL. I 1428, renamed UGB, Oct. 27, 2005, BGBL. I No. 120/2005, as amended BGBL. I No. 35/2012 , § 270 (Austria); OR art. 730 (Switz.); Ley de Sociedades Anónimas art. 204 (Spain); BW art. 2:393(Neth.). The vote is a requirement of EU law. EU Audit Directive 2006/43/EC of May 17, 2006, O.J. l 157/87, art. 37.

206. C. COM. art. L. 225-100 (Fr.); OR art. 698(3) (Switz.); Ley de Sociedades Anónimas art. 212 (Spain); C.C. art. 2364(1) (It.); CODE DES SOCIÉTÉS art. 554 (Belg.); BW arts. 2:117(5), 2:362(6) (Neth.).

supervisory and the management board.[207] It is also typically required that shareholders vote on the distribution of dividends.[208] Finally, in European companies, shareholders often vote on annual "discharge" resolutions regarding directors, which do not extinguish liability in most jurisdictions, but imply general approval of the board.[209] These votes are often, but not in all countries, explicitly required by the law.[210]

Of course, suits to determine the validity of a shareholder resolution are possible in the United States as well.[211] But given the larger number of significant shareholder votes and the prevalence of concentrated ownership structures in Continental Europe, these suits address some of the issues that would be litigated in shareholder derivative suits or class actions take in the United States, thus making the absence of such suits a much less significant concern. Under concentrated ownership, shareholder resolutions are typically passed with the vote of majority shareholders or a coalition of large shareholders, who are effectively able to put the board in place and to determine corporate policies. While the formal defendant in a suit of this type is the corporation,[212] they are de facto directed against the corporation's majority shareholders.[213] For example, in France, the doctrine of *abus de majorité,* which limits the power of majority shareholders to act in their own interest, developed largely as a result of rescission suits.[214] In Germany and Italy, these lawsuits have become so widespread that legislative measures have been

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207. *See* AktG § 173 (Ger.); AKTG § 104(3) (Austria); for France see, for example, MERLE & FAUCHON, *supra* note 22, ¶ 481 (discussing "quitus"). If an Italian company uses the German-inspired dualistic system, shareholders do not vote on the financial statements.

208. *See* AktG § 58 (Ger.); C. COM. art. L. 232-11 (Fr.); AKTG § 104(2)(2) (Austria); OR art. 698, para. 4 (Switz.); Ley de Sociedades Anónimas art. 213 (Spain); C.C. art. 2364bis(1)(4) (It.).

209. Among the countries surveyed here, Belgium seems to be the only one where a discharge resolution extinguishes liability. *See* Bertrand & Coibion, *supra* note 44, at 283–84, 287.

210. AktG § 120(1) (Ger.); AKTG § 104(2)(3) (Austria); OR art. 698, para. 5 (Switz.); CODE DES SOCIÉTÉS art. 554 (Belg.); EUGENIA UNANYANTS-JACKSON, DIRECTORS' LIABILITY DISCHARGE PROPOSALS: THE IMPLICATIONS FOR SHAREHOLDERS 28, 31 (Sarah Wilson ed., 2008) (pointing out that discharge resolutions are common also in the Netherlands and Spain, but do not extinguish directors' liability).

211. *See, e.g.*, DEL. CODE ANN. tit. 8 § 225 (2011).

212. *See* van Aaken, *supra* note 31, at 302; Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. 765, 784 (2002) [hereinafter Enriques, *Do Corporate Law Judges Matter?*].

213. Enriques, *Do Corporate Law Judges Matter?*, *supra* note 212, at 784.

214. Germain, *supra* note 24, at 412; GUYON, *supra* note 16, at 488.

taken to curb alleged abuse.[215] Generally, nullification suits do not require the plaintiff shareholder to hold a certain percentage of shares.[216] Only in 2003 did Italy introduce a threshold of 5% for unlisted and 0.1% for listed companies.[217] Rescission suits are sometimes limited by a short prescription period, e.g., one month after the meeting in Germany for most suits,[218] ninety days in Italy,[219] but three years in France.[220]

In Germany, allegedly abusive litigation by so-called "predatory shareholders"[221] continues to cause debate and resulted in the production of voluminous literature. In 2010 alone, 70 publicly-traded companies were sued.[222] For the years 2006 through 2008, Vermeulen and Zetzsche report 135, 164, and 163 suits respectively, which is by all means not a negligible number given that 752 German companies were listed in regu-

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215. Abuse has also been an issue elsewhere. *See* Klaus J. Hopt, *Shareholder Rights and Remedies: A View from Germany and the Continent*, 1 COMPANY FIN. & INSOLVENCY L. REV. 261, 268 (1997) (reporting that abuse has become common in France and Belgium as well, although the issue was dealt with by the courts and has received less attention from academic commentators); GUYON, *supra* note 16, at 490–91 (discussing the abuse of legal rights of minority shareholders in France); *see also* Bertrand & Coibion, *supra* note 44, at 498 (reporting a "significant amount" of suits in Belgium).

216. AktG § 245(1) (Ger.); AKTG § 196(1)(1) (Austria) (both providing that a shareholder who submitted a written objection in the shareholder meeting has standing); OR art. 406 para. 1 (Switz.); CODE DES SOCIÉTÉS art. 178 (Belg.); BW art. 2:15(3)(a) (Neth.) (both providing that a person with a legal interest can sue); Ley de Sociedades Anónimas (B.O.E. 1989, 1564) art. 117 (Spain); *see* Germain, *supra* note 24, at 412; CHAVARÉT ET AL., *supra* note 79, ¶ 28353 (both explaining that in France, the party the law intends to protect can sue).

217. C.C. art. 2377(3) (It.). Since 1975, a 5% threshold has prevented—and still prevents today—small shareholders of listed companies from challenging the validity of resolutions approving annual accounts of listed companies on the grounds that the companies fail to conform with the provisions governing the preparation thereof, provided that the company's auditor has judged the accounts to be consistent with such provisions and generally accepted accounting principles. *See* Enriques, *Do Corporate Law Judges Matter?*, *supra* note 212, at 785–86.

218. AktG 246(1) (Ger.).

219. C.C. art. 2377(6) (It.). There are longer limitation periods for violations of the law that are so fundamental that they are not considered just voidable, but void. *See* AktG 242(2) (Ger.) (three years). For Italy, see GALGANO & GENGHINI, *supra* note 176, at 393 (three years).

220. C. COM. art. L. 235-9 (Fr.).

221. The German term is "räuberischer Aktionär." *See, e.g.*, Burkhard Hess & Christoph Leser, *"Räuberische" Aktionäre—Ist das Prozessrecht hilflos?*, *in* FESTSCHRIFT FÜR UWE H. SCHNEIDER, *supra* note 16, at 519.

222. Walter Bayer & Thomas Hoffmann, *Beschlussmängelklagen: Rechtstatsachen aus 2010*, 2011 DIE AKTIENGESELLSCHAFT (AG-REPORT) R175, R175.

lated markets and 450 were traded in open markets in 2008.[223] Most of these suits are brought by a small circle of about 40 repeat plaintiffs.[224] Baums et al. report 580 suits in publicly traded firms between July 1, 2007 and July 30, 2011.[225]

Rescission suits are attractive because their disruptive potential creates an effective bargaining tool for the plaintiff against the firm and dominant shareholders.[226] While the suit is pending, plaintiffs can enjoin the transaction that has been voted on, thus often preventing the transaction from proceeding.[227] Even a pending lawsuit relating to the firm's annual decisions—such as the discharge resolution—the election of the auditor, or the payment of dividends, can be bothersome.[228] It is thus often alleged that certain plaintiff shareholders bring lawsuits basically to "to blackmail companies into lucrative settlement agreements."[229] Most academic commentators seem to believe that the majority of rescission suits in Germany are abusive.[230] Instead of suing derivatively, "predatory shareholders" are alleged to excessively use shareholder rights in the formal meeting to provoke formal mistakes that are grounds for rescission suits.[231] Some firms are reported to have preemptively paid "professional plaintiffs" to not attend the annual general meeting.[232]

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223. Erik P.M. Vermeulen & Dirk A. Zetzsche, *The Use and Abuse of Investor Suits*, 7 EUR. COMPANY & FIN. L. REV. 1, 24–25 (2010).

224. Theodor Baums, Astrid Keinath & Daniel Gajek, *Fortschritte bei Klagen gegen Hauptversammlungsbeschlüsse*, 28 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] [JOURNAL OF BUSINESS LAW] 1629, 1635–37 (2007) (Ger.) [hereinafter Baums et al., *Fortschritte bei Klagen*] (listing the names of repeat plaintiffs).

225. Theodor Baums, Florian Drinhausen & Astrid Keinath, *Anfechtungsklagen und Freigabeverfahren. Eine empirische Studie,* 32 ZIP 2329, 2331 (2011) (Ger.) [hereinafter Baums et al., *Anfechtungsklagen und Freigabeverfahren*].

226. Conac et al., *supra* note 50, at 513.

227. *Id.* at 513; *see* C.C. art. 2378(3) (It.) (plaintiffs may petition court to order directors not to execute the resolution). For Germany, see HÜFFER, *supra* note 22, § 243, ¶ 66. The trial court may issue an injunction halting the registration in the register of companies under ZPO §§ 935–45 (Ger.).

228. Baums et al., *Anfechtungsklagen und Freigabeverfahren*, *supra* note 225, at 2337 (noting an increase in the number of suits attacking the election of the auditor).

229. Conac et al., *supra* note 50, at 513.

230. *E.g.*, Hopt, *supra* note 215, at 267 ("Since the late 70s this has become a plague."); Vermeulen & Zetzsche, *supra* note 223, at 60 (finding that most suits between 2005 and 2008 qualified as abusive, using criteria such as the person of the plaintiff, the type of legal counsel, the nature of the complaint, and backing by institutional shareholders).

231. Hess & Leser, *supra* note 221, at 522.

232. *Id.* at 521–22.

A rescission lawsuit can be particularly disruptive when a corporation needs shareholder approval to issue new shares or to reduce the firm's capital since these measures cannot be recorded in the company register while the suit is pending.[233] Germany, therefore, introduced a "clearance procedure" (*Freigabeverfahren*) in 2005, thus allowing the court to let an increase or reduction of capital, or the integration of a corporation into a contractual group to go ahead in spite of a pending suit. The court may grant the corporation's motion "if the suit is patently baseless, or if the alleged violations of the law are less onerous to the firm and its shareholders than the disadvantage of the transaction grounding to a halt."[234] The introduction of a percentage threshold in Italy was motivated by similar concerns.

Given the scarcity of derivative suits in Germany, even after the 2005 reform, the omnipresence of rescission suits provides a puzzle, but only at first glance. There are four distinct advantages. First, as already explained, a shareholder can relatively easily "harass" the corporation with suits of this type. Second, the absence of a minimum ownership threshold may play a role in comparison to derivative suits (but not in comparison to suits under the law of corporate groups). Third, the substantive case for a claim is easier to make. A plaintiff does not need to show a "serious" violation of a law to pass a judicial prescreening procedure as he would to bring a derivative suits. Many suits rest on claims that the corporation failed to follow the appropriate procedure (e.g., by providing

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233. *E.g.*, Thorsten Helm & Nikolaus Vincent Manthey, *Missbräuchliche Anfechtungsklagen im Aktienrecht—Rechtsvergleich und Lösungsansätze*, 2010 NZG 415, 415 (Ger.).

234. Conac et al., *supra* note 50, at 514; § 246a AktG, as amended by UMAG, Sept. 22, 2005, BGBL. I at 2802 (Ger.); *see also* Till Naruisch & Fabian Liepe, *Latest Developments in the German Law on Public Companies by the Act on Corporate Integrity and Modernisation of the Right of Resolution-Annulment (UMAG)—Shareholder Activism and Directors' Liability Reloaded*, 2007 J. BUS. L. 225, 231–32 (discussing the express release procedure under Aktiengesetz). The procedure was reformed with the Gesetz zur Umsetzung der Aktionärsrechterichtlinie (ARUG), July 30, 2009, BGBL. I at 2479 (Ger.). The new law, among other things, requires the petitioner to show that he owned shares corresponding to a legal capital of €1,000 since the time when the meeting was called. *See* Baums et al., *Anfechtungsklagen und Freigabeverfahren*, *supra* note 225, at 2348–49 (providing empirical data the prevalence and effectiveness of the procedure).

Similarly, the Italian corporate law reform of 2003 specified that the judge has to decide upon a petition to block a shareholder resolution by comparing the prejudice the plaintiff would suffer following execution with the prejudice the company would suffer from not executing the resolution. *See* C.C. art. 2497 *et seq.* (It.); *see also* Fasciani, *supra* note 193, at 211–12.

inadequate disclosure to shareholders before the general meeting).[235] However, alleged violations of substantive standards such as the duty of loyalty also play a role.[236]

Fourth, the cost risk is limited and foreseeable. In principle, the English Rule applies to these lawsuits as well, the defendant being the corporation.[237] However, the amount in dispute—which determines the amount of court fees the plaintiff has to advance—is limited to the lower of 10% of the corporation's nominal capital or €500,000.[238] The limitation is therefore similar to the one in the preliminary procedure to admit a derivative suit (see above Section 2.2), but unlike in the latter case, there is no second stage of litigation where the amount in dispute could reach many millions, and the cost therefore is limited to tens of thousands of Euros. Theodor Baums argues that the risk of having to bear cost will therefore deter "occasional," but not "professional," plaintiffs.[239] For the latter group, the possibility to put pressure on the corporation creates an equivalent incentive for plaintiffs to take action, as the contingency fee does for derivative suits in the United States.

3.2. Criminal Investigations

Another important alternative is shareholders' ability to "piggyback" on criminal investigations. In France, directors' duties are often thought to be subject to stronger scrutiny under criminal law than equivalent duties in other countries.[240] This does not imply that the risk of criminal liability in general is the greatest in France. This honor may in fact go to the United States, where violations of disclosure duties under the securities law carry strong criminal sanctions.[241] By contrast, the French crime of *abus de biens sociaux* (abuse of corporate assets) penalizes directors' misuse of the company's property and credit in bad faith, "when direc-

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235. *See* Baums et al., *Fortschritte bei Klagen*, *supra* note 224, at 1640–41 (providing data about professed reasons for the suits).

236. *Id.*

237. Theodor Baums, *Die Prozesskosten der aktienrechtlichen Anfechtungsklage*, *in* FESTSCHRIFT FÜR MARCUS LUTTER zum 70. GEBURTSTAG 283, 284 (Uwe H. Schneider, Peter Hommelhoff, Karsten Schmidt, Wolfram Timm, Barbara Grunewald & Tim Drygala eds., 2000) (Ger.) [hereinafter Baums, *Die Prozesskosten*].

238. § 247 I AktG (Ger.).

239. Baums, *Die Prozesskosten*, *supra* note 237, at 296.

240. *See, e.g.*, James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT'L L.J. 31, 85 (1998) (quoting Senator Marini's observation that "French corporate law is extremely criminalized").

241. Securities Exchange Act of 1934 § 32(a), *as amended in* 15 U.S.C. § 78ff(a) (2006).

tors knew that it was contrary to its interest."[242] Hence, prosecutors and courts look at the substance of managerial decision-making.

Criminal sanctions used to enforce directors' duties are not unique to France. Italian *infedeltà patrimoniale*[243] and German *Untreue*,[244] both meaning "disloyalty," serve a similar function at least in part.[245] French law, however, has been most widely discussed, particularly with respect to how minority shareholders can initiate criminal prosecution by filing a criminal complaint (*plainte avec constitution de partie civile*). Shareholders can attach themselves to the prosecution in order to receive compensation for damages.[246] As explained by Conac et al., "[i]n order for the complaint to be admissible, it is enough that the circumstances which gave rise to the complaint allow the examining magistrate to consider 'possible' the existence of the damage to the company and the link with the alleged abuse of corporate assets."[247] If this criterion is met, the examining magistrate has the duty to investigate.[248] The examining judge also has the right to access the company's documents, which solves the information problem shareholders otherwise would have to overcome. There were between 416 and 480 convictions per year between 2000 and 2006, of which an estimated 20% have led to actual jail time.[249] While it is likely that these are mostly small firms, it is potentially relevant for large firms as well. Recent developments have also made it easier for Italian shareholders to similarly file a criminal complaint by way of the so-called "*parte civile.*"[250]

In recent years, dissatisfaction with the extent of criminal liability risk has grown in France, which is why the government commissioned a re-

242. C. COM. L. 242-6 (Fr.). The maximum penalty is five years in prison. For a doctrinal description in English see Nicole Stolowy, *Company-Related Offences in French Legislation*, 2007 J. BUS. L. 1, 3–7.

243. *See* C.C. art. 2634 (It.).

244. STRAFGESETZBUCH [STGB] [PENAL CODE], Aug. 21, 1995, BGBL. I, as amended, § 266 (Ger.).

245. *See, e.g.*, Conac et al., *supra* note 50, at 520–22 (discussing German and Italian law).

246. GUYON, *supra* note 16, at 497 (explaining that shareholders often prefer to obtain damages this way); DE NICOLA, *supra* note 171, at 146; Bernard Black et al., *Legal Liability of Directors Part 2*, 2008 COLUM. BUS. L. REV. 1, 18–19.

247. Conac et al., *supra* note 50, at 518.

248. *Id.* at 518.

249. *Id.* at 519.

250. *Id.* at 522 (referring to Cass., sez. V, 16 giugno 2006, n. 37033, Giur. comm. 2007, 1030 (It.) where shareholders are qualified as victims and therefore enabled to file a petition to the court).

port on the "decriminalization" of business law published in 2008. The core corporate infraction of *abus de biens sociaux,* however, was to remain in place according to the report.[251] At least for now, the decriminalization project has been shelved. Overall, criminal redress often seems to assume the function of enforcing the duties of directors and officers, both in terms of deterrence and permitting the recovery of damages. It appears to be superior for shareholders, given that it involves no court fees or litigation risk, and that it also helps to overcome the information problem solved by discovery in the United States.

3.3. The Dutch Inquiry Proceedings

Dutch law provides another interesting model that combines a privately instigated judicial investigation with enforcement and is widely thought to be successful. While there is no derivative suit under Dutch corporate law,[252] minority shareholders can petition the enterprise chamber (*ondernemingskamer*), a special division of the Amsterdam Court of Appeals, to launch an official investigation. A petition for an investigation can be brought, among other situations, to conduct an investigation into the business policies and the conduct of affairs of a legal person, i.e., when there is a problem with the company's management (*enquête* or inquiry proceedings).[253] A similar procedure can be launched to challenge the accuracy of a corporation's financial statements.[254]

A petition to start inquiry proceedings can be brought either by the advocate general of the court for reasons of public policy,[255] by a labor union,[256] or by shareholders holding the lower of a nominal capital of €225,000 or a 10% share in the company.[257] The petitioner has to submit a written request stating why he believes that the company was being mismanaged. At that point, control and initiative over the investigation pass to the court.[258] If the enterprise chamber finds that the petition is

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251. JEAN-MARIE COULON ET AL., LA DÉPÉNALISATION DE LA VIE DES AFFAIRES 31–37 (2008) (Fr.).

252. SCHUIT ET AL., *supra* note 43, at 155.

253. BW art. 2:345(1) (Neth.).

254. *Id.* art. 2:447 (Neth.). Furthermore, similar procedures can be used as redress in situations of conflict relating to the removal of directors (*Id.* arts. 2:158, 2:161a (Neth.)), and to review the fairness of freezeouts. *Id.* art. 2:92a (Neth.).

255. *Id.* art. 2:345(2) (Neth.).

256. *Id.* art. 2:347 (Neth.).

257. *Id.* art. 2:346(b) (Neth.).

258. SCHUIT ET AL., *supra* note 43, at 157.

sufficiently substantiated, it appoints investigators.[259] On the basis of the investigators' report, the enterprise chamber determines whether the case amounts to "misconduct" and requires further action.[260] The enterprise chamber can take an array of measures, including the dismissal of board members, the rescission of board or shareholder resolutions, the appointment of temporary board members, and even the dissolution of the company.[261] While damages cannot be awarded in these proceedings, the corporation may subsequently ask the court to have the director responsible for "a wrong policy or an unsatisfactory state of affairs" to indemnify the corporation for the costs of the proceedings.[262] Furthermore, successful inquiry proceedings may tarnish a director's reputation and will consequently facilitate liability suits.[263]

Interestingly, the *inquiry proceeding* has become reasonably common in spite of the high 10% threshold: in publicly traded firms alone, there were twenty-three cases from 2000 to 2007,[264] nineteen of which were brought by minority shareholders, such as institutional investors and the Dutch Investors' Association.[265] Commentators argue that the main driver was that injunctive relieve became available in 1994 and has since become the rule, and often the de facto final decision, in disputes between majority and minority shareholders.[266] Since then, the enterprise chamber acquired a reputation for resolving conflicts in a speedy manner

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259. Vermeulen & Zetzsche, *supra* note 223, at 16.

260. BW art. 2:356 (Neth.). Some jurisprudence revolves around the question what constitutes misconduct. While the enterprise chamber recognizes the need for managerial discretion with respect to company policies, the violation of minority shareholders' rights generally qualifies. L. Timmerman & A. Doorman, *Rights of Minority Shareholders in the Netherlands*, 6 ELECTRONIC J. COMP. L. 181, 199–202, nn.24–25 (Dec. 2002), *available at* http://www.ejcl.org/64/art64-12.html.

261. BW art. 2:356 (Neth.); Martijn van Empel, *The Netherlands*, *in* THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS 123, 147 (Arthur Pinto & Gustavo Visentini eds., 1998); SCHUIT ET AL., *supra* note 43, at 159.

262. BW art. 2:354 (Neth.).

263. *See* Maarten J. Kroeze, *The Companies and Business Court as a Specialized Court*, *in* THE QUALITY OF CORPORATE LAW AND THE ROLE OF CORPORATE LAW JUDGES 143, 147 *(*Louis Bouchez, Marco Knubben, Joseph McCahery & Vino Timmerman eds., 2006).

264. Vermeulen & Zetzsche, *supra* note 223, at 17. Before 2000, inquiry proceedings were much rarer. *Id.*

265. *Id.* at 58.

266. *See* Kroeze, *supra* note 263, at 149; Vermeulen & Zetzsche, *supra* note 223, at 18–20; Joseph A. McCahery & Erik P.M. Vermeulen, *Conflict Resolution and the Role of Corporate Law Courts: An Empirical Study*, *in* COMPANY LAW AND SMES 207, 239–40 (Mette Neville & Karsten Engsig Sørensen eds., 2010); *see also* BW art. 2:349a (Neth.).

and coming to reasonable and pragmatic solutions.[267] Cost is not a deterrent factor, since expenses are by default borne by the firm; however, the court may order the petitioner to indemnify the firm if the petition was not made on well-founded grounds.[268] Moreover, the comparatively high threshold of 10% most likely also prevents abusive petitions, given that such a high ownership stake typically indicates a strong commitment to the firm. Nevertheless, the inquiry proceeding has become an important mechanism for corporate law enforcement in the Netherlands that is widely considered a success, thus making the absence of a derivative suit mechanism a less pressing problem.

CONCLUSION

In my contribution to the symposium, I have attempted to demonstrate two things. First, the absence of derivative suits in Continental Europe cannot be explained with a single factor, but only with a whole range of elements that make them unavailable or render derivative suits unattractive to small shareholders. A version of the "Anna Karenina principle" applies analogously; in other words, several prongs have to be met to make a particular type of suit attractive. This is the case in the United States, but not in Continental Europe. Second, the dearth of derivative suits does not necessarily mean that there is no corporate law enforcement, but rather that shareholders are likely to choose the "path of least resistance" (section 3) and use other methods to address grievances.

Specifically, I have identified four necessary factors, which are as follows: the presence of liberal standing requirements, as opposed to European minimum ownership thresholds; a litigation cost structure that sets incentives that overcome the collective action problem; availability of information to plaintiffs; and the ability to sue those who actually control the firm, which in Europe often includes large shareholders.

The most complicated factor, the allocation of litigation cost and risk, has three aspects. A considerable upfront cost can deter many suits. Between the other two factors, the "English Rule" of litigation cost and the availability of contingency fees, there are strong reasons to believe that contingency fees are more important given that the distinctions between the American and the English Rule are smaller than one might think at first glance. By contrast, contingency fees illustrate the importance of setting strong incentives for a private actor (such as a lawyer or a repeat

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267. *See* Kroeze, *supra* note 263, at 149; McCahery & Vermeulen, *supra* note 266, at 241–43.

268. BW art. 2:354 (Neth.).

plaintiff). Other examples include conditional fees in Japanese shareholder litigation and rescission suits brought by shareholders in Germany. In the latter example, the motivation is also not the shareholder's proportionate benefit from the shareholder's stake of the firm, but personal advantages that the plaintiff can obtain in a settlement. As in the United States, there is an extensive debate regarding abusive suits by repeat plaintiffs and their illegitimate motives. Viewing both systems positively, one can suspect that plaintiffs need to be incentivized with a reward that exceeds their individual share in the social harm. In a system of private enforcement, plaintiffs are bounty hunters that need to be promised a reward. The problem is that bounty hunters sometimes set excessive enforcement actions and cause collateral damage.

This Article shows that there are other systems of enforcement of corporate law in Continental Europe. Some of these, such as rescission suits, are primarily private, and some are public, such as criminal enforcement. The prevalence of private mechanisms demonstrates that we do not need a "cultural" theory of corporate law to explain why derivative suits have not spread as widely in Europe as they have in the United States. The case of the rescission suit, most of all in Germany, does not support the hypothesis that Europeans are inherently less litigious than Americans, but rather indicates that the right incentives set by the institutional framework are decisive. The eclectic presentation of partly functional equivalent mechanisms of course does not demonstrate that Continental European corporate law is equally well enforced. For example, rescission suits may capture issues that are important enough to warrant a shareholder vote, but not violations of directors' fiduciary duties that happen below the radar screen of the shareholder meeting. Furthermore, the absence of derivative suits seems to imply that Continental European private enforcement mechanisms suffer from the inability of plaintiffs to obtain sufficient information. While private enforcement mechanisms often invite excessive use, public mechanisms may tend to under-enforce and weaken incentives to vigorously pursue wrongdoing by directors, managers, and controlling shareholders. No system is perfect, and a global assessment is beyond the scope of this contribution.

THE RECOGNITION OF U.S. CLASS ACTION JUDGMENTS ABROAD: THE CASE OF LATIN AMERICA

Antonio Gidi[*]

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* Assistant Professor, University of Houston Law Center. Visiting Professor, University of Tennessee College of Law. S.J.D., University of Pennsylvania Law School; LL.M., Ph.D., PUC University, Sao Paulo, Brazil; LL.B., Federal University of Bahia, Brazil. The author has worked as an expert witness on the cases related to the recognition of class action judgments in Latin America in the Parmalat Securities Litigation class action and in the class action derived from the Bernard Madoff Ponzi scheme. *See In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472 (S.D.N.Y. 2005); Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372 (S.D.N.Y. 2010). The author would like to thank Keith Rosenn of the University of Miami Law School and Stefaan Voet of the University of Ghent Law School.

INTRODUCTION

The number of class actions in the United States with foreign class members—alternatively known as global, multinational, international, or transnational class actions—has steadily increased in the past few years.[1] The increase can be attributed to a combination of the global presence of multinational corporations[2] and the aggressively broad reach of American class action attorneys.[3]

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1. See, most recently, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010) (refusing to apply U.S. securities laws in a class action brought by foreign class members against a foreign bank). The issue is not new. U.S. courts have been including foreign people in class definition for almost half a century. For an earlier example in the area of securities litigation class actions, see Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 977–78 (2d Cir. 1975) ("[T]he suit here is a class action on behalf of thousands of plaintiffs preponderantly citizens and residents of Canada, Australia, England, France, Germany, Switzerland, and many other countries in Europe, Asia, Africa, and South America."); *see also* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 799 (1985) (brought on behalf of a class of about 28,000 members, residing in all 50 States, the District of Columbia, and several foreign countries). For earlier examples in the area of mass tort, see, for example, *In re* "Agent Orange" Prod. Liab. Litig., 100 F.R.D. 718, 729 (E.D.N.Y. 1983).

> The plaintiff class is defined as those persons who were in the United States, New Zealand or Australian Armed Forces at any time from 1961 to 1972 who were injured while in or near Vietnam by exposure to Agent Orange or other phenoxy herbicides . . . . The class also includes spouses, parents, and children of the veterans born before January 1, 1984, directly or derivatively injured as a result of the exposure.

Id.; *In re* Dow Corning Corp., 244 B.R. 634, 641–42 (Bankr. E.D. Mich. 1999) (a worldwide class of women affected by silicone breast implants). A high profile worldwide class action was brought on behalf of victims of the Nazi holocaust. *See In re* Holocaust Victim Assets Litig., 105 F. Supp. 2d 139 (E.D.N.Y. 2000). *See generally* SWISS BANK SETTLEMENT, http://www.swissbankclaims.com (last updated Feb. 29, 2012); *see also* Bowling v. Pfizer, Inc., 143 F.R.D. 138, 139–40 (S.D. Ohio 1992) (a "futures only" worldwide class of people affected by allegedly defective heart valves). Needless to say, the idea of binding "future class members" creates a new set of obstacles for the recognition of U.S. class actions abroad. *See* Isabelle Romy, *Class actions américaines et droit international privé suisse*, AKTUELLE JURISTISCHE PRAXIS [AJP] 783, 796–97 (1999) (Switz.).

A related issue is the rise of international class arbitration. *See* S.I. Strong, *Enforcing Class Arbitration in the International Sphere: Due Process and Public Policy Concerns*, 30 U. PA. J. INT'L L. 1, 53, 89 (2008) (discussing the increasing numbers of international class arbitrations and the attendant problems with the international recognition of class arbitration awards and arguing that, although "parties will likely oppose enforcement of international class awards under the New York Convention on due process and public policy grounds," ultimately "international class awards should be given the same presumption of enforceability as other international awards").

2. *See* Hannah Buxbaum, *Multinational Class Actions under Federal Securities Law: Managing Jurisdictional Conflict*, 46 COLUM. J. TRANSNAT'L L. 14, 16 (2007)

Once a judgment is obtained or a settlement is reached in an American opt-out class action in which at least some of the class members are foreigners, the issue remains whether such judgment will be recognized and enforced in foreign courts. If the class action judgment is against the interest of the foreign class members, some foreign courts might not allow foreign class members to be bound by such adverse judgment. If the class action judgment or settlement is less than the amount foreign class members believe they should be entitled to, a foreign court might not enforce the result. The question therefore remains whether the class action defendant will be able to assert res judicata against the foreign absent class members in a subsequent proceeding, or whether foreign absent class members will be able to bring their own individual or class action lawsuits abroad.

This is an important procedural issue for foreign class members as well as U.S. courts.[4] Yet there are few examples of foreign courts enforcing U.S. class action judgments or court-approved settlements.[5] This Article

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("The globalization of financial markets has brought about the globalization of securities litigation"); George A. Bermann, *U.S. Class Actions and the "Global Class*,*"* 19 KAN. J.L. & PUB. POL'Y 91, 93 (2009) ("The emergence of multinational classes in securities, antitrust, and mass tort claims is something we can expect in a world of truly international markets."); Richard A. Nagareda, *Aggregate Litigation Across the Atlantic and the Future of American Exceptionalism*, 62 VAND. L. REV. 1 (2009).

> In our world, no formal political state has authority of a scope commensurate with modern global business. As a result, our world is one that virtually invites regulatory mismatches. The underlying dispute is likely to be global, as might well be the desired preclusive scope for litigation. But aggregate litigation necessarily must proceed in some court within some government whose territorial authority stops considerably short of the entire globe.

Id. at 13.

3. *See* Rolf Sturner, *International Class Actions from a German Point of View*, *in* CURRENT TOPICS OF INTERNATIONAL LITIGATION 107 (Mohr Siebeck, Rolf Sturner & Masanori Kawano eds., 2009) [hereinafter CURRENT TOPICS] ("American law firms are therefore fishing for claimants all over the world with the intention to represent a worldwide international class in American courts.").

4. *See* John C. L. Dixon, *The Res Judicata Effect in England of a US Class Action Settlement*, 46 INT'L & COMP. L.Q. 134 (1997) (Eng.) (foreign class members need to know the consequences of opting out, remaining in, or ignoring a class action notice and U.S. courts need to know the binding nature of its class action decree).

5. *See* Andrea Pinna, *Recognition and Res Judicata of US Class Action Judgments in European Legal Systems*, 1 ERASMUS L. REV. 31, 38 (2008) ("[T]he specificities of [the class action] procedure make it nearly impossible to apply reasoning by analogy, simply because European courts have not had the opportunity to rule on similar situations."); Bermann, *supra* note 2, at 96 ("[N]o foreign court has ever addressed the question [of foreign class action judgment recognition]."); Marina Matousekova, *Would*

will attempt to answer some of these questions that have confounded U.S. courts and commentators. Although this Article's scope is largely limited to the enforceability of U.S. class action judgments and court-approved settlements in Latin America, the conclusions are applicable to all countries, particularly within the civil law tradition.

Individual U.S. judgments are routinely recognized and enforced in Latin America, but class action proceedings present some very specific considerations that do not arise in the litigation of individual claims. Because of these differences, the recognition of U.S. class action judgments and settlements presents unique challenges to foreign courts.

The resolution of this issue may have a significant effect on U.S. class action law as well. Many American courts have denied certification of a foreign class due to lack of "superiority," whenever there is a concern that the foreign court will not recognize[6] the resultant judgment or court-

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French Courts Enforce U.S. Class Action Judgments?, 2006 CONTRATTO E IMPRESA 651, 653 (It.) ("the issue of whether an American class action judgment could be recognized and enforced in France . . . . has not yet been referred to any French judge"); Jonathan Harris, *The Recognition and Enforcement of US Class Action Judgments in England*, 2006 CONTRATTO E IMPRESA 617 (It.) ("There is no clear English authority as to whether, and in what circumstances, a United States class action judgment is entitled to recognition and enforcement in England."); Dixon, *supra* note 4, at 150 ("The law in this area is difficult to analyse as there is no case that has really come close to considering this issue."); *see also In re* Vivendi Universal, S.A. Sec. Litig., 242 F.R.D 76, 102–05 (S.D.N.Y. 2007) (no authority in England, Germany, Austria, and the Netherlands). *But see* Rechtbank Amsterdam, 23 juni 2010, No. 398833/HA ZA 08-1465 (Stichting Onderzoek Bedrijfs Informatie Sobi/Deloitte Accountants B.V.) (Neth.) (where an Amsterdam court recognized a U.S. class action judgment as binding upon non-U.S. residents who did not opt out of *In re* Royal Ahold N.V. Sec. & ERISA Litig., No. Civ.103MD01539, 2006 WL 132080 (D. Md. Jan. 9, 2006), where the fraudulent acts occurred in the United States); *Amsterdam Court Recognizes US Class Settlement*, STIBBE (June 25, 2010), http://www.stibbe.nl/upload/166c3273c01297daa3dd301435.htm; Sturner, *supra* note 3, at 114 (discussing a case in which the State District Court of Stuttgart refused recognition of a U.S. class action judgment).

6. The Author uses the expression "will not recognize" loosely. There is no uniform standard as to how confident a U.S. court must be as to whether the foreign court would recognize the potential class action judgment or settlement. *Compare* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 996 (2d Cir. 1975) (establishing the "near certainty" standard by holding that an American court need not certify a class action involving foreign class members when it is near certain that a foreign court may not recognize or enforce the class judgment), *with Vivendi*, 242 F.R.D. at 95. *In re* Vivendi Universal established the "more likely than not" standard by holding that a court may consider in the certification of a class involving foreign class members, whether it is likely or probable that a foreign court may recognize and enforce the class judgment, and stating that

> [i]t seems more appropriate, instead, to evaluate the risk of nonrecognition along a continuum. Where plaintiffs are able to establish a probability that a

approved settlement and the defendant risks possible litigation elsewhere regarding the same conflict, even after the U.S. class action has concluded.[7] This approach, conditioning class certification on the enforceability of the result abroad, has garnered the support of the International Bar Association.[8]

> foreign court will recognize the res judicata effect of a U.S. class action judgment, plaintiffs will have established this aspect of the superiority requirement. . . . Where plaintiffs are unable to show that foreign court recognition is more likely than not, this factor weighs against a finding of superiority and, taken in consideration with other factors, may lead to the exclusion of foreign claimants from the class. The closer the likelihood of non-recognition is to being a "near certainty," the more appropriate it is for the Court to deny certification of foreign claimants.

Id. at 95. *See generally* Matthew H. Jasilli, Note, *A Rat Res? Questioning the Value of Res Judicata in Rule 23(b)(3) Superiority Inquiries for Foreign Cubed Class Action Securities Litigations*, 48 COLUM. J. TRANSNAT'L L. 114, 121–31 (2009) (discussing several standards developed by U.S. courts); Michael P. Murtagh, *The Rule 23(b)(3) Superiority Requirement and Transnational Class Actions: Excluding Foreign Class Members in Favor of European Remedies*, 34 HASTINGS INT'L & COMP. L. REV. 1 (2011) (same); Tanya J. Monestier, *Transnational Class Actions and the Illusory Search for Res Judicata*, 86 TULANE L. REV. 1, 13–20 (2011) (same).

7. In the tradition of class action litigation, each actor is behaving in his or her own interest. Class counsel wants to include foreign class members to increase the settlement value of the claim and, consequently, attorney's fees. Defendants want to exclude foreign class members to reduce the scope of liability and, consequently, the value of the judgment or the settlement value of the claim. *See* Sturner, *supra* note 3, at 107–08; *see, e.g.*, *Vivendi*, 242 F.R.D. at 92 (class action on behalf of foreign class members partly dismissed for lack of superiority); Mohanty v. Bigband Networks, Inc., No. C 07-5101, 2008 WL 426250, at *5 (N.D. Cal. Feb. 14, 2008) (the class representative is not typical). See the discussion of *forum non convenies* in Monestier, *supra* note 6, at 11 n.24; Buxbaum, *supra* note 2, at 35, 39–41 (stating that, out of forty-five class claims involving foreign class members in securities class actions, fourteen had generated no specific resolution on the question of subject-matter jurisdiction, sixteen had excluded all foreign class members, and fifteen cases included all or some foreign class members. Many of the foreign class members were from Canada, a country that has a regulatory scheme that is similar to that of the United States, but some involved class members from countries which have different legal systems, like the Netherlands, Germany, and France).

8. *See* IBA LEGAL PRACTICE DIV., GUIDELINES FOR RECOGNISING AND ENFORCING FOREIGN JUDGMENTS FOR COLLECTIVE REDRESS 13 (Int'l Bar Ass'n ed., 2008) [hereinafter IBA LEGAL PRACTICE, GUIDELINES] ("It is appropriate for a court to assume jurisdiction over foreign class members if . . . it is reasonable for the court to expect that its judgment will be given preclusive effect by the jurisdictions in which the [absent] foreign class members . . . would ordinarily seek redress."). Although the language of the guidelines seems to apply only to the situations when the foreign class member prevails and "seek[s] redress," the IBA Task Force was cognizant that the most pressing issue was probably when the foreign class members would have their rights precluded. *See id.* at 12–13.

It is beyond the scope of this Article to discuss whether U.S. courts should certify transnational class actions (either with an opt-in or an opt-out procedure) regardless of the potential recognition of the result in a foreign court.[9] The objective of this Article is limited to determining

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> [D]uring its deliberations, the Task Force noted that a request to 'recognise and enforce' a traditional foreign judgment most commonly occurs when a foreign judgment creditor is trying to collect on the judgment. That is, a creditor is seeking to enforce an unsatisfied judgment obtained from a foreign country against a recalcitrant judgment debtor. However, the Task Force anticipates that these Guidelines will only rarely be invoked in those situations. Rather, the Task Force contemplates that these Guidelines will be most commonly used in situations where the preclusive effect of a foreign judgment will be at issue so as to prevent an absent claimant from re-litigating a claim that has been resolved by a foreign collective redress judgment.

Id.

9. *See Bersch*, 519 F.2d at 997 n.48 (proposing an opt-in class action to increase the possibility of enforcement abroad of U.S. class action judgments); Debra Lyn Bassett, *U.S. Class Actions Go Global: Transnational Class Actions and Personal Jurisdiction*, 72 FORDHAM L. REV. 41, 87–89 (2003) ("[T]he opt-in procedure is a superior device from a due process perspective."); Monestier, *supra* note 6, at 1–2 (proposing the adoption of the opt-in device for foreign class members). *But see* Janet Walker, *Crossborder Class Actions: A View from Across the Border*, 2004 MICH. ST. L. REV. 755, 769–71 [hereinafter Walker, *A View from Across the Border*] (stating that an opt-in solution for non-residents would not solve the problem of fairness to foreign class members). *See infra* Part II.B. (A U.S. Court Cannot Validly Obtain Personal Jurisdiction over Foreign Absent Plaintiff Class Members).

Linda Sandstrom Simard and Jay Tidmarsh propose the abandonment of the consensus that courts should not certify a class action with foreign citizens from countries that do not recognize an American judgment. *See* Linda Sandstrom Simard & Jay Tidmarsh, *Foreign Citizens in Transnational Class Actions*, 97 CORNELL L. REV. 87, 87–129 (2011). According to the authors, the most efficient test is to determine whether or not the foreign class member is likely to commence a subsequent foreign proceeding. Using standard tools of economic analysis, the authors propose the class action should "include foreign citizens with claims that are not individually viable and exclude foreign citizens with claims that are viable." *See id.* at 87. The idea is not new. It has been argued by plaintiff attorneys and commentators. *See, e.g.*, Ilana T. Buschkin, Note, *The Viability of Class Action Lawsuits in a Globalized Economy—Permitting Foreign Claimants to Be Members of Class Action Lawsuits in the US Federal Courts*, 90 CORNELL L. REV. 1563, 1595–96 (2005).

> When considering the res judicata concerns introduced by foreign class members, few federal judges are factoring in the actual likelihood of repeat litigation . . . . The risk that absent foreign class members will sue again in the courts of their home countries is often more theoretical than actual . . . . The practical difficulties involved in litigating abroad, however, usually make this theoretical possibility impracticable. If judges were to weigh these factors more carefully when considering certification of a class, in most cases they would discover

whether Latin American countries would recognize and enforce a U.S. class action judgment or court approved settlement.

This Article is structured in two parts. In order to illuminate the issues behind the recognition of a U.S. class action judgment in Latin America, Part I of this Article classifies Latin American countries into four categories, and discusses the obstacles to recognition of a U.S. class action judgment that are applicable to specific Latin American countries according to each nation's individual approach to class action litigation.

The first category is comprised of countries that do not allow class actions for damages. Some of the countries in this category may have some form of injunctive class actions with varying levels of sophistication.[10]

> that the risk of repeat litigation in foreign courts is minor and does not justify exclusion of foreign claimants.

Id. at 1595–96. There are other compelling arguments that supplement that analysis. For example, class actions may not be available abroad and the defendant may not be subject to jurisdiction abroad. *See also id.* at 1569, 1598–99 (stating that, because the objective of the small-claim class action is to deter corporate misconduct and preserve investor confidence in the marketplace (global deterrence), not efficiency "courts should adopt a presumption in favor of including foreign claimants in small claim class action lawsuits").

The perceived unfairness to defendants being exposed to litigation abroad may be more theoretical than real for yet another reason: by the time the U.S. class action is settled, the statute of limitations may have precluded any possibility of litigation abroad. *See* Peter L. Murray, *Class Actions in a Global Economy*, *in* CURRENT TOPICS, *supra* note 3, at 95, 103; *see also* Jasilli, *supra* note 6, at 118–19 ("the binding effect of judgments should not be addressed as part of the superiority inquiry of Rule 23(b), but should be replaced by the subject-matter inquiry for the extraterritorial application of U.S. securities laws.").

10. Most civil law scholars reserve the name "class actions" exclusively for "class action for damages" and some only use the expression to designate an "opt-out class action for damages." The many examples of injunctive class actions in their legal tradition are not considered "class actions." *See, e.g.*, Samuel P. Baumgartner, *Class Actions and Group Litigation in Switzerland*, 27 NW. J. INT'L L. & BUS. 301, 316–17 (2006–2007).

> Just because there is no class action device [in Switzerland] does not mean, however, that there is no procedural vehicle to allow for group litigation in Switzerland. . . . Probably the best known such device is the association suit (*Verbandsklage* in German). [T]he Swiss legislature first introduced the *Verbandsklage* in the area of unfair competition, granting associations that are authorized by their bylaws to pursue the economic interests of their members to bring claims of violations of the Unfair Competition Act on behalf of those members. However, associations are limited to claiming declaratory relief and injunctions to stop the alleged violations.

Id.; *see also infra* 139–42 and accompanying text (discussing the tradition in civil law scholarship to use different terminology based on immaterial differences of the different types of class actions, such as whether they are opt in or opt out, brought by a class member or an association, injunctive, or damages).

Other countries may have specifically rejected proposals to enact class actions for damages. Other countries simply do not have any type of class action at all.

The second category is comprised of countries that do have class actions for damages in their legal systems, but judgments in such actions are only binding if favorable to the interests of the class. In these countries, the binding effect of settlements is often controversial.

The third category is composed of countries that have class actions for damages, with the final judgment binding on the class regardless of the outcome, but these countries adopt a system of opt-in class action procedure. In an opt-in system, absent class members must take affirmative steps to include themselves in the class action before they may be bound by the judgment.

The fourth category of Latin American countries is composed of countries that have a class action system that is substantially similar to the U.S. model. The systems may not be exactly the same in all aspects, but the differences are not relevant for the purpose of recognition. These countries adopt an opt-out class action procedure in which the judgment is binding whether favorable or not to the class and also allow class action settlements.

The Latin American countries (or any country for that matter) that fall under the first three categories would likely not recognize or enforce a U.S. class action judgment or settlement because the peculiarities of each country's class action model present insurmountable obstacles. Because the fourth category of countries has a class action device that is substantially similar to the U.S. model, the class action rules alone do not pose an obstacle to recognition of an American class action judgment. Whether these countries would recognize a U.S. class action judgment will depend on other factors, discussed in Part II.

Part II of this Article discusses general obstacles to recognition of a U.S. class action judgment or court approved settlement in all Latin American countries, regardless of the particular class action apparatus. It argues that, regardless of which of the four categories a Latin American country falls into, none of them would recognize or enforce a class action judgment or court-approved settlement for at least three additional reasons.

First, the class action notice to foreign class members will likely be deemed inadequate, both under the standards of the specific Latin American country and the standards of U.S. class action law. This is the case even where the notice is translated with flexibility and the utmost sensitivity for the cultural and legal peculiarities of each Latin American country, and even where notice is written to be devoid of any legalism

and accessible to the Latin American public (itself a very challenging hurdle). There is a strong probability that absent class members will simply not understand the legal implications of the class action notice and what it requires of them. Being completely unfamiliar with the American class action device, the idea that one must actively exclude oneself from a proceeding to which the person was not formally served with process is completely alien to the nationals of these countries.

Second, a U.S. court cannot validly obtain jurisdiction over Latin American absent class members that have no contacts with the United States. No Latin American country would recognize a U.S. judgment (whether it is a class or an individual action) against a national who lacked significant contact with the United States and is not subject to jurisdiction there, even if the person was to be properly served with process through rogatory letter.

Third, Latin American countries are not likely to recognize a foreign judgment that binds their nationals in a proceeding in which they were not made parties through formal service of process or notice performed through rogatory letters.

These three obstacles are applicable to all Latin American countries, regardless of which of the four categories they fit.

Finally, this Article concludes that no Latin American country would recognize or enforce a U.S. opt-out class action judgment or court approved settlement which would bind foreign nationals.

I. OBSTACLES TO RECOGNITION OF A U.S. CLASS ACTION JUDGMENT DERIVED FROM SPECIFIC CLASS ACTION RULES

The various Latin American class action regimes are as diverse as the Latin American culture itself. Each country has its own perspective on class action litigation, ranging from (a) countries that do not have class action for damages, (b) countries where a class action judgment is binding only if it is favorable to the class, (c) countries that adopt an opt-in class action mechanism, and (d) countries that adopt a class action model that is substantially similar to the American model. Not only are these legal approaches to class action litigation different from one another, but they differ significantly from the U.S. system.[11]

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11. *See* Ángel R. Oquendo, *Upping the Ante: Collective Litigation in Latin America*, 47 COLUM. J. TRANSNAT'L L. 248, 251 (2008–2009) (explaining how Latin American legal systems have transplanted the concept of class action litigation from the United States and "radically transformed it. They have established causes of action inspired by the U.S. class action, but based on autochthonous institutions, in order to creatively process group rights. Additionally, they have designed procedural means for the vindication of comprehensive guarantees.").

As one might expect, individual countries with unique class action rules will review a U.S. class action judgment from different perspectives. These perspectives will influence a nation's willingness to recognize and enforce the U.S. judgment.

A. Countries That Do Not Have Class Actions for Damages

Several Latin American countries, including Venezuela,[12] Peru,[13] Uruguay, Costa Rica,[14] El Salvador, Bolivia,[15] and the Dominican Republic,[16] do not have class action for damages available within their respective legal systems.[17] Some of these nations may allow for injunctive class

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12. *See* JUAN ESTEBAN KORODY TAGLIAFERRO, EL AMPARO CONSTITUCIONAL Y LOS INTERESES COLECTIVOS Y DIFUSOS (2004) (Venez.) (a book about injunctive class actions in Venezuela); Enrique Luis Fermín Villalba, *La Cosa Juzgada y Sus Efectos Extensivos en las Sentencias Sobre Intereses Difusos y Colectivos en la Jurisprudencia de la Sala Constitucional del Tribunal Supremo de Justicia de Venezuela*, *in* CODIGO MODELO DE PROCESOS COLECTIVOS: UN DIALOGO IBEROAMERICANO 585 (Antonio Gidi & Eduardo Ferrer eds., 2009) (Mex.) [hereinafter UN DIÁLOGO IBEROAMERICANO] (article about injunctive class actions in Venezuela).

13. *See* Antonio Gidi, *Comentario: Artículo 82 del Código Procesal Civil Peruano*, *in* I CÓDIGO PROCESAL CIVIL: COMENTADO "POR LOS MEJORES ESPECIALISTAS" 360–70 (Johan S. Camargo Acosta ed., 2010) (Peru) (discussing and critiquing the Peruvian class action); *see also* Aníbal Quiroga León, *La Proteción de Intereses Difusos y Colectivos en la Legislación Peruana y el Proyecto de Código Modelo de Procesos Colectivos para Ibero-América*, *in* UN DIÁLOGO IBEROAMERICANO, *supra* note 12, at 476.

14. In a recent project to enact the new Code of Civil Procedure in Costa Rica, Article 128 would not allow res judicata effect if the judgment was issued based on insufficient evidence. CÓDIGO PROCESAL CONTENCIOSO ADMINISTRATIVO [ADMINISTRATIVE PROCEDURE CODE], Ley No. 8508 de 4 de abril de 2006, art. 128 (Costa Rica); *see infra* Part I.B. (Countries in Which a Class Action Judgment is Binding Only if Favorable to the Class).

15. *See* Diego Rojas & Ariel Morales, *Bolivia: Litigation Reference*, CR&F ROJAS ABOGADOS, http://www.latinlawyer.com/reference/topics/60/jurisdictions/99/bolivia (last visited Apr. 22, 2012).

16. *See* Marcos Peña-Rodríguez, Laura Medina Acosta & Rosa E Díaz Abreu, *Dominican Republic: Litigation Reference*, JIMÉNEZ CRUZ PEÑA, http://www.latinlawyer.com/reference/topics/60/litigation (last visited Apr. 23, 2012) ("In civil and commercial matters, class actions are not expressly foreseen in the law. In environmental and criminal matters as well as in consumer protection actions, non-profit organisations or associations or groups of individuals, may pursue a claim when the collective interests have been affected.").

17. The situation in Europe is very similar—although injunctive class actions are usually available in Europe, several European countries still do not have class actions for damages. *See* CIVIC CONSULTING (LEAD) & OXFORD ECONOMICS, EUR. COMM'N—DG SANCO: EVALUATION OF THE EFFECTIVENESS AND EFFICIENCY OF COLLECTIVE REDRESS MECHANISMS IN THE EUROPEAN UNION: FINAL REPORT, PART I: MAIN REPORT 20 (2008), *available at* http://ec.europa.eu/consumers/redress_cons/finalreportevaluationstudypart1-

actions with varying levels of sophistication. This ranges from a broad recognition of injunctive class actions for the defense of the environment or consumer to a more limited allowance of injunctive class actions for the protection of the public interest, which is derived from the Roman popular action (*actio popularis*).[18]

These countries would likely not recognize a U.S. class action judgment because opt-out class actions for damages are alien to their procedural traditions and to do so would be contrary to both due process of law and public policy. More specifically, these countries would not accept that their nationals would be bound by a judgment issued in a proceeding to which they were not made parties and had no day in court.

It is a common rule of law that a party can only pursue the party's individual interest in court, not the interests of others. A corollary of this principle is that a person has the right to decide whether or not to bring a lawsuit. These doctrines are embodied in the principles known as *principio dispositivo* in Portuguese, Spanish, and Italian, *Dispositionsmaxime* in German, and *nul ne plaide par procureur* in French, and could be loosely translated as the principles of party control or party autonomy.[19]

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final2008-11-26.pdf ("Almost half ([thirteen]) of EU Member States currently have some mechanisms of collective redress, while the others do not."). The information in the European Commission Report includes in the definition of "collective redress" mechanisms that are not a class action for damages, like those in France, Austria, Germany, and England. However, it excludes Poland, which enacted a class action statute after 2008, but it offers a good overview of the reality in Europe. *See id.* Annex 8 (listing the type of collective redress available in European countries); *see also* Nagareda, *supra* note 2, at 26. The author links the recent development in class action legislation in Europe with the integration of European Markets, but this does not explain a similar development in Latin America and elsewhere.

18. Some Latin American countries may have had popular actions in their legal systems for more than a century. *See* JOSÉ CARLOS BARBOSA MOREIRA, *A ação popular do direito brasileiro como instrumento de tutela jurisdicional dos chamados interesses difusos*, *in* TEMAS DE DIREITO PROCESSUAL (1977) (Braz.) (discussing the Roman *actio popularis* as injunctive class action); Oquendo, *supra* note 11, at 271–77; CARLO FADDA, L'AZIONE POPOLARE: STUDIO DI DIRITTO ROMANO ED ATTUALE (1894) (It.) (discussing the popular action in Roman law).

19. These principles have a long pedigree in the history of civil law civil procedure. *See* ARTHUR ENGLEMANN ET AL., A HISTORY OF CONTINENTAL CIVIL PROCEDURE 179, § 72 & 389–90, § 105 (Robert Wyness Miller trans. & ed., 1969) (discussing the *Dispositionsmaxime* since medieval German law and Roman law); LEOPOLD WENGER, INSTITUTES OF THE ROMAN LAW OF CIVIL PROCEDURE 80 (Otis Harrison Fisk trans., 1955) (discussing the principle in Roman law); *see also* Baumgartner, *supra* note 10, at 321 (discussing the principle of *Dispositionsmaxime* as a traditional obstacle to class action legislation). *But see* Matousekova, *supra* note 5, at 673–74 (considering that the French principle of *nul ne plaide par procureur* would not be an obstacle to the recognition of a U.S. class action judgment in France).

These foundational principles of civil procedure present barriers to countries that have yet to adopt the class action device. These old principles should not discourage a country from adopting class actions in their domestic legal systems. Quite the contrary, I have dedicated most of my career proposing the adoption of class actions in all civil law countries. However, before a country is psychologically and culturally ready to adopt a new procedural paradigm, it is impossible to escape from these barriers.[20] It is difficult to contemplate a country that would recognize

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20. It is commonplace for opponents, particularly those potential class action defendants, to consider class actions unconstitutional for a myriad of reasons, as class actions are being discussed in the political process. *See, e.g.*, Roberth Nordh*, Group Actions in Sweden: Reflections on the Purpose of Civil Litigation, the Need for Reforms, and a Forthcoming Proposal*, 11 DUKE J. COMP. INT'L L. 381, 384 (2001) (discussing criticisms from the industry against the introduction of class actions in Sweden); Richard B. Cappalli & Claudio Consolo, *Class Actions for Continential Europe? A Preliminary Inquiry*, 6 TEMP. INT'L & COMP. L.J. 217 (1992); *see also* Linda S. Mullenix, *Lessons From Abroad, Complexity and Convergence*, 46 VILL. L. REV. 1 (2001); Edward F. Sherman, *Group Litigation under Foreign Legal Systems: Variations and Alternatives to American Class Actions*, 52 DEPAUL L. REV. 401, 401 (2002) ("Other countries have eyed the American class action with both admiration and suspicion."); Baumgartner, *supra* note 10, at 310 ("proponents of [class actions] in Switzerland face considerable doctrinal, jurisprudential, cultural, and economic objections"); Thomas D. Rowe, *Foreword: Debates over Group Litigation in Comparative Perspective: What Can We Learn From Each Other?*, 11 DUKE J. COMP. INT'L L. 157 (2001); Michele Taruffo, *Some Remarks on Group Litigation in Comparative Perspective*, 11 DUKE J. COMP. INT'L L. 405, 413–17 (2000) [hereinafter Taruffo, *Remarks on Group Litigation*] (discussing European resistance to class actions and the perceived need to prevent the class action Frankenstein monster from "penetrating the quiet European legal gardens"); Tiana Leia Russell, *Exporting Class Actions to the European Union*, 28 B.U. INT'L L.J. 141 (2010); Stefano M. Grace, *Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the Acquis Communautaire*, 15 J. TRANSNAT'L L. & POL'Y 281 (2006).

Opposition to class actions is also derived from a misunderstanding of the reality of American civil litigation. *See* Sherman, *supra*, 403.

> Horror stories about an overly litigious society, entrepreneurial plaintiff attorneys, runaway jury verdicts, abusive class action practices, and legal blackmail through meritless suits that drive up business costs are well-known abroad. Whether or not such stories convey an accurate picture, most other countries view American class actions as a Pandora's box that they want to avoid opening.

Id.; Filippo Valguarnera, *Legal Tradition as an Obstacle: Europe's Difficult Journey to Class Action*, 10 GLOBAL JURIST (2010), *available at* http://www.astrid.eu/Riforma-de6/Dossier—C/Valguarnera_Global-Jourist_2_2010.pdf; Baumgartner, *supra* note 10, at 315–16, 348–49 (opposition to class action also derived from propaganda of U.S. "tort reform movement," and insensitive behavior of U.S. courts towards legitimate international interests.); Samuel Issacharoff & Geoffrey P. Miller, *Will Aggregate Litigation Come to Europe?*, 62 VAND. L. REV. 179, 180 (2009) (acknowledging "that the aversion

and give preclusive effect to a judgment issued by means of a procedural device as exotic as an opt-out class action, when that device does not exist in the country's own legal system.[21]

The reason for the absence of class actions in some Latin American countries is similar to the resistance of other civil law countries throughout the world in adopting the device. Those countries struggling with the need to adopt such legislation could study the Model Class Action Code recently proposed by this Article's author, and specifically tailored for the peculiarities of the civil law tradition.[22]

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to the American-style class action corresponds to sustained critiques of class actions in the United States as well," and mentioning the recent law reforms that "limited the class action as an effective vehicle for resolution of mass personal injuries").

> At bottom, the gulf between the European and American developments in class actions and other forms of aggregation reflects a deeper divide than doctrines and formal laws alone would reveal. For the civil law countries of continental Europe, the resistance to collectivist measures of adjudication is in part a continuation of what Hayek has termed a "constructivist rationalism"—a deep-seated belief in the importance of rationalist expertise in top-down administrative decisionmaking. What characterizes the American legal tradition—what Hayek in turn would term "spontaneous order"—is the common law attachment to the bottom-up competitive evolution of legal rules.

Id. at 208–09.

21. *See* IBA LEGAL PRACTICE, GUIDELINES, *supra* note 8, at 5 (stating that the Guidelines are applicable only in countries that recognize class actions ("collective redress") in their domestic legal system.)

22. *See generally* Antonio Gidi, *The Class Action Code: A Model for Civil-Law Countries*, 23 ARIZ. J. INT'L & COMP. L. 37 (2005) [hereinafter Gidi, *The Class Action Code*]. This project has been translated into several languages and published in several countries. *See, e.g.*, Antonio Gidi, *Código de Processo Civil Coletivo: Um Modelo Para Países de Direito Escrito*, 111 REPRO 192 (2003) (Braz.); Antonio Gidi, *Il codice del processo civile collettivo: Un modello per i paesi di diritto civile*, 2 RIVISTA TRIMESTRALE DI DIRITTO E PROCEDURA CIVILE, ANNO LIX FASC. 697 (Alessandro Barzaghi trans., 2005) (It.); Antonio Gidi, *Le Code de L'Action Collective: Un Modéle Pour les Pays de Droit Civil*, *in* GILBERTE CLOSSET-MARCHAL & JACQUES VAN COMPERNOLLE, VERS UNE "CLASS ACTION" EN DROIT BELGE? 147–63 (M. Guy Sohou & Caroline Gilbert trans., 2008) (Belg.) (introductory study in Dutch by Stefaan Voet); Antonio Gidi, *Código de Proceso Civil Colectivo: Un modelo para países de derecho civil*, 11 REVISTA PRACTICA DE DERECHO DE DAÑOS 56 (Adriana León & Joaquín Silguero Estagnan trans., 2003) (Spain); Antonio Gidi, *Código de Proceso Civil Colectivo: Un modelo para países de derecho civil*, *in* MEMORIAS XXVI CONGRESO COLOMBIANO DE DERECHO PROCESAL 601 (2005) (Colom.); Antonio Gidi, *Código de Proceso Civil Colectivo: Un modelo para países de derecho civil*, *in* EDUARDO OTEIZA, PROCESOS COLECTIVOS 463 (2006) (Arg.); Antonio Gidi, *Código de Proceso Civil Colectivo: Un modelo para países de derecho civil*, *in* 126 REVISTA JURIDICA DEL PERU 93 (2011) (Peru); Antonio Gidi, *Código de Proceso Civil Colectivo: Un modelo para países de derecho civil*, *in* 16 REVISTA VASCA DE DERECHO PROCESAL Y ARBITRAJE 753 (2004) (Spain).

Naturally, the reason why a U.S. opt-out class action judgment would not be recognized or enforced in civil law countries is not simply because these countries do not have the same or a substantially equivalent procedural device in their legal system.[23] The explanation is more complex.[24]

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23. *See* Romy, *supra* note 1, at 796 (stating that the mere fact that Swiss law does not have a procedure similar to the U.S. class action does not mean that such procedure violates the Swiss public order. It is necessary to investigate whether such representative action violates the fundamental principles of the Swiss procedural law).

> International public policy does not prevent a juridical situation created abroad to produce effect in the forum simply because the legal institution or the procedure applied do not exist. In other words, the mere fact that a legal rule or a procedural tool that does not exist, or even could not be enacted, in the country where a foreign judgment is asked to produce its *Res Judicata* effects, is not enough to consider the foreign judgment to be contrary to public policy. The application of foreign rules is only contrary to the international public policy of the forum if these rules contradict the main, essential and fundamental legal principles of the forum.

Pinna, *supra* note 5, at 41; Matousekova, *supra* note 5, at 665 ("the mere fact that such actions do not currently exist in French law does not make them incompatible with our legal tradition"); Harris, *supra* note 5, at 639–40 ("Of course, the English court's own rules of civil procedure do not need to be mirrored when it comes to the recognition and enforcement of foreign judgments in England."); Leonardo Greco, *A tutela jurisdicional internacional dos interesses coletivos*, *in* ESTUDOS DE DIREITO PROCESSUAL 471 (2005) (Braz.) (discussing several procedural differences). *But see* Richard H. Dreyfuss, *Class Action Judgment Enforcement in Italy: Procedural "Due Process" Requirements*, 10 TUL. J. INT'L & COMP. L. 5, 7–8 (2002) ("Foreign courts are more likely to scrutinize the procedural aspects when presented with American judgments resulting from class actions because the procedure is unique and, to most legal practitioners in the rest of the world, largely unfamiliar.").

24. In the same vein, the mere fact that an opt-out class action exists in a foreign country does not mean *ipso facto* that the courts of that country would recognize a U.S. class action judgment. *See infra* Part I.D. (Countries That Have a Class Action System That is Substantially Similar to the United States) (stating that even countries that have a class action system substantially similar to the United States will not recognize a U.S. class action judgment); *see also infra* Part II (discussing the reasons). But the opposite seems to be the conclusion of Andrea Pinna and Tanya J. Moestier. *See* Pinna, *supra* note 5, at 46, 49, 60.

> The first way of addressing the public policy issue is to verify whether there are similar procedural tools in the legal system of the foreign forum. If that is the case, the *Bersch* test is positive and, most of the time, the US court then certifies a class including the relevant absent class members . . . . [T]he recent initiatives of several European legal systems to introduce class actions or procedural techniques of consolidation of individual judicial application into collective claims, some by including an opt-out mechanism, tend to indicate that the hostility towards class actions is disappearing progressively. This should facilitate the recognition, at least in some European legal systems, of US class action

For example, as we have seen, most of these countries have allowed some sort of "representative litigation" for injunctive claims for several decades.[25]

Moreover, even though these legal systems do not have an opt-out class action, there is a high probability that a U.S. class action judgment would be recognized and enforced against the defendant (as opposed to the absent class members).[26] As long as class action defendants have had their day in court according to U.S. law, and as long as enforcement would not violate local public policy, none of the objections raised in this Article are applicable as to foreign recognition of a U.S. class action as against a defendant.[27]

> judgments, since the contrariety to public policy of the forum can hardly be upheld.

Id. at 46, 49; *see also* Monestier, *supra* note 6, at 43 ("At a very broad level, the more the foreign country regime resembles that which exists in the United States, the more likely a U.S. court is to conclude that the foreign court would accord preclusive effect to a U.S. class judgment."). Contrary to the position of these authors, as will be seen more fully below, even countries that have class action legislation substantially similar to the U.S. model will probably deny recognition of a class action judgment issued by a foreign court. *See infra* Part II.

25. *See In re* Vivendi Universal, S.A. Sec. Litig., 242 F.R.D 76, 100–05 (S.D.N.Y. 2007). In addressing the issue of whether its class decree would be recognized abroad, the *Vivendi* court based its decision substantially on whether the laws of several countries have procedural devices analogous to the class action device. The court considered that countries, like Germany, that did not have any class action equivalent, would not recognize a U.S. class action decree. The court also stated that "the Dutch Legislature has recently enacted class action legislation in other contexts indicating that recognition of a judgment in this case would not be contrary to fundamental principles of fairness in Dutch law." *Id.* at 105. The Court made similar assessment of England, France, and Austria. *See* Jasilli, *supra* note 6, at 114, 128 (strongly criticizing *Vivendi* for relying in this method as based on dubious foundation and stating that "[n]owhere are either analogous forms of action or emerging legal norms held out as even reliable, not to mention powerful, evidence for assessing the likelihood of foreign recognition of a judgment"); *see also* Harris, *supra* note 5, at 637.

> English law permits group and representative actions in English courts. The availability of such actions in English courts may be an indication that English courts will not regard the U.S. class action procedure as so unfamiliar to an English court as to warrant a refusal to recognise a US class action judgment.

Id.

26. *See* Bermann, *supra* note 2, at 95. It is also entirely possible that foreign courts would recognize U.S. class action judgments against U.S. class members. *See infra* notes 34–35 and accompanying text.

27. *See* Bermann, *supra* note 2, at 95 ("Though not impossible, it is hard to imagine that foreign courts will consider it fundamentally unfair for the defendant company to have had to defend itself in a class action in a U.S. court, if everything else about the

The only objection that a class action defendant could raise in a foreign court against recognition of a U.S. class action judgment is an argument based on mutuality.[28] Mutuality is a preclusion doctrine in American civil procedure which states that a party can invoke issue preclusion against an opponent only if that same party was bound by the judgment as well.[29] It was traditionally thought that the rules of issue preclusion must be symmetric: a third party should not be able to benefit from a favorable judgment if that third party could not have been prejudiced by an unfavorable result.[30] However, the mutuality doctrine, which was once the general rule in the United States,[31] has been largely abandoned.[32]

Some civil law courts might initially feel uncomfortable recognizing a class action judgment against a defendant when the same judgment would not have been recognized against the absent class members had it been unfavorable to the interests of the class. Such uneasiness, however, is misguided. Most modern civil law systems are accustomed to treating unequal parties in ways that compensate for their inequalities and level the procedural playing field. For example, in consumer law, civil law

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proceeding was proper."); *see also* Murtagh, *supra* note 6, at 8 ("foreign defendants with enough contacts with the U.S. to support jurisdiction tend to also have assets in the U.S. sufficient to support the enforcement of a judgment in the U.S."); Sturner, *supra* note 3, at 108 (same).

28. *See* Bernhard v. Bank of Am. Nat. Trust & Sav. Ass'n, 19 Cal. 2d 807, 814, 122 P.2d 892, 895–96 (1942).

29. *See id.*

30. *See id.* at 894 ("The estoppel is mutual if the one taking advantage of the earlier adjudication would have been bound by it, had it gone against him."); Comment, *Privity and Mutuality in the Doctrine of Res Judicata*, 35 YALE L.J. 607, 608 (1926) ("The estoppel or bar of the judgment operates mutually if the one taking advantage of it would have been bound by it, had it gone the other way.").

31. *See* Bigelow v. Old Dominion Copper Co., 225 U.S. 111, 127 (1912) ("It is a principle of general elementary law that estoppel of a judgment must be mutual."); Triplett v. Lowell, 297 U.S. 638, 645 (1936).

> [A] person who is not a party or privy to a party to an action in which a valid judgment other than a judgment in rem is rendered . . . is not bound by or entitled to claim the benefits of an adjudication upon any matter decided in the action.

RESTATEMENT (FIRST) OF JUDGMENTS § 93(b) (1942).

32. *See Bernhard*, 122 P.2d at 895–96 (allowing defensive use of non-mutual issue preclusion); Blonder-Tongue Laboratories, Inc. v. Univ. of Ill. Found., 402 U.S. 329, 348–50 (1971) (same); Parklane Hosiery Co. v. Shore, 439 U.S. 322, 331 (1979) (allowing offensive use of non-mutual issue preclusion).

countries consider forum selection and arbitration clauses binding on the companies that draft contracts of adhesion but not on the consumers.[33]

Foreign courts would have an easier time recognizing a class action judgment against a strictly American class member (one who is domiciled, acquired the good or service, and suffered damage in the United States) than a foreign class member (who is domiciled, acquired the good

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33. Class action defendants raise the same "mutuality" arguments in U.S. courts in the hopes of attacking the class certification of transnational classes. The arguments that it is substantially unfair to bind class defendants to a class action judgment but not bind foreign class members is also deeply rooted in the concepts that support the doctrine of mutuality, although we are talking here of a novel concept of "mutuality of claim preclusion," as opposed to the traditional "mutuality of issue preclusion." *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 996 (2d Cir. 1975). Stating that the fact that a foreign court may not recognize a U.S. class action judgment

> must be considered not simply in the halcyon context of a large recovery which plaintiff visualizes but in those of a judgment for the defendants or a plaintiffs' judgment or a settlement deemed to be inadequate. As Judge Frankel stated in his order permitting the case to proceed as a class action: if defendants prevail against a class they are entitled to a victory no less broad than a defeat would have been.

Id.; *see also* Walker, *A View from Across the Border*, *supra* note 9, at 763, 797.

> [I]t is unfair to purport to bind defendants to a result that some plaintiff class members might be free to accept or to reject as they please at some later date. To do so would require a defendant to respond to a claim by a class of indeterminate size and scope. . . . It is an important feature of fairness to the defendant, if not a requirement of due process, for the court to take into account the likely challenges to the preclusive effect of its certification order in defining the class.

Walker, *A View from Across the Border*, *supra* note 9, at 763.

> The argument of defendants in resisting class-action lawsuits that include foreign investors is that if they, as defendants, are successful, they may still face a potential lawsuit in a foreign jurisdiction brought by the absent class plaintiffs. . . . [Defendants] argue that the lack of 'preclusion protection' amount[s] to a due process violation.

Stephen J. Choi & Linda J. Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465, 480, 482 (2009). Arguably defendant's assertion that it is unfair to certify a class action when the judgment would not be recognized abroad does not come into play when the defendant itself also seeks class certification, usually coupled with a global class settlement. Defendants, even those who originally challenged the certification of a foreign class as unfair, are perfectly content to get the settlement approved and deal with the risk of non-enforceability "when, and if, it were to develop." *See* Monestier, *supra* note 6, at 29–33 ("[T]he preclusive effect of a U.S. judgment abroad is only a problem if the defendant says it is."); Murray, *supra* note 9, at 101–03 (discussing the behavior of the defendant in the *Royal Ahold* case).

or service, and suffered damage abroad),[34] because most obstacles raised on this Article are not applicable to American class members. After all, in such cases, the notice was performed in the United States and the U.S. courts had jurisdiction over the American absent class member.[35] However, the question remains as to whether binding a person who was not made party to a proceeding would violate the public policy of the recognizing country.

In any event, between a wholly foreign class and a wholly American class, there are several different possibilities, depending on the many variables in a specific case, including the domicile of the class member, the domicile of the defendant, where the defendant committed the allegedly wrongful act, where the class member interacted with the defendant, and where the damage occurred. All these variables significantly affect the issues discussed in this Article, including issues of personal jurisdiction, subject matter jurisdiction, and notice.

B. Countries in Which a Class Action Judgment is Binding Only if Favorable to the Class

Brazil's system of governing class actions for damages is both similar to and different from its American counterpart.[36] Brazil has a relatively mature and sophisticated legislation[37] and scholarship on the subject of class actions for damages.[38] Brazil's class action system is set forth in the

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34. These types of class members are commonly known as "foreign cubed" or "f cubed class," because the three elements of the transaction are foreign. Choi & Silberman, *supra* note 33, at 466. In securities class actions, it means that foreign investors purchased shares of foreign issuers on foreign stock exchanges. *Id.* For purposes of comparison, a class comprised of U.S. domiciliaries who acquired the good or service in the United States and suffered damages in the United States, could be called "American cubed class" or "a-cubed class."

35. *See infra* Part II (Obstacles to Recognition of a U.S. Class Action Judgment Derived from Traditional Rules) (discussing notice and personal jurisdiction of absent class members).

36. *See* Antonio Gidi, *Class Actions in Brazil: A Model for Civil Law Countries*, 51 AM. J. COMP. L. 311, 318–20 (2003) [hereinafter Gidi, *Class Actions in Brazil*] (discussing Brazilian class actions in the comparative law context);

37. *See* Lei No. 8078, de 11 de Setembro de 1990, DIARIO OFICIAL DA UNIÃO [D.O.U.] de 11.9.1990 (Braz.) [hereinafter Brazilian Consumer Code]; Lei No. 7347, de 24 de Julho de 1985, D.O.U. de 25.7.1985 (Braz.).

38. *See*, *e.g.*, MARCELO ABELHA, AÇÃO CIVIL PUBLICA E MEIO AMBIENTE (2003) (Braz.); GREGORIO ASSAGRA DE ALMEIDA, DIREITO PROCESSUAL CIVIL COLETIVO BRASILEIRO (2003) (Braz.); 4 FREDIE DIDIER JR. & HERMES ZANETI JR., CURSO DE DIREITO PROCESSUAL CIVIL. PROCESSO COLETIVO (2011) (Braz.); PEDRO DA SILVA DINAMARCO, AÇÃO CIVIL PUBLICA (2001) (Braz.); ELPIDIO DONIZETTI & MARCELO MALHEIROS CERQUEIRA, CURSO DE PROCESSO COLETIVO (2010) (Braz.); EURICO FERRARESI, AÇÃO

Brazilian Consumer Code, which is a trans-substantive procedural legislation applicable to all types of claims across all substantive law areas.[39]

There are several differences between the class action regimes in Brazil and the United States.[40] For example, associations and public entities are granted standing to sue in Brazil, but not individual class members.[41] This difference between the Brazilian and American models, however, is largely insignificant for the purposes of international recognition of U.S.

POPULAR, AÇÃO CIVIL PUBLICA E MANDADO DE SEGURANÇA COLETIVO (2009) (Braz.); LUIZ PAULO DA SILVA ARAUJO FILHO, AÇÕES COLETIVAS: A TUTELA JURISDICIONAL DOS DIREITOS INDIVIDUAIS HOMOGENEOS (2000) (Braz.); JOSE DOS SANTOS CARVALHO FILHO, AÇÃO CIVIL PUBLICA (6th ed. 2007) (Braz.) [hereinafter FILHO, AÇÃO CIVIL PUBLICA]; LUIZ MANOEL GOMES, JR., CURSO DE DIREITO PROCESSUAL CIVIL COLETIVO (2008) (Braz.); 2 ADA PELLEGRINI GRINOVER, KAZUO WATABABE & NELSON NERY JR., CODIGO BRASILEIRO DE DEFESA DO CONSUMIDOR COMENTADO PELOS AUTORES DO ANTEPROJETO (2011) (Braz.); MARCIO FLAVIO MAFRA LEAL, AÇÕES COLETIVAS: HISTORIA, TEORIA E PRATICA (Sergio Antonio Fabris ed., 1998) (Braz.); RICARDO DE BARROS LEONEL, MANUAL DO PROCESSO COLETIVO (2002) (Braz.); PEDRO LENZA, TEORIA GERAL DA AÇÃO CIVIL PUBLICA (2d ed. 2005) (Braz.); RODOLFO DE CAMARGO MANCUSO, AÇÃO CIVIL PUBLICA (2004) (Braz.); HUGO NIGRO MAZZILLI, A DEFESA DOS INTERESSES DIFUSOS EM JUIZO (2007) (Braz.) [hereinafter MAZZILLI, A DEFESA DOS INTERESSES DIFUSOS EM JUIZO]; HUMBERTO DALLA BERNARDINA DE PINHO, A NATUREZA JURIDICA DO DIREITO INDIVIDUAL HOMOGENEO E SUA TUTELA PELO MINISTERIO PUBLICO COMO FORMA DE ACESSO A JUSTIÇA (2002) (Braz.); ELTON VENTURI, PROCESSO CIVIL COLETIVO (2007) (Braz.); JOSE MARCELO MENEZES VIGLIAR, TUTELA JURISDICIONAL COLETIVA (1999) (Braz.); LIONEL ZACLIS, PROTEÇÃO COLETIVA DOS INVESTIDORES NO MERCADO DE CAPITAIS (2007) (Braz.); TEORI ALBINO ZAVASCKI, PROCESSO COLETIVO (2007) (Braz.).

39. *See* Brazilian Consumer Code, art. 110 (providing that class actions are applicable to the judicial protection of any group right).

40. Class actions in Brazil have attracted considerable attention in the English language scholarship. *See* Keith S. Rosenn, *Procedural Protection of Constitutional Rights in Brazil*, 59 AM. J. COMP. L. 1009, 1031–33 (2011); Roger W. Findley, *Pollution Control in Brazil*, 15 ECOLOGY L.Q. 1, 38–52 (1988); Antonio Herman V. Benjamin, *Group Action and Consumer Protection in Brazil*, *in* GROUP ACTIONS AND CONSUMER PROTECTION 141, 141–55 (Thierry Bourgoignie ed., 1992); Oquendo, *supra* note 11, at 250; Manuel A. Gómez, *Will the Birds Stay South? The Rise of Class Actions and Other Forms of Group Litigation across Latin America*, 43 U. MIAMI INTER-AM. L. REV. (forthcoming 2012) (manuscript at 42–54), *available at* http://dx.doi.org/10.2139/ssrn.1930413. The Brazilian class action may have influenced the ALI's Principles of Aggregate Litigation and its novel concept of the indivisibility of the class action remedy (or of the class substantive right) as a criterion to determine the right to opt out. *See* PRINCIPLES OF THE LAW OF AGGREGATE LITIGATION § 2.04, at 118–29 (2010); *see also* Gidi, *Class Actions in Brazil*, *supra* note 36, at 311, 350–54 (discussing the indivisibility of class claims from a comparative perspective and suggesting that "[r]ecognition of the concept of indivisible class claims would be an important evolution in American class action law. . . . [F]or example, to decide whether there should be a right to 'opt out' of the class or not.").

41. Brazilian Consumer Code, art. 82.

class action judgments. The most important difference, and the one that is relevant to this Article, is that Brazilian class action judgments are binding only to the extent that they are favorable to the interests of the class members.[42]

An examination of the Brazilian class action model is important because it has been replicated by several other Latin American countries.[43] Further, it was the basis for the Model Class Action Code for Latin America, sponsored by the Ibero-American Institute of Civil Procedure.[44]

1. A Peculiar Approach to Res Judicata in Latin American Class Actions

Article 103 of the Brazilian Consumer Code regulates the res judicata effect of class actions in Brazil.[45] The statute prescribes that a class action judgment shall bind all members of the class, but the judgment cannot prejudice the individual rights of absent class members.[46] Therefore, the class judgment does not bind individual class members unless it is favorable to the class.[47]

Put simply, if the class action is decided in favor of the group, all absent members of the class benefit from the decision. If the class action is decided against the group, however, the class members are not bound by

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42. *See id.* art. 103.

43. *See infra* I.B.3. (The Peculiar Res Judicata Model is Followed by Some Latin American Countries).

44. *See* Ada Pellegrini Grinover, Kazuo Watanabe & Antonio Gidi, *Código Modelo de Procesos Colectivos para Iberoamérica*, 9 REVISTA IBEROAMERICANA DE DERECHO PROCESAL 251 (2006) (Arg.) [hereinafter Grinover, Watanabe & Gidi, *Código Modelo de Procesos Colectivos para Iberoamérica*]. Although the Author was a co-reporter of the Ibero-American Class Action Code, he distances himself from the adoption of this type of res judicata regime. In other opportunities, both prior to and after the enactment of the Ibero-American Class Action Code, he manifested his opinion in favor of a "whether favorable or not" approach to class action judgments, as long as supported by judicial control of adequacy of representation, judicial approval of class action settlements, adequate notice, and the right to opt out, among other guaranties of fairness to absent class members. *See* Gidi, *The Class Action Code*, *supra* note 22, at 47 (providing, in Article 18 of the Author's own proposed Class Action Model Code that "[r]es judicata shall bind both the class and its members whether the judgment is favorable or not [to the class]"); ANTONIO GIDI, RUMO A UM CÓDIGO DE PROCESSO CIVIL COLETIVO 286–99 (2008) (Braz.) [hereinafter GIDI, RUMO A UM CÓDIGO DE PROCESSO CIVIL COLETIVO] (critiquing the Brazilian model of res judicata and discussing the Author's proposal of the Class Action Model Code).

45. *See* Brazilian Consumer Code, art. 103.

46. *Id.*

47. This rule is in sharp contrast to the American class action. *See generally* Geoffrey C. Hazard, Jr. et al., *An Historical Analysis of the Binding Effect of Class Suits*, 146 U. PA. L. REV. 1849 (1998).

the decision and may still go to court to pursue their individual rights in individual actions. The only impact of a decision adverse to the class is that the same class action cannot be brought again, but class members may sue individually.

According to the Brazilian class action statutes, only the benefits from the class decree are extended to the individual absent members—these members cannot be prejudiced by an unfavorable decision.[48] Civil law scholars call this situation an extension *in utilibus* (from the Latin "useful") of the class decree, because it happens only when the decree is favorable to the interest of the group.[49] It is also known as res judicata *secundum eventum litis*, a Latin expression that means that the ultimate effect of the class judgment would depend on the outcome of the litigation, or more specifically, whether the class won or lost the action.[50] In common law terminology, it could also be called "one-way preclusion."[51]

The idea of a res judicata *secundum eventum litis* in Brazilian class action is derived from a rather famous debate in Italian civil procedure scholarship in the 1970s. At a time when Italian scholars were enamored with the American class action, some Italian scholars came to believe that res judicata *secundum eventum litis* would serve as an Italian solution to the difficulties of adopting class actions in the Italian legal system.[52] Other Italian academics were against such a proposal.[53] The Brazilian scholars who drafted the Brazilian class action law adopted the Italian scholars' res judicata *secundum eventum litis* concept.[54]

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48. *See* Brazilian Consumer Code, art. 103, paras. 1–2.

49. See the seminal article of Ada Grinover, one of the academic co-authors of the Brazilian Consumer Code. Ada P. Grinover, *Da Coisa Julgada no Código de Defesa do Consumidor*, 33 REVISTA DO ADVOGADO 8 (1990) (Braz.) [hereinafter Grinover, *Da Coisa Julgada no Código de Defesa do Consumidor*].

50. *Id.*

51. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 388 (proposing that terminology).

52. Andrea Proto Pisani, *Appunti preliminari per uno studio sulla tutela giurisdizionale degli interessi collettivi (o più esatamente: superindividuali) innanzi al giudice civile ordinario*, *in* LE AZIONI A TUTELA DEGLI INTERESSI COLLETTIVI 284–86 (Vittorio Denti ed., 1976) (It.) [hereinafter LE AZIONI A TUTELA]; Giorgio Costantino, *Brevi note sulla tutela giurisdizionale degli interessi collettivi davanti al giudice civile*, DIR. E GIUR. 235 (1974); Vittorio Denti, *Relazione introdutiva*, *in* LE AZIONI A TUTELA, *supra*, at 18; Michele Taruffo, *Intervento*, *in* LE AZIONI A TUTELA, *supra*, at 330–36.

53. Mauro Cappelletti, *Appunti sulla tutela giurisdizionale di interessi collettivi o diffusi*, *in* LE AZIONI A TUTELA, *supra* note 52, at 205–06; VINCENZO VIGORITI, INTERESSI COLLETTIVI E PROCESSO: LA LEGITTIMAZIONE AD AGIRE 111–12, 127–28 (1979) (It.).

54. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 324–25, 404 ("The Brazilian class action traces its origins to academic papers delivered in Italy in the 1970s, when a group of Italian scholars began studying American class actions.").

Class members in a Brazilian class action have only a single opportunity to pursue class litigation. Should the group prevail, all individual absent class members will benefit from the favorable decision. If the group loses, however, only the right to litigate collectively on behalf of the group will perish, and only additional class action litigation on the same controversy is precluded. In this respect, the class judgment is binding on the group as a whole, whether favorable or not. However, individual rights stemming from the same controversy are not precluded, and the absent class members retain the opportunity to sue individually to vindicate their individual rights. Moreover, absent class members are not bound by any findings made in the class action, since there is no concept of issue preclusion in Brazil.[55]

Res judicata *secundum eventum litis* was adopted in Brazil because interested persons are not necessarily made parties to a class action, given a direct day in court, or personally informed of the action's existence. The Brazilian legislature therefore considered it acceptable that an individual benefit from the class decree, but not be prejudiced by it. After all, there are no compelling reasons for excluding absent class members from the benefits of a successful class action, but the Brazilian legislature believed that important due process guarantees might be violated or impaired should an adverse decision have a preclusive effect.[56]

This unnecessarily complex class action res judicata rule is well-settled in Brazil.[57] Several Brazilian scholars and courts consider it a violation

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55. Issue preclusion is a controversial topic in U.S. class action litigation. *See* Antonio Gidi, *Issue Preclusion Effect of Class Certification Orders*, 63 HASTINGS L.J. 1023, 1028–56 (2012) [hereinafter Gidi, *Issue Preclusion*] (discussing the issue preclusive effect of class certification orders); Antonio Gidi, *Loneliness in the Crowd: Why Nobody Wants Opt-Out Class Members to Assert Offensive Issue Preclusion Against a Class Defendant* (forthcoming 2012) (on file with the author) (discussing the use of offensive issue preclusion by opt-out class members).

56. *See generally* Grinover, *Da Coisa Julgada no Código de Defesa do Consumidor*, *supra* note 49.

57. There are literally dozens of law review articles and books about res judicata in Brazilian class actions. *See, e.g.*, Gidi, *Class Actions in Brazil*, *supra* note 36, at 397; RENATO ROCHA BRAGA, A COISA JULGADA NAS DEMANDAS COLETIVAS (2000) (Braz.); IBRAHIM ROCHA LITISCONSÓRCIO, EFEITOS DA SENTENÇA E COISA JULGADA NA TUTELA COLETIVA (2002) (Braz.); MOTAURI CIOCCHETTI DE SOUZA, AÇÃO CIVIL PÚBLICA (2003) (Braz.); RONY FERREIRA, COISA JULGADA NAS AÇÕES COLETIVAS (2004) (Braz.); NILTON LUIZ DE FREITAS BAZILONI, A COISA JULGADA NAS AÇÕES COLETIVAS (2004) (Braz.); ROBERTO CARLOS BATISTA, COISA JULGADA NAS AÇÕES CIVIS PÚBLICAS (2005) (Braz.); JÚLIA MARIA MILANESE BUFFARA, COISA JULGADA NAS DEMANDAS COLETIVAS (2005) (Braz.); LUIZ RODRIGUES WAMBIER, SENTENÇA CIVIL: LIQUIDAÇÃO E CUMPRIMENTO (2006) (Braz.); CHRISTIANINE CHAVES SANTOS, AÇÕES COLETIVAS E COISA JULGADA (2006) (Braz.); RODOLFO DE CAMARGO MANCUSO, JURISDIÇÃO COLETIVA E COISA

of due process to bind an absent class member whose individual rights were negatively impacted by a class action of which they were not made party to by service of process and did not have an opportunity to be heard personally about their interests.[58]

Brazil recently had an opportunity to reconsider its exotic class action judgment rule. In 2003, this Article's author proposed a new class action law by which a judgment, whether favorable or not, would bind all absent class members.[59] Several other proposals followed, all of which chose to maintain the Brazilian approach to class action res judicata with some minor changes.[60] In 2009 the Brazilian federal government pro-

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JULGADA (2007) (Braz.); JOSÉ ROGÉRIO CRUZ E TUCCI, LIMITES SUBJETIVOS DA EFICÁCIA DA SENTENÇA E DA COISA JULGADA CIVIL (2007) (Braz.); CAMILO ZUFELATO, COISA JULGADA COLETIVA (2011) (Braz.); *see also* Oquendo, *supra* note 11, at 282–83, discussing the

> complex set of *res judicata* rules . . . . The judgments in these actions, consequently, have extremely asymmetrical *res judicata* effects. When the plaintiff seeks to enforce [damages], the purported beneficiaries profit from a victory, but do not have to endure the consequences of a defeat. . . . [And class members] usually also benefit from a favorable determination, but are not bound by an unfavorable outcome.

Id.

58. *See generally* Grinover, *Da Coisa Julgada no Código de Defesa do Consumidor*, *supra* note 49.

59. *See* Gidi, *The Class Action Code*, *supra* note 22, at 47 (providing, in Article 18 of the Author's own proposed Class Action Model Code that "[r]es judicata shall bind both the class and its members whether the judgment is favorable or not [to the class]."). The Author's proposal is discussed in GIDI, RUMO A UM CÓDIGO DE PROCESSO CIVIL COLETIVO, *supra* note 44, at 286–99. Other Brazilian scholars have also proposed a shift to a res judicata whether-favorable-or-not standard, but mostly for reasons of fairness to the defendant and procedural economy. *See, e.g.*, José Ignácio Botelho de Mesquita, *Na ação do consumidor, pode ser inútil a defesa do fornecedor*, 33 REVISTA DO ADVOGADO 81 (1990) (Braz.); José Rogério Cruz e Tucci, *Código do Consumidor e processo civil: Aspectos polêmicos*, 671 REVISTA DOS TRIBUNAIS 35, 39 (1991) (Braz.); LEAL, *supra* note 38, at 209–12; ALUISIO GONÇALVES DE CASTRO MENDES, AÇÕES COLETIVAS NO DIREITO COMPARADO E NACIONAL 261–63 (2002) (Braz.); DINAMARCO, *supra* note 38, at 104–06; Luiz Norton Baptista de Mattos, *A litispendência e a coisa julgada nas ações coletivas segundo o Código de Defesa do Consumidor e os anteprojetos do Código Brasileiro de Processos Coletivos*, *in* DIREITO PROCESSUAL COLETIVO E O ANTEPROJETO DE CÓDIGO BRASILEIRO DE PROCESSOS COLETIVOS 194, 207 (Ada Pellegrini Grinover, Aluisio Gonçalves de Castro Mendes & Kazuo Watanabe eds., 2007) (Braz.) [hereinafter DIREITO PROCESSUAL COLETIVO].

60. See, for example, the projects spearheaded by Ada Pellegrini Grinover and Aluisio Gonçalves de Castro Mendes. *See generally* ALVARO LUIZ VALERY MIRRA, PARTICIPAÇÃO, PROCESSO CIVIL E DEFESA DO MEIO AMBIENTE 500–11 (2011) (Braz.) (discussing the res judicata rules of some but not all of the projects).

posed Bill 5139, which would create a new class action statute.[61] The Bill maintained the current approach to class action res judicata, with one significant change: it provided that class action judgments have binding effect, whether favorable or not, only when the decision is based on issues of law, not issues of fact or evidence.[62] In 2009, Brazilian Congress enacted Law 12016 regulating a class action against acts of the government and no changes were made or proposed to the peculiar Brazilian class action res judicata rule.[63]

Therefore, a U.S. class action judgment or court-approved settlement will only be recognized in Brazil if the result benefits the interests of the absent class members. Accordingly, if the plaintiff class prevails in the U.S. class action, individual class members may enforce such judgment in Brazil. If the plaintiff class does not prevail in the United States, individual class members will not be negatively precluded and will remain free to litigate their claims in Brazil on an individual or class basis.[64] Similarly, the terms of a class settlement will not bind those class members who are dissatisfied with them, and such class members are not precluded from bringing an individual action to litigate anew the settled claims.

Rhonda Wasserman has addressed the problem of inconsistent recognition of U.S. class action judgments and court-approved settlements

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61. *See* Projeto de Lei No. 5139, de 29 de Abril de 2009 (pending Determination of Appeal in the Officers of the House of Representatives (MESA)) (Braz.), *available at* http://www.camara.gov.br/proposicoesWeb/fichadetramitacao?idProposicao=432485.

62. *See id.* art. 25. Although the Author participated in the drafting of this project, the Author distances himself from the idea that it makes sense to distinguish issues of law from issues of fact or evidence for purposes of res judicata. This choice assumes that issues of law are obvious and easily ascertainable by courts, independently of an adequate representative and adequate maturity of the discussion, whereas issues of fact and of evidence are not. As it is well known by all who follow the developments on mass litigation, the first years of litigation are plagued by uncertainties of issues of fact, evidence, and in many cases, novel issues of law as well. Therefore, it is common for the first lawsuits to be decided against the interest of the plaintiffs. As the litigation gradually "matures," the uncertainties fade away and the plaintiffs start to be successful. *See* Francis E. McGovern, *Resolving Mature Mass Tort Litigation*, 69 B.U. L. REV. 659, 659 (1989).

63. *See* Lei No. 12016, de 7 de Agosto de 2009, art. 22, D.O.U. de 7.8.2009 (Braz.), *available at* http://www.planalto.gov.br/ccivil_03/_ato2007-2010/2009/lei/l12016.htm; *see also* GOMES ET AL., COMENTÁRIOS À NOVA LEI DO MANDADO DE SEGURANÇA 197–211 (2009) (Braz.); ANDRE VASCONCELOS ROQUE & FRANCISCO CARLOS DUARTE, MANDADO DE SEGURANÇA 168–77 (2011) (Braz.); Antonio Herman Benjamin & Gregório Assagra de Almeida, *Comentários ao artigo 22*, *in* MAIA FILHO ET AL., COMENTÁRIOS À NOVA LEI DO MANDADO DE SEGURANÇA 294–329 (2010) (Braz.); *see also* CASSIO SCARPINELLA BUENO, DIREITO PROCESSUAL CIVIL 268–69 (2010) (Braz.); HERMES ZANETI JR., O "NOVO" MANDADO DE SEGURANÇA COLETIVO (2012) (Braz.).

64. Greco, *supra* note 23, at 471.

abroad in a different context.[65] According to Wasserman, in addition to the issue of recognition, American courts should also consider the level of preclusive effect a foreign court would grant to the class action result.[66] Wasserman further states that "even if a foreign court were to recognize an American class action judgment, the defendant could face a risk of relitigation if the judgment were not accorded robust preclusive effect."[67] She concludes, "[i]t is not enough for American courts entertaining motions to certify transnational class actions to determine whether an American judgment will be recognized abroad. They also need to determine the preclusive effects, if any, that the judgment will have if it is recognized abroad."[68]

2. Class Representatives Have No Authority to Settle and Compromise the Rights of Absent Class Members

In general, Brazilian class actions are initiated by the office of the public prosecutor or by associations.[69] Class members do not have standing to bring class actions in Brazil. Brazilian class actions are therefore similar to *parens patriae* standing and associational standing in the United

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65. *See* Rhonda Wasserman, *Transnational Class Actions and Interjurisdictional Preclusion*, 86 NOTRE DAME L. REV. 313, 314–15 (2011).

> In considering [the] argument against certification [of a class of foreign nationals], American courts often use judgment recognition and preclusion terminology interchangeably. They discuss the "possibility" that a foreign court may not recognize a judgment and the fear that an American class action judgment "might not be given preclusive effect in foreign courts" as though recognition and preclusion analyses are identical. But they are not.

Id.

66. *See id.* at 316, 325–28 ("American courts are conflating what should be a two-step analysis into one. They should be asking, first, would the foreign court recognize the American class action judgment? And second, if it would, what preclusive effect, if any, would the American class action judgment have in the foreign court?").

67. *See id.* at 316.

68. *See id.* at 379.

69. There has been some field research about which type of class representative is more active, associations or the office of the public prosecutor. *See* PAULO CEZAR PINHEIRO CARNEIRO, ACESSO À JUSTIÇA: JUIZADOS ESPECIAIS CÍVEIS E AÇÃO CIVIL PÚBLICA. UMA NOVA SISTEMATIZAÇÃO DA TEORIA GERAL DO PROCESSO (2d ed. 2003) (Braz.); *see also* Luiz Werneck Vianna & Marcelo Baumann Burgos, *Entre Princípios e Regras: Cinco Estudos de Caso de Ação Civil Pública*, 48 DATA RIO DE JANEIRO 777, 782 (2005) (Braz.), *available at* http://www.scielo.br/pdf/dados/v48n4/28479.pdf; CENTRO BRASILEIRO DE ESTUDOS E PESQUISAS JUDICIAIS [CEBEPEJ] & BANCO MUNDIAL, TUTELA JUDICIAL DOS INTERESSES METAINDIVIDUAIS: AÇÕES COLETIVAS (Sept. 2007) (Braz.).

States.[70] Most other Latin American countries have standing doctrines similar to the Brazilian model.[71]

The powers of the Brazilian class representative are very limited. Since the substantive rights of the class do not belong to the representative but to the group as a whole, a class representative cannot freely dispose of the group's rights. These rights are considered "inalienable rights" ("*direitos indisponíveis*"). Therefore, representatives are allowed to make only peripheral concessions over how the defendant may adjust its behavior in response to the class proceeding. Most Brazilian scholars agree that class representatives in Brazil lack broad powers for negotiating a settlement of the group's rights.[72] Therefore, according to the few Brazil-

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70. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 382–84 (discussing *parens patriae* and associational standing in the United States and comparing it to the Brazilian class action).

71. *See generally* Oquendo, *supra* note 11, at 262–71; Gómez, *supra* note 40 (manuscript at 30–83). *But see* Issacharoff & Miller, *supra* note 20, at 193–95 ("The interests of nonprofit consumer organizations may reflect ideological considerations that may not necessarily coincide with the economic interests of consumers.").

72. *See* Paulo Cezar Pinheiro Carneiro, *A proteção dos direitos difusos através do compromisso de ajustamento de conduta*, 6 LIVRO DE ESTUDOS JURÍDICOS 234 (1993) (Braz.); Gidi, *Class Actions in Brazil*, *supra* note 36, at 341–44; Fernando Grella Vieira, *A Transação na Esfera de Tutela dos Interesses Difusos e Coletivos: Compromisso de Ajustamento de Conduta*, *in* AÇÃO CIVIL PÚBLICA 224–26, 238–40 (Édis Milaré ed., 2001) (Braz.) [hereinafter AÇÃO CIVIL PÚBLICA 2001]; ANTONIO AUGUSTO MELLO DE CAMARGO FERRAZ, ÉDIS MILARÉ & NELSON NERY JR., A AÇÃO CIVIL PÚBLICA E A TUTELA JURISDICIONAL DOS INTERESSES DIFUSOS 43–44 (1984) (Braz.); CELSO ANTÔNIO PACHECO FIORILLO, MARCELO ABELHA RODRIGUES & ROSA MARIA BARRETO BORRIELLO DE ANDRADE NERY, DIREITO PROCESSUAL AMBIENTAL BRASILEIRO 174–79 (1996) (Braz.); FRANCISCO SAMPAIO, NEGÓCIO JURÍDICO E DIREITOS DIFUSOS E COLETIVOS 101–20 (Lumen Juris ed., 1999) (Braz.); Marcelo Dawalibi, *Limites subjetivos da coisa julgada em ação civil pública*, *in* AÇÃO CIVIL PÚBLICA 2001, *supra*, at 538–42; Édis Milaré, *A Ação Civil Pública em Defesa do Ambiente*, *in* AÇÃO CIVIL PÚBLICA 193, 225–29, 255–56 (Édis Milaré ed., 1995) (Braz.) [hereinafter AÇÃO CIVIL PÚBLICA 1995]; LUIS ROBERTO PROENÇA, INQUÉRITO CIVIL 123–25, 138–40 (2001) (Braz.); PINHO, *supra* note 38, at 170; ADRIANO PERÁCIO DE PAULA, DIREITO PROCESSUAL DO CONSUMO 48–49, 238–240, 290–94 (2002) (Braz.); FILHO, AÇÃO CIVIL PÚBLICA, *supra* note 38, at 221–22; GEISA DE ASSIS RODRIGUES, AÇÃO CIVIL PÚBLICA E TERMO DE AJUSTAMENTO DE CONDUTA 4, 51–52, 59–62, 112, 122–23, 142–59, 176–80, 189, 207–08, 236 (2d ed. 2006) (Braz.); Daniel Fink, *Alternativa à ação civil pública ambiental (reflexões sobre as vantagens do termo de ajustamento de conduta)*, *in* AÇÃO CIVIL PÚBLICA 2001, *supra*, at 118–22; MAZZILLI, A DEFESA DOS INTERESSES DIFUSOS EM JUÍZO, *supra* note 38, at 375–77, 385–86, 391–94, 540–41; HUGO NIGRO MAZZILLI, O INQUÉRITO CIVIL 361–62, 375–76, 392–94 (2d ed. 2000) (Braz.); Hugo Nigro Mazzilli, *Compromisso de ajustamento de conduta—Análise à luz do Anteprojeto do Código Brasileiro de Processos Coletivos*, *in* DIREITO PROCESSUAL COLETIVO, *supra* note 59, at 231, 238–42; MANCUSO, AÇÃO CIVIL PÚBLICA, *supra* note 38, at 316–39; PAULO DE TARSO BRANDÃO, AÇÃO CIVIL PÚBLICA 127–35 (1996) (Braz.);

ian scholars that have addressed the issue, a class settlement agreement does not bind absent members who disagree with its terms and the same class action (or individual actions) may be brought again to protect the rights of the dissatisfied members.[73] Therefore, the courts of Brazil will not permit the rights of absent class members to be negatively impacted, whether by foreign judgment or by a foreign court's approval of a settlement.

Most Latin American class action statutes simply do not contemplate the settlement of class claims, leaving uncertainty as to whether the class representative can freely negotiate a settlement on behalf of the group.[74]

3. The Peculiar Res Judicata Model Followed by Some Latin American Countries

Several Latin American countries adopt a class action model that is somewhat similar to the unique model followed in Brazil. As a matter of fact, they are directly derived from the Brazilian model.[75]

VIGLIAR, *supra* note 38, at 137–41, 165–66; ABELHA, *supra* note 38, at 93–96; LENZA, TEORIA GERAL DA AÇÃO CIVIL PÚBLICA, *supra* note 38, at 77–85; MARCELO PAULO MAGGIO, CONDIÇÕES DA AÇÃO 115–16 (2005) (Braz.); LEONEL, *supra* note 38, at 323–27, 348–49; GOMES, *supra* note 38, at 163–71; ZAVASCKI, *supra* note 38, at 78–79, 151–54; GREGÓRIO ASSAGRA DE ALMEIDA, CODIFICAÇÃO DO DIREITO PROCESSUAL COLETIVO BRASILEIRO 94–95, 118, 125, 155 (2007) (Braz.); GREGÓRIO ASSAGRA DE ALMEIDA, DIREITO PROCESSUAL COLETIVO BRASILEIRO 545–46 (2003) (Braz.); ROBSON RENAULT GODINHO, A PROTEÇÃO PROCESSUAL DOS DIREITOS DOS IDOSOS 85–86 (2007) (Braz.); DIDIER & ZANETI, *supra* note 38, at 305–08. Only a minority of scholars believe that representatives possess a large amount of power relating to settlement. *See* PATRICIA MIRANDA PIZZOL, LIQUIDAÇÃO NAS AÇÕES COLETIVAS 149–53, 211 (1998) (Braz.); PAULO DE BESSA ANTUNES, A TUTELA JUDICIAL DO MEIO AMBIENTE 128–32 (2005) (Braz.).

73. *See* MAZZILLI, A DEFESA DOS INTERESSES DIFUSOS EM JUÍZO, *supra* note 38, at 166; Marcelo Dawalibi, *Limites Subjetivos da Coisa Julgada em Ação Civil Pública*, *in* AÇÃO CIVIL PÚBLICA 2001, *supra* note 72, at 526, 538–42.

74. There are exceptions. Some class action legislation in Latin America does specifically provide for class action settlement. *See, e.g.*, L. 472, agosto 6, 1998, Diario Oficial [D.O.] 43.357, arts. 56, 61 (Colom.) (providing that a class action judgment or settlement binds class members who do not request to opt out). In Mexico and Panama, the law clearly states that a class action may be resolved by settlement, but does not state clearly its binding effect on class members. However, since both of them specifically provide for court approval of the settlement and in both of them the court must determine whether the interests of the absent class members are adequately protected, it is only natural that court-approved class action settlements have the same binding effect as a class action judgment. *See* Código Federal de Procedimientos Civiles [CFPC] [Federal Civil Procedure Code] art. 595, *as amended*, Diario Oficial de la Federación [DO], 30 de Agosto de 2011 (Mex.); Ley 45, de 31 de Octobre de 2007, art. 129.7 (Pan.).

75. *See supra* Parts I.B.1. (A Peculiar Approach to Res Judicata in Latin American Class Actions) (discussing the Brazilian approach to class action res judicata).

In Chile, Article 54 of the Consumer Protection Law provides that judgments in favor of the plaintiff class bind all those who were harmed by the defendant's conduct.[76] According to the statute, the binding effect is limited to a favorable decision that "declares the defendant's liability."[77] Comparatively, even though Peru has only injunctive class actions, according to Article 82.6 of the Civil Procedure Code, only a favorable class action judgment will bind absent class members.[78] Meanwhile, Costa Rica does not even have class actions.[79] It currently only allows individual lawsuits to be consolidated.[80] However, a recent bill proposing a new Code of Civil Procedure seeks to create a class action mechanism by providing that a judgment in a class action for damages will only have binding effect if favorable to the class.[81] In the case of an unsuccessful class action, class members would not be bound and may bring their own individual lawsuits.[82]

Some Latin American countries were influenced by an older Brazilian class action res judicata rule. According to Article 16 of Law 7347 of 1985 (largely modified by the class action res judicata rule enacted with the Consumer Code in 1990), injunctive class action judgments would bind all absent class members, unless the judgment was in favor of the defendant due to a lack of evidence.[83] In the case of dismissal due to lack of evidence, any representative may bring the same class action lawsuit, with the same cause of action, as long as new evidence is produced.[84]

This former Brazilian rule was adopted in article 194 of the Código Procesal Civil Modelo para Iberoamerica, a model code enacted by the Iberoamerican Civil Procedure Institute. From the Model Code, it migrated to the Uruguayan Code. Even though Uruguay has only injunctive

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76. Law No. 19496, Marzo 7, 1997, DIARIO OFICIAL [D.O.], art. 54 (Chile).

77. *Id.*

78. CÓDIGO PROCESAL CIVIL [CÓD. PROC. CIV.] [CIVIL PROCEDURE CODE], Law No. 10 de 1 de agosto de 1993, art. 82.6 (Peru), *available at* http://www.iberred.org/sites/default/files/codigo-procesal-civil-per.pdf.

79. *See* CÓDIGO PROCESAL CONTENCIOSO ADMINISTRATIVO [ADMINISTRATIVE PROCEDURE CODE], Ley No. 8508 de 4 de abril de 2006 (Costa Rica).

80. *See id.* art. 48.

81. *See* Proyecto de Codigo General, Expediente No. 15979, de 11 de agosto de 2005, art. 128.3 (Costa Rica).

82. *See id.* art 128.3; *see also* Sergio Artavia Barrantes, *La Protección de los Intereses de Grupo en el Proyecto del Código Procesal General de Costa Rica*, *in* UN DIÁLOGO IBEROAMERICANO, *supra* note 12, at 568, 575–76 (discussing a previous class action bill in Costa Rica in which there would be no res judicata effect, if a class action judgment was obtained through lack of evidence).

83. *See* Lei No. 7347, de 24 de Julho de 1985, art. 16, D.O.U. de 25.7.1985 (Braz.).

84. *Id.*

class actions, according to article 220 of the *Código General del Proceso*, there is no res judicata effect if a class action proceeding fails due to lack of evidence.[85]

Therefore, even if any of Chile, Peru, or Costa Rica would recognize a foreign judgment in a class action for damages, it would probably do so only to the extent that the class judgment is favorable to the interests of absent class members, or if in Uruguay, only if the judgment was not based on lack of evidence.

The Model Class Action Code for Latin America, sponsored by the Ibero-American Institute of Civil Procedure, substantially adopts the new Brazilian rule on res judicata.[86] Since previous model codes approved by the Ibero-American Institute of Civil Procedure have been extremely influential in Latin America, it is possible that the Model Class Action Code for Latin America will set the tone for the enactment or reform of class action laws in Latin America.[87]

A similar type of class action preclusive effect also exists in an injunctive class action in Germany[88] and Switzerland.[89]

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85. This model was also adopted on the Portuguese class action. *See* Lei No. 83/95, art. 19.1, de 31 de Agosto de 1995, DIARIO DA REPUBLICA [D.R.], no. 201, de 31.08.1995 (Port.).

86. *See* Grinover, Watanabe & Gidi, *Código Modelo de Procesos Colectivos para Iberoamérica*, *supra* note 44. Although the Author was a co-reporter of the Ibero-American Class Action Code, he distances himself from the adoption of this type of res judicata regime. In other opportunities, both prior to and after the enactment of the Ibero-American Class Action Code, I manifested my opinion in favor of a "whether favorable or not" approach to class action judgments, as long as supported by judicial control of adequacy of representation, judicial approval of class action settlements, adequate notice, and the right to opt out, among other guaranties of fairness to absent class members. *See* Gidi, *The Class Action Code*, *supra* note 22, at 47 (providing, in article 18 of my own proposed Class Action Model Code that "[r]es judicata shall bind both the class and its members whether the judgment is favorable or not [to the class] . . . ."); GIDI, RUMO A UM CÓDIGO DE PROCESSO CIVIL COLETIVO, *supra* note 44, at 286–99 (critiquing the Brazilian model of res judicata and discussing my proposal of the Class Action Model Code).

87. *See* Ada Pellegrini Grinover, *Novas Tendências em Matéria de Legitimação e Coisa Julgada nas Ações Coletivas*, *in* ADA PELLEGRINI GRINOVER & PETRONIO CALMON, DIREITO PROCESSUAL COMPARADO 499 (2008) (Braz.).

88. *See* Wasserman, *supra* note 65, at 350 (describing the German model); Sturner, *supra* note 3, at 110 (same).

89. *See* Baumgartner, *supra* note 10, at 325–26.

> [T]he judgment in a *Verbandsklage* [injunctive class action brought by an association] has res judicata effect between the suing association and the defendant, but not between the defendant and individual members of the association [or other associations, who may bring the same injunctive class action again]". However, the judgment in a *Verbandsklage* is likely to have binding effects between defendant and individual members (and between defendant and other as-

C. Countries That Adopt an Opt-In Class Action

Although a very popular model in Europe, only one Latin American country adopts an opt-in class action mechanism: Mexico. In Mexico, absent class members must opt into the class action in order to be able to participate in the class action judgment.[90] Without the affirmative step of opting into the class action, absent class members in Mexico are not bound by any class action judgment or court approved settlement.[91] Curiously, absent class members may opt in even after the judgment is issued.[92] Therefore, presumably class members will only opt into a class action when they agree with its outcome. This peculiarity makes the Mexican class action strikingly similar to the Brazilian res judicata rule described above because, in practice, only a favorable class action judgment will impact class members.[93] It is also painfully similar to the old practice of "one-way intervention" of the spurious class actions before the 1966 amendment to Rule 23.[94]

The Author participated in all discussions related to the drafting of the Mexican Class Action Act, enacted in 2011.[95] The Consulting Group ap-

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> sociations) as a practical matter because neither may want to risk new litigation on the same claim, most likely with the same outcome.

Id.

90. *See* CFPC, *as amended*, arts. 594, 605, DO, 30 de Agosto de 2011 (Mex.) (amending the Mexican Federal Civil Procedure Code to include a title dedicated to class action).

91. *See id.*

92. *See id.*

93. *See supra* Part I.B. (Countries in Which a Class Action Judgment Is Binding only if Favorable to the Class).

94. The short-lived practice of one-way intervention was the subject of much academic attention, in spite of its little practical importance. *Proposed Amendments to Rules of Civil Procedure for the United States District Courts*, 39 F.R.D. 69, 105–06 (1966) (Advisory Committee's Notes on FED. R. CIV. P. 23); Benjamin Kaplan, *Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I)*, 81 HARV. L. REV. 356, 385–86 (1967); Note, *Federal Class Actions: A Suggested Revision of Rule 23*, 46 COLUM. L. REV. 818, 829 n.50 (1946) [hereinafter *Federal Class Actions*]; *see* ZECHARIAH CHAFEE JR., SOME PROBLEMS OF EQUITY 275, 278–80 (1990); FLEMING JAMES, JR., CIVIL PROCEDURE 500–01 (1965); Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 710–14 (1940); Note, *Developments in the Law—Class Actions*, 89 HARV. L. REV. 1318, 1395–96 (1976); *see also* Kenneth W. Dam, *Class Action Notice: Who Needs It?*, 1974 SUP. CT. REV. 97, 121–26 (1974).

95. *See* Alberto Benítez, Eduardo Ferrer Mac-Gregor & Antonio Gidi, *Iniciativa de Reforma al Código Federal de Procedimientos Civiles*, *in* UN DIÁLOGO IBEROAMERICANO, *supra* note 12, at 447 (proposing the original draft of what would later become the Mexican class action law). The legislation in Mexico is too recent and there

pointed by the Mexican Senate debated the merits of opt-in and opt-out class action legislation several times, leading to heated discussion. The original class action initiative presented by the Drafting Committee suggested an opt-out class action.[96] Moreover, the Consulting Group was specifically alerted to the fact that the inertia in the use of an opt-in procedure would tend to keep classes very small, therefore minimizing the power of the device and, as a result, the power of the people.[97] However, the Mexican Senate succumbed to a powerful lobby of major corporations and chose an opt-in system.[98]

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is no case law or scholarship on the subject, but a few articles were written before its enactment. *See, e.g.*, Lucio Cabrera Acevedo, *La Legitimación Para Actuar en Juicio de las Asociaciones Privadas en México Especialmente en Matéria Ambiental*, *in* UN DIALOGO IBEROAMERICANO, *supra* note 12, at 555; EDUARDO FERRER MAC-GREGOR, JUICIO DE AMPARO E INTERES LEGITIMO: LA TUTELA DE LOS DERECHOS DIFUSOS Y COLECTIVOS (2d ed. 2004) (Mex.); Luis Alfredo Brodermann Ferrer, *Los Efectos de la Sentencia en las Acciones de Grupo en México*, 63 ALEGATOS 335 (2006); *see also* LAS ACCIONES PARA LA TUTELA DE LOS INTERESES COLECTIVOS Y DE GRUPO (José Ovalle Favela ed., 2004) (Mex.) [hereinafter LAS ACCIONES PARA LA TUTELA] (the fact that no Mexican authors published an article in this 2004 book is evidence that the subject was almost unknown in Mexico until immediately before the enactment of the class action legislation).

96. *See* Benítez, Mac-Gregor & Gidi, *supra* note 95. This was the initial project commissioned by the Mexican Senate. The final statute that was ultimately enacted is substantially different in relevant parts.

97. Empirical research has substantially validated what most people already knew: only a small percentage of class members actually opt out and even a smaller amount will bring their own individual lawsuit. *See* THOMAS E. WILLGING ET AL., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 52–53 (Fed. Judicial Ctr. 1996) ("In all four districts, the median percentage of members who opted out was either 0.1% or 0.2% of the total members of the class and 75% of the opt-out cases had 1.2% or fewer class members opt out."); JAY TIDMARSH, MASS TORT SETTLEMENT CLASS ACTIONS: FIVE CASE STUDIES 11 (Fed. Judicial Ctr. 1998) (providing number of class members who opted out of mass tort settlement class actions); Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1532, 1559–60 (2004) ("Opt-outs . . . are rare: on average, less than 1 [%] of class members opt-out.").

98. Disclaimer: together with Professors Alberto Benítez and Eduardo Ferrer Mac-Gregor, the Author was one of the three academic drafters of the class action bill that led to the enactment of the Mexican Class Action Statute. However, the Author has no responsibility for its ultimate contents. The adoption of an opt-in class action regime as well as many other misguided choices and traps for the unwary that will make the Mexican class action largely ineffectual in practice was a political decision and the Mexican Senate carries the sole responsibility before the Mexican people. Several important aspects of the project we originally proposed were later abandoned in the political process.

This opt-in avenue seems to be a common tragic path in class action legislation throughout the civil law world, particularly in Europe. Initially, good-intentioned bills propose an opt-out class action, only to have the idea blocked by the legislature in a crude illustration of the political process. For example, the original proposal for the Swedish opt-in class action was originally devised as an opt-out device.[99] The Scottish Law Commission's proposal was to adopt an opt-in class action, although it was clear from its report that the proposal was originally drafted as an opt-out mechanism.[100] In England, in November 2008, the Civil Justice Council proposed a transsubstantive opt-in/opt-out class action.[101] In July 2009, the British Ministry of Justice rejected this proposal.[102]

Indeed, several civil law countries, mostly in Europe, employ an opt-in class action, such as Sweden,[103] Italy,[104] Finland,[105] Poland,[106] Russia,[107]

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99. *See* Nordh, *supra* note 20, at 399–400.

100. *See* SCOTTISH LAW COMM'N, MULTI-PARTY ACTIONS 21–28, 33–37 (1996).

101. *See* CIVIL JUSTICE COUNCIL, "IMPROVING ACCESS TO JUSTICE THROUGH COLLECTIVE ACTIONS": DEVELOPING A MORE EFFICIENT AND EFFECTIVE PROCEDURE FOR COLLECTIVE ACTIONS—FINAL REPORT (John Sorabji et al. eds., Nov. 2008) (U.K.) [hereinafter IMPROVING ACCESS TO JUSTICE], *available at* http://www.americanbar.org/content/dam/aba/administrative/antitrust_law/at800175_improving_access.authcheckdam.pdf. The report was largely based on an extensive report written by Rachael Mulheron, *Reform of Collective Redress in England and Wales: A Perspective of Need*, *in* IMPROVING ACCESS TO JUSTICE, *supra*, at 97–102.

102. *See* Ministry of Justice, The Government's Response to the Civil Justice Council's Report: "Improving Access to Justice through Collective Actions" 11, ¶ 35 (July 2009) (U.K.), *available at* www.justice.gov.uk/publications/docs/government-response-cjc-collective-actions.pdf; Rachael Mulheron, *The Case for an Opt-Out Class Action for European Member States. A Legal and Empirical Analysis*, 15 COLUM. J. EUR. L. 409 (2009) [hereinafter Mulheron, *Opt-Out*]; Rachael Mulheron, *Justice Enhanced: Framing an Opt-Out Class Action for England*, 70 MOD. L. REV. 550 (2007).

103. *See* 14 § LAG OM GRUPPRÄTTEGÅNG (Svensk författningssamling [SFS] 2002:599) (Swed.) ("A member of the group who does not give notice to the court in writing, within the period determined by the court, that he or she wishes to be included in the group action shall be deemed to have withdrawn from the group."). The Swedish law is considered a model in Europe, for those who favor an opt-in model. However, in terms of population and social equality Sweden is considerably different from other major European countries, like Italy, France, England, Ukraine, Spain, Poland, Russia, or Germany. It would be understandable if Monaco or Liechtenstein (each with a population smaller than 40,000) would adopt an opt-in class action, but the same recipe cannot work well in Russia (population of 142 million) or Germany (population of 81 million).

104. *See* Codice del consumo [Consumer Code], art. 140-bis, amended 2009 (It.) (stating that the class judgment will bind only those who enroll in the class); Claudio Consolo, *É Legge una Disposizione Collettiva Risarcitoria: Si è Scelta la Via Svedese Dello 'Opt-in' Anziché Quella Danese Dello 'Opt-out' e il Filtro ('l'Inutil Precauzione')*, 25 IL CORRIERE GIURIDICO 5 (2008) (It.) (discussing the enactment of an opt-in class action in Italy, rather than an opt-out class action). *See generally* Angelo Dondi, *On Some Draw-*

and Japan.[108] This seems to be the European Commission preference as well, at least for the moment.[109]

Only a few European countries, such as Portugal[110] and the Netherlands,[111] have adopted the opt-out model. Belgium attempted to adopt an

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backs in the Italian Road to Class Actions, 12 ZZP INT'L 13 (2007) (It.) (general criticism to the then recently enacted Italian class action statute); Michele Taruffo, *La Tutella Collettiva: Interessi in gioco ed Esperienze a Confronto*, 2007 RIV. TRIM. DIR. PROC. CIV. 529 (2007) (It.); CLAUDIO CONSOLO, PAOLO BUZZELLI, MARCO BONA & PAOLO A. BUZZELLI, OBIETTIVO CLASS ACTION: L'AZIONE COLLETTIVA RISARCITORIA (2008) (It.); Elisabetta Silvestri, The Italian 'Collective Action for Damages': An Update (2008) (unpublished paper) (It.), *available at* http://globalclassactions.stanford.edu/sites/default/files/documents/Italian_Collective_Action_for_Damages.pdf; Andrea Giussani, *Enter the Damage Class Action in European Law: Heading towards Justice on a Bus*, 28 CIV. JUST. Q. 132 (2009); *see also* Dreyfuss, *supra* note 23, at 34–36 (Italian courts may not recognize the class action binding effect on "class members who did not participate personally in the action").

105. *See* 8 § RYHMÄKANNELAKI (13.4.2007/444) (Fin.) ("A class member as defined, who has delivered, within the time limit, a written and signed letter of accession to the class shall belong to the class.").

106. *See* Ustawa o dochodzeniu roszczen w postepowaniu grupowym [Class Actions Law], DZIENNIK USTAW 7 § 44, Dec. 17, 2009 (Pol.); Magdalena Tulibacka1 & Radoslaw Goral, An Update on Class Actions and Litigation Funding in Poland (Nov. 2011) (unpublished paper), *available at* http://globalclassactions.stanford.edu/sites/default/files/documents/Polish%20civil%20justice%20updatePDF.pdf (stating that "roughly one year after the Polish class actions procedure came into force, [forty] class action complaints were filed in various courts," mostly against the Polish Government [the State Treasury] not private businesses).

107. *See* Arbitrazh Protsessual'nyi Kodeks Rossiiskoi Federatsii [APK RF] [Code of Commercial Procedure of the Russian Federation] art. 225.14 (Russ.) (stating that the class member may join the class claim by forwarding a document); *see also* Ivan Marisin & Vasily Keznetsov, *Russia*, *in* GLOBAL LEGAL GROUP, THE INTERNATIONAL LEGAL GUIDE TO: CLASS & GROUP ACTIONS 2011, ch. 21, ¶¶ 1.3–1.4 (2011), *available at* http://www.iclg.co.uk/khadmin/Publications/pdf/3983.pdf.

108. *See* MINJI SOSHŌHŌ [MINSOHŌ] [C. CIV. PRO.] 1996, art. 30 (Japan) (instituting a limited representative action, known as appointed party system, in which persons having a common interest may appoint one member as the representative for the entire body); Yasuhei Taniguchi, *The 1996 Code of Civil Procedure of Japan—A Procedure for the Coming Century?*, 45 AM. J. COMP. L. 767, 782–83 (1997).

109. *Compare* CHRISTOPHER HODGES, THE REFORM OF CLASS AND REPRESENTATIVE ACTIONS IN EUROPEAN LEGAL SYSTEMS 128, 130 (2008) [hereinafter HODGES, REFORM OF CLASS AND REPRESENTATIVE ACTIONS] (noting the European Commission's policy decision that "the opt-in procedure is to be preferred and the opt-out avoided in any Community measures that may be put forward. There may be further heated debate on this issue, but this political decision is likely to stick and to be influential with Member States"), *with* Mulheron, *Opt-Out*, *supra* note 102, at 450–51 (discussing more recent official publications and noting a shift in the position of the European Commission towards a more favorable view of the opt-in device). One can only hope that Hodges' prediction is incorrect and Europe would ultimately adopt a sensible opt-out class action.

opt-out system, but failed and currently does not have any type of class action legislation yet.[112]

The Netherlands is in a class of its own. It is a curious and unique case of a country that did not adopt a class action litigation rule, but adopted (i.e., copied) the untested and much more recent, controversial, and risky "settlement class actions" (or "settlement-only class actions").[113] The Dutch statute allows a class settlement that would have binding effect against every class member that does not exclude him or herself from the class (opt out).[114] However, counterintuitively, the statute does not provide for a class action.[115] The Dutch legislature considered that, because most class action cases brought in the United States settle anyway, it would be more efficient to "cut to the chase" and adopt only the rules in U.S. class action legislation that are most commonly used.[116] The Dutch legislature simply ignored or rejected the common sense idea that without the threat of class action litigation, class action settlement negotiations cannot be conducted at arm's length between the class and the defendant. The possibility of a class resolution of the controversy is entirely in the hands of the good will of the defendant. If the defendant does not want to settle on a class-wide basis, the class has no power to bring a

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110. *See* Lei No. 83/95, art. 15, de 31 de agosto de 1995, D.R., no. 201, de 31.08.1995 (Port.) (providing class members' opt-out rights). The Portuguese class action is called popular action (*acção popular*), adopting the traditional Roman Law terminology. It is important to note, however, that in Portugal a class judgment will not bind absent members if it was decided against the interest of the class due to lack of evidence. *See id.* art. 19.1; *see supra* Part I.B.3. (The Peculiar Res Judicata Model is Followed by Some Latin American Countries) (discussing how some Latin American countries follow a res judicata rule that is similar to an old Brazilian system). *See generally* Mariana Grança Gouveira & Nuno Garoupa, *Class Actions in Portugal*, *in* THE LAW AND ECONOMICS OF CLASS ACTIONS IN EUROPE 342 (Jürgen G. Backhaus, Alberto Cassone & Giovanni B. Ramello eds., 2012).

111. *See* Wet collectieve afwikkeling massaschade [WCAM] [Dutch Collective Settlement of Mass Damage Act], (Dutch Civil Code, s. 7:908.2), Staatsblad van het Koninkrijk der Nederlanden [Stb.] 2005, p. 380 (Neth.).

112. In Belgium, there is a government proposal to introduce an opt-out class action, based on the Quebec system. *See* Piet Taelman & Stefaan Voet, *Belgium and Collective Redress: The Last of the European Mohicans*, *in* THE BELGIAN REPORTS AT THE CONGRESS OF WASHINGTON OF THE INTERNATIONAL ACADEMY OF COMPARATIVE LAW 305, 337–44 (Eric Dirix & Yves-Henri Leleu eds., 2011); *see also* STEFAAN VOET, EEN BELGISCHE VERTEGENWOORDIGENDE COLLECTIEVE RECHTSVORDERING (2012) (Dutch).

113. *See* WCAM (Dutch Civil Code, s. 7:908.2), Stb. 2005, p. 380 (Neth.).

114. *Id.*

115. *Id.*

116. This is the equivalent of a country adopting rules for same-sex divorce without previously having adopted any legislation on same-sex marriage. After all, most marriages end up in divorce anyway.

class action and take the matter to judicial resolution.[117] This deplorable rule has been the object of much hype in Europe and elsewhere, at a level of attention and adulation that is beyond comprehension. Part of it is because of its use in a "successful" international agreement.[118] But another part is marketing for those interested in making Amsterdam a hub for international class actions, as well as multinational companies who feel extremely comfortable in such defendant-friendly environment. The natural drawbacks of the "settlement class actions," which is worrisome enough in the United States, are greatly magnified in the Netherlands, a country that resultantly will never have any practical experience with trying a class action.[119]

Norway[120] and Denmark[121] have adopted a middle ground between these two models. Their default rule is opt in, but the opt-out device can be used in some circumstances, such as in cases of small claims. In Denmark, only the Consumer Ombudsman can initiate an opt-out class action.[122] This hybrid opt-in/opt-out device was reflected in other class action proposals in Europe.[123] This middle ground proposal is certainly

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117. *See generally* Amchem Products, Inc. v. Windsor, 521 U.S. 591, 621 (1997).

> [In a system in which class settlement is allowed,] despite the impossibility of litigation, both class counsel and court would be disarmed. Class counsel confined to settlement negotiations [would not be able to] use the threat of litigation to press for a better offer, and the court would face a bargain proffered for its approval without benefit of adversarial investigation.

Id.

118. *See* Nagareda, *supra* note 2, at 37–41 (discussing, from a critical perspective, the circumstances of the settlement in the United States and The Netherlands of the Royal Dutch Shell case).

119. *See infra* notes 214–23 and accompanying text (discussing the Converium/Morrison settlement in the United States and The Netherlands).

120. *See* Lov om mekling og rettergang i sivile tvister [Act Relating to Mediation and Procedure in Civil Disputes] av 17 juni 2005 JUSTIS- OG BEREDSKAPSDEPARTEMENTET [JD] 2005:8 §§ 35-6, 35-7, 35-8 (2005) (Nor.), *translated at* http://www.ub.uio.no/ujur/ulovdata/lov-20050617-090-eng.pdf.

121. *See* RETSPLEJELOVEN [Administration of Justice Act] § 254(e)(6), (8) (2008) (Den.).

122. *See id.*

123. *See, e.g.*, GUILLAUME CERUTTI & MARC GUILLAUME ET AL., RAPPORT SUR L'ACTION DE GROUPE 29–31 (Dec. 2005) (Fr.), *available at* http://lesrapports.ladocumentationfrancaise.fr/BRP/054004458/0000.pdf; *Commission Green Paper on Consumer Collective Redress*, at 10, 12–13, COM (2008) 794 final (Nov. 27, 2008).

influenced by similar experimentation elsewhere a couple of decades ago, such as in the United States,[124] England,[125] and South Africa.[126]

Although class actions have existed in Spain for more than a decade, the situation there is still uncertain. The language of Spanish class action law is ambiguous[127] and legal commentators have contradictory and uncertain opinions on how to interpret these vagueries.[128]

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124. *See* Edward Cooper, *Rule 23: Challenges to the Rulemaking Process*, 71 N.Y.U. L. REV. 13, 33–34, 70–71 (1996) (proposing to add a new Rule 23(c)(1)(A) giving discretionary power to the court to determine whether a class action should proceed in an "opt-out" or "opt-in" basis); *see also* Edward Cooper, *Class-Action Advice in the Form of Questions*, 11 DUKE J. COMP. INT'L L. 215 (2001). This flexible approach is adopted in Pennsylvania state class actions. *See* PA. R. CIV. P. 1711 (1999).

125. *See* LORD WOOLF, ACCESS TO JUSTICE FINAL REPORT ¶ 46 (2000), *available at* http://webarchive.nationalarchives.gov.uk/+/http://www.dca.gov.uk/civil/final/sec4c.htm (arguing that "[t]he court should have the power to [maintain a class action] on an 'opt-out' or 'opt-in' basis, whichever contributes best to the effective and efficient disposition of the case").

126. SOUTH AFRICAN LAW COMM'N, THE RECOGNITION OF A CLASS ACTION IN SOUTH AFRICAN LAW 38 (Working Paper 57, Project 88, Nov. 1995) (S. Afr.). The proposed Public Interest Actions and Class Actions Act in South Africa, gives the court discretionary powers to adopt an opt-in notice (in limited circumstances), an opt-out notice, or no notice at all. *Id.*; Wouter Le R de Vos, *Reflections on the Introduction of a Class Action in South Africa*, 1996 J.S. AFR. L. 639, 646–48.

127. *See* LEY DE ENJUCIAMIENTO CIVIL [L.E. CIV.] [CODE OF CIVIL PROCEDURE] art. 222.3 (2000) (Spain) (providing that the class action judgment is binding on nonparties) and *id.* art. 519 (allowing, in some circumstances, that class members benefit from a class judgment during the phase of its enforcement). Spain, therefore, does not provide specifically neither for an opt-in nor for an opt-out provision. *Id.*

The Spanish group litigation regime has a special development on Consumer Law. The last version of Consumer Protection Act (Consolidated Text of the General Consumer and User Protection Act and other supplementary laws: Texto Refundido de la Ley General de Defensa de los Consumidores y Usuarios) has been passed by Legislative Royal Decree 1/2007 of 16 November 2007. B.O.E. 2007, 49181 (Spain). Provisions related to consumer actions are in articles 53 to 58. *See* Pablo Gutiérrez de Cabiedes, *Comentario a los artículos 53 a 58*, COMENTARIOS A LAS NORMAS DE PROTECCION DE LOS CONSUMIDORES 414–74 (2011) (Spain).

128. *Compare* PABLO GUTIERREZ DE CABIEDES HIDALGO, GROUP LITIGATION IN SPAIN: NATIONAL REPORT (2007), *available at* http://law.stanford.edu/display/images/dynamic/events_media/spain_national_report.pdf, *with* JUAN MONTERO AROCA ET AL., DERECHO JURISDICCIONAL: PROCESO CIVIL 488 (Tirant lo Blanch ed., 18th ed. 2010) (Spain) (discussing the Spanish class action in Spain as mandatory, *i.e.*, without possibility of opting out, and the res judicata producing effects whether the judgment was favorable or not); ANDRÉS DE LA OLIVA SANTOS & IGNACIO DÍEZ-PICAZO GIMÉNEZ, DERECHO PROCESAL CIVIL: EL PROCESO DE DECLARACIÓN 501 (2000) (same) (Spain); MANUEL ORTELLS RAMOS, DERECHO PROCESAL CIVIL 150, 567 (6th ed. 2005) (Spain) (same); Lorena Bachmaier Winter, *La Tutela de los Derechos e Intereses Colectivos de Consumidores y Usarios en el Proceso Civil Español*, *in* LAS

Germany does not have class actions for damages, but has recently implemented a "test case" or "model case" device.[129] It is not really an "opt-in" device because the decision on the "model case" will bind all shareholders that filed a claim in court.[130]

Rachel Mulheron has said that "[e]ssentially, it is a question of policy as to whether a person's legal rights should be determined without [their] express consent and [a] mandate to participate in the litigation."[131] There is no doubt that the matter is highly controversial.[132] However, this is not

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ACCIONES PARA LA TUTELA, *supra* note 95, at 1, 47–48, *with* Lorenzo M. Bujosa Vadell, *El acceso a la justicia de los consumidores y usuarios*, *in* DERECHOS DE LOS CONSUMIDORES Y USUARIOS 1780–86 (Alicia de León Arce & Luz María García García coords., 2d ed. 2007) (Spain) (admitting that the literal interpretation of the law provides for a mandatory class action without a right to opt out, but considering that it would be unconstitutional to bind class members, at least against their interest, without giving them opt-out rights, and proposing that the class judgment must bind the class members only if favorable), *with* José Luis Vázquez Sotelo, *La Tutela de los Intereses Colectivos y Difusos en la Nueva Ley de Enjuiciamiento Civil Española*, *in* LAS ACCIONES PARA LA TUTELA, *supra* note 95, at 177, 188–89 (considering unconstitutional a class action judgment that is binding on absent members whether-favorable-or-not). *See also* JAVIER LÓPEZ SÁNCHEZ, EL SISTEMA DE LAS CLASS ACTIONS EN LOS ESTADOS UNIDOS DE AMÉRICA (2011) (Spain) (providing a Spanish perspective on the American class actions); Pablo Gutierrez de Cabiedes Hidalgo, *La nueva Ley de Enjuiciamiento Civil y los daños con múltiples afectados*, 37 ESTUDIOS DE DERECHO JUDICIAL 133, 192–98 (2001) (Spain).

129. *See* Gesetz über Musterverfahren in kapitalmarktrechtlichen Streitigkeiten [KapMuG] [Capital Markets Model Case Act], Aug. 15, 2005, BUNDESGESETZBLATT, TEIL I [BGBL. I] at 2437, § 2, ¶ 1 (Ger.).

130. *See generally* Eberhard Feess & Axel Halfmeier, *The German Capital Markets Model Case Law (KapMuG)—A European Role Model for Increasing the Efficiency of Capital Markets? Analysis and Suggestions for Reform* 10 (Working Paper, Jan. 30, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1684528&. Stating that the German model case is neither an opt in nor an opt out,

> since the claimant has no choice whether to participate or not in the model case proceedings. An investor can either not sue at all, thereby foregoing his potential claim due to the relatively short limitation period, or she brings an action which will then automatically be included in the model case proceedings. This no-option rule was chosen to avoid parallel proceedings by collecting cases in one court.

Id.; *see also* Baumgartner, *supra* note 10, at 342–44 (discussing "pilot suits" or "model suits" that has existed since the 1980s in Switzerland, but which, in contrast from the German counterpart, do not have a binding effect on third parties).

131. *See* RACHAEL MULHERON, THE CLASS ACTION IN COMMON LAW LEGAL SYSTEMS: A COMPARATIVE PERSPECTIVE 29 (2004) [hereinafter MULHERON, CLASS ACTION IN COMMON LAW LEGAL SYSTEMS].

132. *See generally* 2 ONTARIO LAW REFORM COMM'N, REPORT ON CLASS ACTIONS 467 (1982) (Can.) [hereinafter ONT. LAW REFORM COMM'N]. The report, written three decades ago, notes that

a matter of policy choice, but an example of the influence of raw political power. No good faith governmental policy can justify an opt-in approach, especially in the case of small claims class actions (negative value class claims).[133] The only reason why countries adopt opt-in class action is because of the lobby of major corporations and the interest of the government itself.

Most major Western common law countries, such as the United States,[134] Canada,[135] and Australia,[136] have adopted opt-out class actions.

> [o]ne of the most controversial issues in the design of a class action procedure is whether class members should be bound automatically by the judgment, unless they exclude themselves from the action after certification, or whether class members . . . should be required to take affirmative action after certification in order to be bound by the judgment.

Id.; Mulheron, *Opt-Out*, *supra* note 102, at 412. ("[T]here is, in this author's view, one question which hovers above all others: should European Member States implement an *opt-out* form of collective redress?").

133. The disadvantage of the opt-in approach is clear and a near unanimity in class action scholarship. *See, e.g.*, ONT. LAW REFORM COMM'N, *supra* note 132, at 467–92; Issacharoff & Miller, *supra* note 20, at 202–08 (discussing four disadvantages of the opt-in approach: low incentive for representatives [and class counsel], low participation rate for class members, lack of global peace for defendants, and low deterrence); Mulheron, *Opt-Out*, *supra* note 102, at 413 ("there is an overwhelming *evidence of need* for an opt-out collective redress mechanism, in order to supplement presently existing procedural devices available to claimants."). No credible theory that the opt-in approach is a superior method of adjudicating collective or mass wrongs has ever been advanced. *See* MARTIN H. REDISH, WHOLESALE JUSTICE: CONSTITUTIONAL DEMOCRACY AND THE PROBLEM OF THE CLASS ACTION LAWSUIT 36–42, 13–33, 169–73 (2009) (advancing the proposition that "a process that requires absent claimants to affirmatively opt into a class proceeding is preferable to an opt-out procedure, purely as a matter of democratic theory"); HODGES, REFORM OF CLASS AND REPRESENTATIVE ACTIONS, *supra* note 109, at 118–30, 245–46 (favoring an opt-in approach). Even Christopher Hodges, however, admits that an opt-in approach may "constitute a barrier to genuine claimants joining a case because of issues of lack of knowledge of the procedure and costs, and thus a barrier to justice." *Id.* at 120. He further recognizes that this is particularly relevant in small value claim and "[t]he result is that justice is not served if an acceptable majority of those who have rights are not vindicated, if damage goes uncompensated or unrectified and if defendants keep illicit gains." *Id.*

134. FED. R. CIV. P. 23(c).

135. *See, e.g.*, Code of Civil Procedure, R.S.Q., c. 40, s. 56, art. 1007 (Can.) (providing that "[a] member may request his exclusion from the group by notifying the clerk of his decision, by registered or certified mail, before the expiry of the time limit for exclusion" and that "[a] member who has requested his exclusion is not bound by any judgment on the demand of the representative"); Province of Ontario Class Proceedings Act, S.O. 1992, c. 6, art. 9 (Can.) (providing that "[a]ny member of a class involved in a class proceeding may opt out of the proceeding in the manner and within the time specified in the certification order"); British Columbia Class Proceedings Act, R.S.B.C. 1996, c. 50, art.

England, however, despite originating class actions,[137] remains the only major Western common law country without any class action system at all. The British system consists of only a modest device that could be described as a voluntary (i.e., opt-in) aggregation of similar individual lawsuits.[138]

16(1) (Can.) (providing that "[a] member of a class involved in a class proceeding may opt out of the proceeding in the manner and within the time specified in the certification order"). Curiously, the British Columbia Act provides an opt-in procedure for non-residents of that province. *See id.* § 16(2) ("[A] person who is not a resident of British Columbia may . . . opt in to [the] class proceeding."). *See generally* WARD K. BRANCH, CLASS ACTIONS IN CANADA, ch. 10 (2006) (discussing the opt out device in Canadian class actions); ELAINE ADAIR ET AL., DEFENDING CLASS ACTIONS IN CANADA 328 (Kathleen Jones-Lepidas ed., 2d ed. 2007) (Can.) (same); Walker, *A View from Across the Border*, *supra* note 9, at 767–71 ("The combined effect of the residency requirement for the local operation of the opt-out class action regime and the opt-in requirement for non-residents is intended to prevent uncertainty from arising in respect of the binding effect of the certification of a multi-jurisdiction class."); *see also* ALBERTA LAW REFORM INST., CLASS ACTIONS: FINAL REPORT NO. 95, ch. 4 (2000) ("an 'opt out' system is the normal choice in Canada").

136. *See Federal Court of Australia Act 1976* (Cth) s 33(j)(2) (Austl.) (providing that "A group member may opt out of the representative proceeding by written notice given under the Rules of Court before the date so fixed"); *see also* MULHERON, CLASS ACTION IN COMMON LAW LEGAL SYSTEMS, *supra* note 131, at 29–38 (discussing the opt-out models of the various common law countries).

137. *See generally* STEPHEN C. YEAZELL, FROM MEDIEVAL GROUP LITIGATION TO THE MODERN CLASS ACTION (1987).

138. *See* Civil Procedure Rules [CPR], 1998, S.I. 1998/3132, r. 19.10 (U.K.) (regulating the Group Litigation Order, by which a person who already brought an individual lawsuit may request that his or her individual case be consolidated with other similar cases and may also request to be removed later). *See generally* NEIL ANDREWS, ENGLISH CIVIL PROCEDURE 971–1011 (2003); ADRIAN ZUCKERMAN, ZUCKERMAN ON CIVIL PROCEDURE: PRINCIPLES OF PRACTICE 517–18 (2003); CHRISTOPHER HODGES, MULTI-PARTY ACTIONS 29–46 (2001).

Although England does not have a class action device, some English commentators that directly faced the issue have tentatively opined that a U.S. class action judgment would be recognized and enforced in England, while others have offered a different opinion. *See* Dixon, *supra* note 4, at 134.

> The law in this area is difficult to analyse as there is no case that has really come close to considering this issue. Rather, there are a number of cases that deal with aspects of the issue. After assessing the principles inherent in those cases, I have come to the conclusion that the US judgment approving the settlement of the class action has a good chance of being upheld in England.

Id.

> [I]t is impossible to be certain on the existing state of English law whether a judgment in a US class action would be recognised and enforced in England in respect of absent claimants who did not opt out of the class action. However, a

Some scholars perceive substantial differences between these types of class actions by reference to contingent procedural variations. For example, some scholars consider that "collective actions" are opt-in procedures and "class actions" are opt-out procedures.[139] Other scholars consider that "collective actions" are those brought by associations and public agencies, whereas "class actions" are brought by class members. These distinctions and the differences in names are immaterial, however, because the various methods represent the same procedural device with slightly different formalities.[140] However, the fact that European scholars try to unsuccessfully distance themselves from the so called "American-style" class actions demonstrates their hostile attitude toward the class action device.[141] The mere existence of the derisive qualification "American-style" class action is troubling.[142]

> good case for such a judgment's recognition and enforcement in England can be made.

Harris, *supra* note 5, at 650. That was enough to convince one U.S. court. *See In re* Vivendi Universal, S.A. Sec. Litig., 242 F.R.D 76, 103 (S.D.N.Y. 2007).

> While the issue is hardly free from doubt, based on the affidavits before it, the Court concludes that English courts, when ultimately presented with the issue, are more likely than not to find that U.S. courts are competent to adjudicate with finality the claims of absent class members and, therefore, would recognize a judgment or settlement in this action.

Id. But see ADRIAN BRIGGS & PETER REES, CIVIL JURISDICTION AND JUDGMENTS 572–73 (4th ed. 2005) (Eng.) (stating that an American class action judgment would have no preclusive effect in England); Mulheron, *Opt-Out*, *supra* note 102, at 446 n.221 (same).

139. *See* Douglas W. Hawes, *In Search of a Middle Ground Between the Perceived Excesses of US-Style Class Actions and the Generally Ineffective Collective Action Procedures in Europe*, *in* PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION: ESSAYS IN HONOUR OF EDDY WYMEERSCH 200, 200–22 (Michel Tison et al. eds., 2009); GAËTANE SCHAEKEN WILLEMAERS, THE EU ISSUER—DISCLOSURE REGIME: OBJECTIVES AND PROPOSALS FOR REFORM 151 (2011).

140. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 334–39 (discussing the concept of "class actions"); *see also supra* note 10 and accompanying text (discussing the tradition in civil law scholarship to mistakenly consider the expression "class action" to refer only to class action for damages, not injunctive class action).

141. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 335–37 (preferring the adoption of the terminology "collective action" in Romance languages, but adopting the terminology "class action" in English, and treating them as synonyms).

142. *See generally* Christopher Hodges, *Multi-Party Actions: A European Approach*, 11 DUKE J. COMP. INT'L L. 321, 346 (2001) ("Europe neither needs nor wishes to import U.S.-style class action litigation."); *see also* Nagareda, *supra* note 2 (discussing European aversion to U.S.-style class actions).

One of the reasons traditionally given in civil law countries against the adoption of an opt-out class action is the fear that binding absent class members—especially to an unfavorable decision—in a proceeding to which they were not a party due to service of process or voluntary intervention would violate the due process of law.[143] This faulty legal argument simply masks the fact that the legislature is opposed to the enactment of a powerful class action device. Many lawmakers are also afraid of scaring business away from their countries, when in a globalized market, companies often flee to a more business-friendly environment.

In such countries, there is a strong predisposition to reject recognition of U.S. opt-out class actions, considering it a violation of the due process of law.[144] At the same time, it is highly likely that most countries would

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> And, yet, one need spend only a few minutes in conversations with European reformers before the proverbial "but" enters the discourse: "But, of course, we shall not have American-style class actions." At this point, all participants nod sagely, confident that collective actions, representative actions, group actions, and a host of other aggregative arrangements can bring all the benefits of fair and efficient resolution to disputes without the dreaded world of American entrepreneurial lawyering.

Issacharoff & Miller, *supra* note 20, at 180. Not all scholars, of course, use the expression "U.S.-style class action" derisively, but it would be convenient to retire its use. There is no such a thing as a U.S.-style class action. The concept of class action is universal: it is simply an action in which a person (a class member, an association or a governmental agency) represents the interests of a group of people in court (for an injunction or damages). What authors want to designate is a class action that is embedded in the American litigation context (of discovery, contingency fees, entrepreneurial lawyers, punitive damages, high jury awards, high attorney's fees, etc.). *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 320–23, 334–35.

143. *See* HODGES, REFORM OF CLASS AND REPRESENTATIVE ACTIONS, *supra* note 109, at 119–30 (discussing also the risk of abuse). The irony was not missed by a commentator; Nagareda, *supra* note 2, at 30–31.

> On this point, the contrast between the United States and Europe makes for an ironic juxtaposition. The nation known in stylized fashion for a kind of "cowboy" individualism actually accords less normative significance to the individual civil claim, in a sense, than do nations in which ideals of socialism and collectivization continue to enjoy greater purchase.

Id.

144. *See* Pinna, *supra* note 5, at 39–41. Pinna states that, after analyzing several affidavits or expert opinions on the matter,

> These reasons [of potential refusal of recognition] seem to be based on the idea that the features of a class action procedure offend the very foundations of domestic law of the European legal systems . . . . [I]t is clear that everywhere in

recognize a foreign opt-in class action judgment, even if the country in question does not have any type of class action in its legal system.[145]

Moreover, as will be more fully developed below, in countries where the legal system only accepts opt-in class actions (or no class actions at all), class members will not be able understand a notice based upon the concept of an opt-out procedure. The idea that one must "exclude" oneself from a class action in order to not be bound by it is simply alien to the people in these countries. The level of notice provided in these situations is simply inadequate to satisfy due process.[146]

D. Countries That Have a Class Action System That is Substantially Similar to the United States

The only country in Latin America that has a class action system that is substantially similar, in the relevant part, to the U.S. model is Colombia.

> Europe the main problem with US class actions is the opt-out mechanism and its asserted contrariety to the domestic foundations of civil procedure.

Id. Paradigmatic of this attitude is the brief filed by the French government in the Supreme Court case *Morrison v. National Australia Bank Ltd.*: "the opt-out aspect of U.S. class actions runs afoul of fundamental French public policy and due process principles." *See* Brief for Republic of France as Amicus Curiae Supporting Respondents, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010) (No. 08-1191); *see also* Mulheron, *Opt-Out*, *supra* note 102, at 412 ("for most European Member States, the concept [of an opt-out class action] is an anathema."); Sturner, *supra* note 3, at 110 (opt-out class actions are a violation of the right to be heard provided for in the German Constitution). *But see* Matousekova, *supra* note 5, at 676 ("Arguably, as criticisable as they may be, foreign class actions do not constitute such intolerable offence to the French forum.").

145. *See, e.g.*, Pinna, *supra* note 5, at 39–40 (stating that "[I]t is almost certain that European legal systems will give *Res Judicata* effect to 'opt-in' class-actions judgments, but this is not self-evident regarding opt-out class actions," but concluding that "European legal systems are presently less allergic to class-action-like procedures than they used to be" and predicting that the courts of Europe will recognize U.S. opt-out class actions); IBA LEGAL PRACTICE, GUIDELINES, *supra* note 8, at 5, 22 (stating that judgments against class members who opted into a class action would be recognized by reference to traditional rules of recognition and stating that "a person who opts in has accepted the jurisdiction of the court and any judgment in the action should be binding on him or her subject to generally recognised exceptions"); Murtagh, *supra* note 6, at 27–28 (stating that an opt-in class action would "enhance the likelihood of foreign courts recognizing class action judgments because the class action would only purport to bind plaintiffs who had affirmatively opted into the class, as opposed to absent parties who did not participate in the case in any way," but cautioned that recent case law may have precluded the possibility of the certification of an opt-in class action).

146. *See supra* Part II.A. (Class Action Notice in Latin America Would Be Inadequate).

Colombia has a reasonably long tradition of sophisticated legislation[147] and scholarship[148] on the subject of class actions for damages. The current class action statute, enacted in 1998, is carefully worded and extremely detailed, and includes eighty-six rules, totaling several dozen pages.[149] Contrary to the reality and trend in Latin America, Colombia's class action device, especially its class action for damages, is in many significant ways very similar to the U.S. model.

It is true that, in certain respects, Colombia's class action model differs from the U.S. model. However, these are mere procedural differences that are not relevant for the purposes of this Article. The important point is that Colombia has adopted an opt-out class action mechanism and the class judgment binds absent class members whether it is favorable to the interests of the class or not.[150] In addition, the Colombian class action model specifically allows for court-approved settlements.[151]

Because Colombia has a class action model that is similar to the United States' in relevant part, the specificities of the Colombian class action do not represent an obstacle to the recognition of a U.S. class action judgment or court-approved settlement.[152] Rather, the obstacles to such rec-

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147. *See* CONSTITUCIÓN POLÍTICA DE COLOMBIA [C.P.] art. 88; L. 472, agosto 6, 1998, D.O. 43.357, arts. 56, 61 (Colom.).

148. *See, e.g.*, MARTÍN BERMÚDEZ MUÑOZ, LA ACCIÓN DE GRUPO: NORMATIVA Y APLICACIÓN EN COLOMBIA (Universidad del Rosario ed., 1st ed. 2007) (Colom.); RAMIRO BEJARANO GUZMÁN, PROCESOS DECLARATIVOS: CIVILES, AGRARIOS, DE FAMILIA, ARBITRAMENTO: ACCIONES POPULARES Y DE GRUPO: LEY DE CONCILIACIÓN (3rd ed. 2005) (Colom.); PEDRO PAULO CAMARGO, LAS ACCIONES POPULARES Y DE GRUPO: GUÍA PRACTICA DE LA LEY 472 DE 1998 (4th ed. 2004) (Colom.); JAVIER TAMAYO JARAMILLO, LAS ACCIONES POPULARES Y DE GRUPO EN LA RESPONSABILIDAD CIVIL (2001) (Colom.); PABLO A. MORENO CRUZ, EL INTERÉS DE GRUPO COMO INTERÉS JURÍDICO TUTELADO (2002) (Colom.); LUIS FELIPE BOTERO ARISTIZÁBAL, ACCIÓN POPULAR Y NULIDAD DE ACTOS ADMINISTRATIVOS: PROTECCIÓN DE DERECHOS COLECTIVOS (1st ed. 2004) (Colom.); Jairo Parra Quijano, *Acciones populares y acciones para tutela de los intereses coletivos*, 2 REVISTA IBEROAMERICANA DE DERECHO PROCESAL 120 (2002) (Colom.); Jairo Parra Quijano, *Algunas Reflexiones Sobre la Ley 472 de 1998 Conocida en Colombia con el Nombre de Acciones Populares y Acciones de Grupo*, *in* LAS ACCIONES PARA LA TUTELA, *supra* note 95, at 111; *see also* Gómez, *supra* note 40 (manuscript at 30–42).

149. *See* L. 472, agosto 6, 1998, D.O. 43.357 (Colom.).

150. *See id.*

151. *See id.* arts. 56, 61; *supra* Part I.B.2. (Class Representatives Have No Authority to Settle and Compromise the Rights of Absent Class Members) (discussing the impossibility of settlement and disposition of group rights in class actions in some Latin American countries).

152.

> On the one hand, if the foreign country has a class-action-like remedy, courts in that country may be more likely to recognize a class-action judgment that in-

ognition are to be found elsewhere. These obstacles include the traditional prerequisites for recognition of any judgment, i.e., inadequacy of class notice,[153] lack of jurisdiction over absent class members,[154] and the need for rogatory letters to communicate with absent class members.[155]

E. Countries with Unique Considerations

Three Latin American countries—Argentina, Panama, and Ecuador—do not fit neatly into any of the four categories discussed above. Argentina is a country in a state of transition with respect to class actions, and Panama and Ecuador have an ambiguous class action regulation.

Argentina is in a class of its own, being perhaps the most unpredictable country in Latin America regarding class actions for damages. Article 43 of the Argentinean Constitution sets the overall favorable tone for the

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> cludes opt-out class members. But at the same time, the availability of an alternative remedy may mean that there is a more appropriate alternative in that country and plaintiffs need not be part of a U.S. class action lawsuit . . . . The availability of an alternative remedy may be a factor . . . on the question of class certification in a case where the connections with the case are largely foreign. Whether a class-action lawsuit is a superior method of proceeding may depend in part on what procedures for settlement or adjudication exist in the foreign forum.

Choi & Silberman, *supra* note 33, at 479, 485–86; *see also* Murtagh, *supra* note 6, at 36–44 (proposing that the inclusion of foreign class members in U.S. class actions may not be a superior method of deciding the controversy, since many countries now, particularly in Europe, have adequate remedies to protect group rights).

> It seems likely that courts outside the United States might consider their own standards for certifying class actions in determining whether to recognize the certification of a class action by another court and to treat absent class members as precluded from bringing claims before them. If a court regards the reasons for including absent non-resident plaintiffs in a class certified elsewhere to be consistent with the objectives of its own class action regime, it may be more likely to give preclusive effect to the certification order.

Walker, *A View from Across the Border*, *supra* note 9, at 776; *id.* at 797 (stating that "there do not appear to be obvious systematic bases" for Canadian courts to deny preclusive effect to U.S. class action judgments); Buxbaum, *supra* note 2, at 60 ("[S]ystems that themselves use class actions are likely to enforce claim preclusion [of U.S. class action judgments]."). Although it is true that legal systems that adopt an opt-out class action are more likely to recognize U.S. class action judgments, there are other obstacles to recognition. *See also* Catherine Piché, *The Cultural Analysis of Class Action Law*, 2 J. CIVIL L. STUD. 102 (discussing a case in which a Québec court refused recognition of an Ontario class action judgment).

153. *See infra* Part II.A.

154. *See infra* Part II.B.

155. *See infra* Part II.C.

country's openness to class actions.[156] Recently, the Supreme Court in the *Halabi* case criticized the absence of class action legislation. The Court went so far as to say that Article 43 is self-executing and that lower courts may entertain class proceedings even in the absence of written procedural norms, quite a departure from the civil law tradition.[157] Moreover, Argentinean scholarship on the subject is vast and sophisticated.[158]

The fact remains, however, that Argentina still does not have legislation on class actions for damages. Currently, several committees are proposing different class action legislation, but no main project has formally emerged thus far. Although it is fair to predict that Argentina will likely enact class action legislation in the next few years, it is impossible to foresee its content.

However, despite the good will expressed by the Supreme Court and the Constitution, and despite the sophistication of jurists, the current circumstances in Argentina are not favorable to an effective class action system. Most of the existing provincial class action laws are either opt-in systems or permit only a limited binding effect for class action judgments. For example, in the Provinces of Catamarca, La Pampa, and Chubut, class actions are opt in, and in the Provinces of Rio Negro and Corrientes, the class judgment is only binding if it is favorable to the class. In the General Law of Environment, in the consumer and environmental laws of the Province of Buenos Aires, and in the Código Procesal de la Província de Tierra del Fuego, the class action judgment is not

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156. Art. 43, CONSTITUCIÓN NACIONAL [CONST. NAC.] (Arg.) (providing for lawsuits for the protection of group rights in general, including specifically those related to the environment, discrimination, consumer, and antitrust.).

157. *See* Corte Suprema de Justicia de la Nación [CSJN] [National Supreme Court of Justice], 24/2/2009, "Halabi, Ernesto c. P.E.N. / ley 25.873 –dto. 1563/04 s/amparo law 16.986," La Ley [L.L.] (2009) (Arg.).

158. *See, e.g.*, LEANDRO J. GIANNINI, LA TUTELA COLECTIVA DE DERECHOS INDIVIDUALES HOMOGÉNEOS (2007) (Arg.); JAVIER H. WAJNTRAUB, PROTECCIÓN JURÍDICA DEL CONSUMIDOR (2004) (Arg.); ENRIQUE M. FALCÓN, 6 TRATADO DE DERECHO PROCESAL CIVIL Y COMERCIAL (2007) (Spain); PROCESOS COLECTIVOS (Eduardo Oteiza, ed., 2006) (Arg.); FRANCISCO VERBIC, PROCESOS COLECTIVOS (2007) (Arg.); GUSTAVO MAURINO, EZEQUIEL NINO & MARTÍN SIGAL, LAS ACCIONES COLECTIVAS (2005) (Arg.); OSVALDO ALFREDO GOZAÍNI, PROTECCIÓN PROCESAL DEL USUARIO Y CONSUMIDOR (2005) (Arg.); Roberto Berizonce & Leandro Giannini, *La Acción Colectiva Reparadora de los Daños Individualmente Sufridos en el Anteproyeto Iberoamericano de Procesos Colectivos*, *in* UN DIÁLOGO IBEROAMERICANO, *supra* note 12, at 63; Patricia Bermejo, *Algunas Reflexiones Sobre la Aplicación del Anteproyecto de Código Modelo de Procesos Colectivos para Ibero-América en la República Argentina*, *in* UN DIÁLOGO IBEROAMERICANO, *supra* note 12, at 490; *see also* Gómez, *supra* note 40 (manuscript at 54–64).

binding on the class if the judgment was in favor of the defendant due to a lack of evidence.[159] This mechanism was also the proposal of a group of scholars, judges, and practitioners who met in Mendoza in 2005 to discuss the subject of class actions in the XXIII National Civil Procedure Conference (Conclusion 9).[160] The Argentine scholarship generally is divided.[161]

If Argentina adopts either an opt-in class action or a class action system in which a judgment will be binding only if favorable to the class, it is doubtful that Argentina will recognize a foreign class action judgment or court-approved class action settlement.[162]

Panama is in a completely different situation. It has an extremely undeveloped class action system with no class action tradition whatsoever. The class action regulation is found solely in Article 129 of Law 45 of 2007, a statute that governs consumer protection.

Class actions in Panama, as is the case in many other Latin American and European countries, are limited solely to actions for damages or injury resulting from a product or service.[163] Therefore, the type of class

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159. *See* VERBIC, *supra* note 158, at 261–66. For a broad comparative study of provincial class action law in Argentina, see MAURINO, NINO & SIGAL, *supra* note 158, at 359–76. *See also* Law No. 5034, Cat., Aug. 14, 2001, [68] B.O.P. 2001–24, art. 20 (Catamarca, Arg.); Law No. 1352, LPa., Nov. 14, 1991, B.O. 13–12–1991 (La Pampa, Arg.); Law No. 4572, Cht., June 20, 2006 (Chubut, Arg.); CÓDIGO PROCESAL CIVIL Y COMERCIAL DE LA PROVÍNCIA RIO NEGRO [CÓD. PROC. CIV. Y COM. RNG.] art. 225 (Pablo Verani & Oscar Alfredo Machado eds., 1998) (Arg.); CÓDIGO DE PROCEDIMIENTOS EN LO CONTENCIOSO ADMINISTRATIVO DE LA PROVINCIA DE CORRIENTES [C.C.A. CTES.] art. 85 (Arg.); Ley General del Ambiente, Law No. 25675, Nov. 6, 2002, B.O. 28–11–2002, art. 33 (Buenos Aires, Arg.); Law No. 147, TFg., July 1, 1994, B.O.T. 17–08–94, art. 192 (Tierra del Fuego, Arg.).

160. *See* FALCÓN, *supra* note 158, at 1000.

161. *Compare* GIANNINI, LA TUTELA COLECTIVA DE DERECHOS INDIVIDUALES HOMOGÉNEOS, *supra* note 158, at 188–92 (proposing a res judicata whether favorable or not as long as there is judicial control of adequacy of representation) *and* Alejandro C. Verdaguer, *Litispendencia y cosa juzgada en los procesos colectivos*, *in* PROCESOS COLECTIVOS, *supra* note 158, at 369 (same), *with* MAURINO, NINO & SIGAL, *supra* note 158, at 334 (proposing to adopt both the opt-in and the binding effect only if the judgment is favorable).

162. *See supra* Part I.B. (Countries in Which a Class Action Judgment is Binding Only if Favorable to the Class) (discussing the reasons why these countries would not recognize a U.S. class action judgment); *supra* Part I.C. (Countries that Adopt an Opt-In Class Action) (same).

163. *See* Ley 45, de 31 de Octobre de 2007 (Pan.). This is an inexplicably common development in civil law countries. Instead of enacting a transsubstantive rule on class action litigation, some countries limit the class action applicability to specific areas of substantive law, like securities, antitrust, consumer, etc. *See, e.g.*, Taruffo, *Remarks on Group Litigation*, *supra* note 20, at 406 (stating that most European countries do not ap-

action available in Panama is significantly different and more limited than that available in the United States.

The main difficulty is that while Panama adopts an opt-out class action device, it is not clear whether the binding effect is "whether favorable or not" or *secundum eventum litis*. The statute simply states that the judgment binds all class members.[164] The Author is aware of less than a dozen class action cases in Panama, and all were denied certification or dismissed for procedural reasons, except for one settlement. Therefore, there is no case law on the matter. The Author is not aware of any books or law review articles on the subject.[165]

A literal interpretation of the statute seems to provide for binding effect "whether favorable or not," but a constitutional interpretation, on due process of law grounds, could lead to an effect *secundum eventum litis*, especially because of the statute's lack of adequate protection of class members' rights through adequate notice, judicial control of adequate representation, etc.

Ecuador is yet in a different situation. Despite being a country with no tradition of scholarship on class actions,[166] Ecuador does have a class

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proach class action litigation in general terms and take into consideration only particular instances of collective interests, such as those involved in consumer and environmental protection).

> while the American class action can be used to litigate, in principle, all subject-matters, the continental European representative group actions are mostly regulated by laws covering specific legal fields, most commonly consumer litigation and environmental issues. From a practical point of view, the piecemeal legislation that characterizes group litigation in most European countries is the product of two opposing forces: the general tendency to restrict group litigation as much as possible and the political pressure coming from certain social groups such as consumer associations and environmentalists. While the state is not willing to grant a general solution, it is forced to concede partial ones.

Valguarnera, *supra* note 20, at 37–38. This course of conduct is not only indefensible, it is also unsustainable in the long run. With time, either the legislature will extend class actions to all areas of substantive law or courageous courts will simply apply these statutes in other situations by analogy.

164. *See* Ley 45, de 31 de Octobre de 2007 (Pan.).

165. *But see* MARCO A. FERNÁNDEZ, CONDICIONES GENERALES DE COMPETENCIA EN PANAMA 16–17, U.N. Doc. LC/L.2394-P, U.N. Sales No. S.05.II.G.137 (2005) (a publication about antitrust law in Panama, with a two-page description of the Panamenian class action).

166. Probably there has never been any legal article published about class action before the enactment of the Environmental Management Law of 1999 and possibly none has been published for several years after its enactment.

action system.[167] In 1999, Ecuador enacted its Environmental Management Law (the "EML"), which is mostly dedicated to substantive law, but contains several procedural rules.[168] The EML was first used in the litigation between indigenous people from the Amazon Forest and the large oil companies of Texaco and Chevron. This action, after a decade-long litigation process that still seems to show no end, resulted in an eighteen billion dollar verdict in 2011, the largest verdict in history.[169]

The EML does not speak to key elements of a functioning class action system, demanding great judicial creativity to apply it in practice.[170] Although it is clear that the EML allows class actions to recover damages for the restoration of the environment as a whole, it is not clear whether it also allows class actions for individual damages. If the statute will be interpreted to allow class actions for individual damages, it is not clear about the binding effect of the judgment or the possibility of settlement. There is also no indication as to whether the EML adopts an opt-in or an opt-out system.

II. OBSTACLES TO RECOGNITION OF A U.S. CLASS ACTION JUDGMENT DERIVED FROM TRADITIONAL RULES

In addition to the obstacles discussed above, which are derived from the specific class action rules of each country, there are at least three other major obstacles to the recognition of U.S. class action judgments that are applicable to all Latin American countries. It is important to stress that there are other obstacles to recognition of a U.S. class action judgment and that the existence of only one obstacle is sufficient to frustrate recognition.

The first obstacle is that the U.S. class action notice delivered outside of the United States will invariably be deemed inadequate both according to U.S. class action law and the domestic laws of the specific Latin American country. The second obstacle is that the U.S. court in many cases will not be able to obtain personal jurisdiction over Latin American

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167. Ley No. 37 de Gestión Ambiental [Law of Environmental Management], de 30 de julio de 1999, R.O. 245, arts. 28, 29, 41, 42, 43 (Ecuador), *available at* http://www.ambiente.gob.ec/sites/default/files/archivos/leyes/gesion-ambiental.pdf.

168. *Id.*

169. *See* JAMES E. BERGER & CHARLENE C. SUN, RECENT DEVELOPMENTS: CHEVRON-ECUADOR DISPUTE 1–2 (Mar. 2011), *available at* http://www.paulhastings.com/assets/publications/1870.pdf; Lou Dematteis & Suzana Sawyer, *Boiling Oil: ChevronTexaco Faces Ecuador's Courts*, IN THESE TIMES (Dec. 2003), http://www.thirdworldtraveler.com/South_America/Boiling_Oil.html.

170. *See* Law of Environmental Management, de 30 de julio de 1999, R.O. 245 (Ecuador).

absent class members. The third, and more technical, obstacle is that formal service of process through rogatory letters is essential to perfect personal jurisdiction over foreign absent class members in Latin America.

These factors are examined in more detail below.[171]

A. Class Action Notice Would Be Inadequate

Although Brazil has had a sophisticated class action system for almost twenty years, its proceedings completely ignore absent class members. A Brazilian class action proceeding is conducted solely by the class representatives, usually by the office of the state or federal attorney general or by an association. Brazilian class action statutes offer no meaningful notice to absent class members.[172] The notice requirement is satisfied merely by a single bureaucratic publication in an official newspaper.[173] Brazil is a geographically vast and undeveloped country. Therefore, it would be impossible to create an adequate and effective notice device in such circumstances.[174]

Further, Brazil does not have an opt-out form of class action. The absence of a right to opt out is explained by the fact that class members do not *need* to opt out of the class in Brazil because their individual rights would never be bound by a class judgment or settlement. The opt-out device is only justified in a system in which the class judgment is binding on absent class members, regardless of whether the case's ultimate outcome is favorable or not to the class. Therefore, an opt-out system is incompatible with Brazil's system of res judicata *secundum eventum litis*. Where absent members will not be bound by an unfavorable outcome, they need not exclude from the class.[175]

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171. Although this article is focused on Latin American countries, the obstacles herein discussed are equally applicable to any other country.

172. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 341; *see also* CARNEIRO, *supra* note 68, at 57–58, 220–22, 228, 236; José Marcelo Menezes Vigliar, *Alguns aspectos sobre a ineficácia do procedimento especial destinado aos interesses individuais homogêneos*, *in* A AÇÃO CIVIL PÚBLICA APÓS 20 ANOS 328–29 (Édis Milaré coord., 2005); DE ASSIS RODRIGUES, *supra* note 71, at 41–42, 138–39, 279, 302, 303, 312, 313; VENTURI, *supra* note 38, at 395–99.

173. *Id.*

174. Brazil has approximately 170 million inhabitants, *The World Fact Book: Brazil*, CENTRAL INTELLIGENCE AGENCY, https://www.cia.gov/library/publications/the-world-factbook/geos/br.html (last visited Apr. 22, 2012), unevenly spread over approximately 8.5 million square kilometers, *id.*, an area larger than the Contiguous United States (*i.e.*, excluding Alaska, Hawaii, and Puerto Rico).

175. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 399; *see also supra* Part I.B. (Countries in Which a Class Action Judgment is Binding Only if Favorable to the Class).

Because the notion of having one's rights bound by a failure to "opt-out" is a foreign concept in Brazil, and in most Latin American countries other than Colombia, it would be fundamentally unfair and a denial of due process to bind absent class members who do not opt out of a class action conducted under the laws of a foreign country. This is even more evident when the absent class members have no contacts with the foreign country and thus no reason to expect being haled into a foreign court.

The same reality of class action notice is true in other Latin American countries, including Peru,[176] Panama,[177] and Colombia.[178] In each of these countries, notice is given in a bureaucratic manner in the official newspaper.[179] If it would be fundamentally unfair and a denial of due process to bind absent class members in countries that lack a tradition of effective class action notice; the effect is even more manifest in those countries with no established rules on class action notice at all. The problem is compounded in the many countries that do not have class actions for individual damages,[180] and in those countries that adopt an opt-in class action procedure.[181]

Even if, hypothetically, a country which does not have an opt-out class action model would be interested in recognizing a U.S. class action judgment, the problem remains as to how to convey adequate notice to people (class members) who know nothing about the concept of a class action or the notion of opting out of one. How can absent class members receive meaningful notice if they do not know and have no way of knowing what class actions are?[182] Apart from the difficulties of adequate no-

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176. *See* CÓD. PROC. CIV., Law No. 10 de 1 de agosto de 1993, art. 82.5 (Peru) (providing for class notice in the Official Reporter).

177. Ley 45, de 31 de Octubre de 2007, art. 129 (Pan.) (providing for class notice in a newspaper of national circulation).

178. *See* L. 472, agosto 6, 1998, D.O. 43.357, art. 53 (Colom.); *see also* MUÑOZ, *supra* note 148, at 335–37 (stating that in Colombia the class action notice is a fiction).

179. Costa Rica does not have a class action notice provision, but if it will have one, it will probably be in the Official Reporter. *See* Proyecto de Codigo General, Expediente No. 15979, de 11 de agosto de 2005, art. 125 (Costa Rica) (a bill proposing class action notice in the Official Reporter).

180. *See supra* Part I.A. (Countries that Do Not Have Class Actions for Damages).

181. *See supra* Part I.C. (Countries that Adopt an Opt-In Class Action).

182. *See* Bassett, *supra* note 9, at 65–66.

> As unintelligible as a legal notice may seem to a U.S. citizen, a foreign citizen is likely to find it even more so . . . . [t]hus, potential language issues, unfamiliarity with the U.S. legal system, and the natural human tendency to ignore that which we do not understand, all combine to render notice potentially ineffectual for foreign claimants.

tice, how can absent class members have a meaningful opportunity to opt out if they have no idea what an opt-out class proceeding is?[183] How can an absent class member in a foreign country have a meaningful opportunity to be heard, to participate in the proceeding, and to control the adequacy of the representative if the class proceeding is being conducted in a foreign land, using a foreign language with complex legal jargon?[184]

Latin Americans are simply not accustomed to receiving official messages from the judiciary informing them that they are part of a judicial proceeding, let alone to having an obligation to actively exclude themselves from it in order not to be bound by the result. Since the whole idea is simply alien to Latin Americans, any notice stating that they are part of an unknown kind of judicial proceeding in the United States would likely be read as ludicrous.

Finally, there is the issue of the content of the notice itself. How would one draft a notice to effectively communicate the idea that the claim of a foreigner, with no contact to the United States, is the object of litigation in the courts of that country? The notice could not merely be a translation of the English version, but would have to be written from scratch, in a form accessible to the Latin American lay public and devoid of legal jargon. In addition, the drafter might need to be sensitive to the cultural and legal peculiarities of each Latin American country. This is a very challenging hurdle.[185] There is a strong probability that absent class members

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Id.; Buschkin, *supra* note 9, at 1582–83 (discussing the unintelligible character of a U.S. class action notice to a foreigner); Bermann, *supra* note 2, at 96.

183. *See* Bassett, *supra* note 9, at 74.

> Without careful and clear language, the non-U.S. recipient is unlikely to understand its significance, and therefore is more likely merely to discard it, thus frustrating both purposes of the opt-out notice. If the notice is not understood, an absent class member will not be able to opt out from the existing class litigation, thereby remaining in the class, although not necessarily by choice, which foils the notion of implied consent to the court's jurisdiction.

Id.

184. *See id.* at 67.

> [E]ven for those recipients who are able to decipher the class action notice, providing a foreign claimant with notice of the pending class litigation does not immediately translate into an opportunity to be heard. Retaining counsel in the location where the class litigation is proceeding can be both difficult and expensive for a U.S. citizen living within the country, but handling such a matter from outside the U.S. is exponentially more so.

Id.

185. Debra Lyn Bassett suggests adding a cover letter to the notice.

will simply not understand the legal implications of the class action notice and what it requires of them. Therefore, the class action notice will likely be deemed inadequate, both under the standards of the specific Latin American country and the standards of U.S. law.[186]

In light of the inherent inadequacy of class action notice, it would be a denial of due process for a U.S. court to require a foreign class member residing in Latin America to take affirmative steps to "opt out" of an American class proceeding on threat of forfeiture of the foreigner's right to pursue individual actions. This would not only violate the constitutional guarantee of due process of law of the Latin American constitutions,[187] but also the U.S. Constitution.

B. A U.S. Court Cannot Validly Obtain Personal Jurisdiction over Foreign Absent Plaintiff Class Members[188]

In order to recognize and enforce a foreign judgment, Latin American nations generally demand that the rendering court have jurisdiction over the parties.[189] Therefore, no Latin American country would recognize a

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> To facilitate the recipient's comprehension, [class action] notice . . . . should include a cover letter, in the language of the recipient's home country, addressed to the specific individual recipient, explaining the purpose of the notice in a straightforward manner without legal jargon.

Bassett, *supra* note 9, at 90. However, it seems that it would be better to incorporate the contents of the cover letter in the notice itself. As a matter of fact, the whole notice must be written in the target language, not mechanically translated from English.

186. *See* FED. R. CIV. P. 23(c)(2)(b) ("the court must direct to class members the best notice that is practicable under the circumstances").

187. *See, e.g.*, CONSTITUIÇÃO FEDERAL [C.F.] [CONSTITUTION] art. 5, sect. LIV (Braz.) ("No person shall be deprived of his or her property without due process of law.").

188. Personal jurisdiction over foreign class members is not the only problem faced in an international class action. Other important issues are subject matter jurisdiction, the extraterritorial application of U.S. law (prescriptive or legislative jurisdiction), forum non conveniens, etc. *See generally* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010) (discussing subject matter jurisdiction); *In re* Parmalat Sec. Litig., 497 F. Supp. 2d 526 (S.D.N.Y. 2007) (discussing extraterritorial application of U.S. law); Buxbaum, *supra* note 2 (discussing subject matter jurisdiction); Choi & Silberman, *supra* note 33 (discussing extraterritorial application of U.S. law); *In re* Royal Dutch/Shell Transp. Sec. Litig., 522 F. Supp. 2d 712, 724 (D.N.J. 2007) (holding that the court did not have subject matter jurisdiction over claims by non-U.S. class members); Jasilli, *supra* note 6, at 114.

189. *See* CÓD. PROC. CIV., Law No. 295 de 24 de julio de 1984, art. 2104.2 (Peru), (providing that the foreign court must have jurisdiction according to its own private international law and to general principles of international jurisdiction.); Ley No. 36.511 de Derecho Internacional Privado [Private International Law Statute], de 6 de agosto de 1998, art. 53.4 (Venez.), *available at* http://www.analitica.com/bitblio/congreso_venezuela/private.asp (providing that the

U.S. judgment against a foreigner who lacked significant contacts with the United States and was not properly subject to jurisdiction there.

Typically the focus of personal jurisdiction revolves over a defendant because the judgment will generally be enforced against the defendant. Moreover, by taking the active step of bringing a lawsuit, the plaintiff consents to jurisdiction in the foreign court, thereby rendering moot the issue of personal jurisdiction over the plaintiff. Therefore, in traditional individual litigation, it is unnecessary to discuss the court's personal jurisdiction over a plaintiff.

In the class action setting, however, in addition to personal jurisdiction over the defendant, the court must also consider personal jurisdiction over the absent class members. After all, the absent plaintiffs' rights are being affected in much the same way as the defendant's.[190] And contrary to a plaintiff in an individual lawsuit, the issue of personal jurisdiction over absent class members was not rendered moot by any affirmative step of subjecting voluntarily to the court's jurisdiction.[191]

Therefore, a foreign class action judgment that is issued without personal jurisdiction over absent class members is void and would not be recognized in Latin America. The fact is that there are simply no accepted standards under which United States courts would have personal

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foreign court must have jurisdiction according to Venezuelan law); Regimento Interno de Supremo Tribunal Federal [Internal Rules of the Supreme Court] art. 217 (2008) (Braz.) (providing that a prerequisite of enforcement of foreign judgments is that the foreign court have jurisdiction over the party). This rule is well-settled in the Brazilian legal system. *See* Lei Introdução ao Código Civil, Decreto-Lei No. 4.657, de 4 de Setembro de 1942, D.O.U. de 09.09.1942, art. 15 (Braz.) (same); *see also* ZIVILPROZESSORDNUNG [ZPO] [CODE OF CIVIL PROCEDURE], Dec. 5, 2005, BGBL.I 3202, *as amended*, art. 328.1.1 (Ger.) (German courts would not recognize a foreign judgment if the foreign court did not have jurisdiction according to the German law).

190. Rolf Sturner compares a class action judgment that is unfavorable to the class to a negative declaratory judgment denying liability. *See* Sturner, *supra* note 3, at 115.

191. *See* Romy, *supra* note 1, at 793–94 (stating that under Swiss law the rules of jurisdiction over defendants should be applied to absent class members by analogy). *But see* Harris, *supra* note 5, at 617, 618, 625, 630, 635, 650 (It.) (placing a disproportionate importance throughout the article in the fact that the absent person is the plaintiff not the defendant: "[w]e shall see that the English rules on recognition and enforcement of foreign judgments, as stated in the authorities and leading works, are concerned with the position of the defendant and not that of the claimant."). *Id.* at 625. ("the requirements of jurisdictional competence are all focused on the position of the defendant. There is nothing in English law to suggest that a foreign court's jurisdictional competence depends upon the position of the claimant to the action."). *Id*. at 650 (Orthodox principles of English law are concerned with jurisdictional competence over a defendant and not over a claimant.).

jurisdiction over foreign absent class members domiciled outside the United States who have had no contacts with the United States.[192]

Assuming the foreign class member received actual adequate notice, the issue then becomes whether, by not affirmatively opting out of the U.S. class action, a foreign class member consented to the jurisdiction of U.S. courts.[193] In the Author's opinion, because foreign absent plaintiff class members are not taking the active step of bringing a lawsuit against the defendant but rather are being represented in court, absent class members cannot be said to have consented to the jurisdiction of a U.S. court.

The U.S. Supreme Court in *Phillips Petroleum Co. v. Shutts* held that a state court in the United States may properly assert jurisdiction over out-of-state absent class members that lack minimum contacts with the state.[194] However, this solution is not universal. In some, but not all, Canadian provinces, class members who are not residents of that province (known as "extraprovincial class members"), must take the affirmative step of opting in to a class action that purports to have nationwide ef-

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192. *See* Sturner, *supra* note 3, at 115 ("It is unlikely that German group members will always have sufficient contacts with U.S. to meet the requirement . . . . to support U.S. jurisdiction under German law.").

193. Andrea Pinna has correctly distinguished the issue of jurisdiction over foreign absent class members in an opt-out class action from the issue of non-conformity of the opt-out mechanism with the public policy of the foreign country. These are two completely different issues.

> Although this legal issue [jurisdiction over foreign absent class members] is often confused with the matter of conformity of the opt-out mechanism with public policy, it must be distinguished intellectually because the two issues do not converge at the same level of scrutiny of the foreign judgment. However, in practice, the answer to the question of the validity of consent to US jurisdiction by absent class members can depend strongly on the analysis of the actual opt out mechanism. Indeed, when it is considered that the right for absent class members to opt out from a class action lawsuit grants them sufficient protection and is therefore not contrary to international public policy, it is possible to conclude that the absence of opting out is also a valid consent of the absent plaintiff to the jurisdiction of US courts.

Pinna, *supra* note 5, at 58.

194. *See* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 811–12 (1985) (holding that a court may exercise jurisdiction over damage claims of absent class members without minimum contacts with the rendering state, as long as the court provides "minimal procedural due process protection," such as adequate notice, adequate representation, an opportunity to be heard, and an opportunity to opt out).

fect.[195] This provincial rule may not be very effective for a nationwide class action within a country,[196] but it may prove to be an effective option in the international context.[197]

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195. *See* British Columbia Class Proceedings Act, R.S.B.C. 1996, c. 50, art. 16(2) (Can.) (providing that "a person who is not a resident of British Columbia may . . . . opt in to [the] class proceeding").

196. The Saskatchewan Class Actions Act of 2002 and the Alberta Class Proceedings Act of 2003 adopted a similar rule based on the British Columbia Class Proceedings Act, but they were repealed in 2007 and 2010 respectively. *See* ALBERTA LAW REFORM INST., *supra* note 135, at 92–100 (proposing an opt-in class action for non-residents). *Compare* Peter W. Hogg & S. Gordon McKee, *Are National Class Actions Constitutional?*, 26 NAT'L J. CONST. L. 279 (2010), *with* Janet Walker, *Are National Class Actions Constitutional?—A Reply to Hogg and Mckee*, 48 OSGOODE HALL L.J. 95 (2010).

197. *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 997 n.48 (2d Cir. 1975) (recognizing that the affidavits presented by party-appointed experts had stated that if that class action was certified in opt-in form, it would be "far more likely, although still not certain," that foreign jurisdictions would recognize the class action judgment as binding to the class members who decided to opt in.

> Potential language barriers, unfamiliar legal procedures, and potential intimidation in dealing with the courts and lawyers of another country all tend to increase the risks of fear, confusion, and misunderstandings by foreign claimants. Requiring foreign claimants to affirmatively opt in, rather than absurdly construing their silence as an agreement to be bound by the class litigation, will ensure that their consent is genuine.

Bassett, *supra* note 9, at 87–89; *id.* at 88 ("[T]he opt-in procedure is a superior device from a due process perspective."); *id.* at 89 ("This provides superior due process protections, and avoids the loss of individual rights under circumstances where neither minimum contacts nor genuine consent exist."); Monestier, *supra* note 6, at 1–2 (arguing, after a convincing criticism of the current practice, that it is impossible to determine *ex ante* whether foreign courts would recognize U.S. class action judgments or settlements and proposing the adoption of the opt-in device for foreign class members). According to Monestier,

> [A]n opt-in regime presents a more principled way of determining foreign claimants' class membership in a U.S. class action because an opt-in class action: eliminates the res judicata problem altogether, allows all foreign claimants to participate in U.S. litigation if they so choose, provides additional protections for absent foreign claimants, respects international comity; and sufficiently deters defendant misconduct.

Id. at 61; *see also* IBA LEGAL PRACTICE, GUIDELINES, *supra* note 8, at 5, 22 (stating that judgments against class members who opted into a class action would be recognized by reference to traditional rules of recognition and stating that "a person who opts in has accepted the jurisdiction of the court and any judgment in the action should be binding on him or her subject to generally recognised exceptions"). *But see* Walker, *A View from Across the Border*, *supra* note 9, at 769–71 (stating that an opt-in solution for non-residents would not solve the problem of fairness to foreign class members); Kern v. Siemens Corp., 393 F.3d 120 (2d Cir. 2004) (reversing a first instance court who certified

In many ways, the issues discussed in this subchapter relating to personal jurisdiction directly mirror the issues faced by the U.S. Supreme Court in *Shutts* and in the Canadian nationwide opt-in provisions. However, the personal jurisdiction over foreign absent plaintiff class members involve more complex considerations than in a wholly domestic setting.

First, the rule of jurisdiction over out-of-state class members established in *Shutts* is not necessarily applicable as a rule of jurisdiction over foreign class members.[198] The issues of jurisdiction over a foreign person involve different considerations that are not present in the analysis of jurisdiction over an out-of-state, or extraprovincial, class member. Therefore, it cannot be said that *Shutts* authorizes jurisdiction over foreign class members.[199]

Second, the focus of this Article is not whether, according to U.S. law, U.S. courts have jurisdiction over foreign absent class members. For the purposes of this Article, it is irrelevant where U.S. courts consider the limits of their international jurisdiction. The objective of this Article is not to determine whether the U.S. court may certify a class action that includes foreign class members. Since the focus of this Article is to determine whether a U.S. class action judgment can be enforced abroad, the laws of the foreign countries are determinative, not the determination of the U.S. Supreme Court in *Shutts*. The laws of the foreign countries

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an opt-in class action for foreign class members. According to the Second Circuit an opt-in class action is prohibited under Rule 23). *See also* Buschkin, *supra* note 9, at 1577 (cautioning against adopting the opt-in class action as a default rule for foreign claimants, but recognizing that a certified opt-in class action is better than a dismissed opt-out class action:

> if the judge must choose between denying all foreign claimants access to the class or certifying foreign claimants under an opt-in class in order to solve potential jurisdictional concerns, the opt-in class is the more desirable of these options because the opt-in class gives foreign claimants to opportunity to obtain redress.

Strong, *supra* note 1, at 96 (stating that opt-in arbitrations would be easier to be recognized in some civil-law countries).

198. *See generally* Bassett, *supra* note 9, at 61 ("a transnational class raises any number of specialized due process concerns, as contrasted with a class comprised solely of U.S. citizens. However, despite facing a class with foreign claimants, *Shutts* completely ignored the impact of their presence."); *see also id.* at 79 ("If the class action includes foreign claimants, additional due process protections may be necessary as a means of ensuring that the assertion.").

199. *But see* Pinna, *supra* note 5, at 58–59 (stating that *Shutts* is also applied in the context of foreign class members and concluding that, "[t]herefore, according to US law, a US court has jurisdiction over foreign absent class members since they have an actual right to opt out.").

would not accept such broad assertion of personal jurisdiction by U.S. courts.[200]

As Isabelle Romy observes, an unrestricted refusal to recognize U.S. class action judgments could lead to unfair results.[201] Taken to its extreme, even U.S. class members dissatisfied with a class action judgment, either because the class lost or because the class recovery was insufficient, could escape U.S. res judicata doctrine by bringing individual suits in foreign countries against the class defendant.[202] Romy proposes a compromise whereby foreign absent class members do not consent to U.S. jurisdiction by merely not exercising the right to opt out.[203] Because foreign class members are not parties to the class proceedings, Romy submits that they are not bound by the U.S. class judgment and may bring a lawsuit against the defendant in Switzerland.[204] However, foreign absent class members who *are* subject to jurisdiction in the United States, for example because they are domiciled in the United States, are considered party to the class proceeding and therefore are bound by it.[205]

However ingenious the Romy compromise may be, it remains to be seen whether civil law countries, particularly those without a class action device or those that adopted an opt-in class action, would recognize any opt-out class judgment issued by a foreign court, even one involving a purely American class. Romy's proposal seems to conflate two different and independent obstacles to the recognition of opt-out class judgments. While her compromise removes the obstacle of the lack of jurisdiction over foreign absent class members, it does nothing to reduce the concerns that an opt-out class procedure may be against the public policy of the recognizing country.[206] The author's compromise is consistent, however, with her own belief that opt-out class actions do not in principle violate the Swiss public order when all the members of the class are identified.[207]

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200. *See, e.g.*, Sturner, *supra* note 3, at 114 (discussing a case in which the State District Court of Stuttgart refused recognition of a U.S. class action judgment because the U.S. court did not have personal jurisdiction over foreign absent class members, according to German law.).

201. *See* Romy, *supra* note 1, at 793–94.

202. *Id.*

203. *Id.*

204. *Id.*

205. *See id.*

206. *See supra* Part I.A. (Countries that Do Not Have Class Actions for Damages) & Part I.C. (Countries that Adopt an Opt-In Class Action).

207. *See* Romy, *supra* note 1, at 796–99 (stating that an opt-out class action judgment would violate Swiss public order whenever the class includes people who are not identified).

However well-intentioned the certification of a worldwide class action, there is the lingering concern that the United States views itself as a "Courthouse for the World" to right the wrongs committed all over the planet. Enforcing U.S. class actions worldwide may be thought to encourage "arrogant and imperialistic" American behavior[208] which may even be viewed as an "intrusion into the internal social policies and cultures of other sovereign states."[209]

Although this view of American egotism is not shared by all,[210] the foregoing suggests that the most important exercise may not be to deter-

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208. *See* Richard O. Faulk, *Armageddon Through Aggregation? The Use and Abuse of Class Actions in International Dispute Resolution*, 37 TORT & INS. L.J. 999, 1018 (2002) ("The political impact of enhancing the power of American jurisprudence in this manner is nothing less than imperialistic."); Monestier, *supra* note 6, at 74 ("It is arrogant and imperialistic for U.S. courts to attempt to bind foreign claimants to a result reached in an action thousands of miles away that they had no knowledge of or control over."); *see also* Peta Spender & Michael Tarlowski, Case Note, Morrison v. National Australia Bank Ltd.: *Adventures on the Barbary Coast:* Morrison *and Enforcement in a Globalised Securities Market*, 35 MELB. U. L. REV. 280, 291–92 (2011) (discussing the extraterritorial jurisdiction of U.S. courts in global securities class actions and the perceptions of the United States as security police or legal and economic imperialist). *But see* Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 175 (2d Cir. 2008) ("[W]e are an American court, not the world's court, and we cannot and should not expend our resources resolving cases that do not affect Americans or involve fraud emanating from America.").

209. *See* Faulk, *supra* note 208, at 1000.

> The use of U.S. [class actions] . . . to resolve claims of nonresident foreign litigants represents a major intrusion into the internal social policies and cultures of other sovereign states. Although 'globalism' may be useful as a commercial cliché, its intrusion into jurisprudence is disturbing, especially when procedural devices that are not yet recognized internationally are used to resolve claims arising from conduct that occurs beyond the forum state's borders.

Id.

210. *See* Pinna, *supra* note 5, at 61 (concluding that, "because [European consumers] would not be able to benefit from the access to justice granted by US courts even against a non-[European] defendant. . . . [F]rom a policy perspective, refusing to recognize a US class action judgment is not a good solution for European countries."); Seth A. Northrop, Note, *Exporting Environmental Justice by Importing Claimants: The Suitability and Feasibility of the Globalization of Mass Tort Class Actions*, 18 GEO. INT'L ENVTL. L. REV. 779, 781, 803 (2006) (considering U.S. class action "a vehicle for otherwise voiceless plaintiffs to resist the exploitation at the hands of U.S.-based [multinational corporations]" and discussing the risk of impunity of U.S. corporations for their actions abroad); Buschkin, *supra* note 9, at 1588–93 (discussing the behavior of multinationals operating in a global economy that know that they are subject to class actions for their wrongdoing in the United States, but "a large portion of the globe is easy prey to their lucrative, but illegal, selling practices" and discussing the impact of that behavior in the U.S. market.) According to the author,

mine whether foreign courts might recognize and enforce U.S. class action judgments and settlements against the interests of foreign class members. Rather, perhaps the most revealing analysis may be to determine whether U.S. courts are willing to recognize and enforce foreign class action judgments and settlements (or the generic collective redress alternatives indigenous to "exotic" legal systems) against the interests of American citizens that may have been included as foreign absent class members in these lawsuits.[211] Indeed, American courts would look rather foolish if, after an established case law of consistent certification of foreign classes based primarily on the expectation that foreign courts would recognize U.S. class action judgments, American courts realize that they do not have the stomach to recognize foreign class action judgments against American defendants or American class members.[212]

Two recent examples are particularly compelling.[213]

> [i]f foreign claimants are excluded from securities classes, everyone loses. Foreign claimants suffer because they lose their investments, U.S. corporations suffer because it becomes more difficult to raise capital, and U.S. citizens suffer as foreign investors pull their money out of U.S. financial markets and the economy declines as a result.

Id. at 1593.

211. *See* Buxbaum, *supra* note 2, at 61.

> Until the United States is ready to contemplate a system in which even the claims of U.S. investors, based on U.S. trading, are subject to the laws of another country, it is inappropriate to solve the problem of multiple proceedings by suggesting that they all take place in U.S. courts.

Id.

> [T]he day will soon come when American courts will have to decide whether to give effect to class or other aggregate judgments rendered by foreign courts purporting to bind U.S. class members. Unless American courts are fully prepared to enforce such foreign judgments, they would be wise to exhibit some restraint in assuming jurisdiction over foreign claimants in U.S. class actions.

Monestier, *supra* note 6, at 75 n.260.

212. Naturally, this criticism is limited to the idea that U.S. courts must condition the certification of a foreign class to the expectation that foreign courts will recognize the U.S. class action judgment.

213. The class action case in Ecuador brought by indigenous people against Texaco (later Chevron) that led to an eighteen billion dollar verdict against Chevron is beyond the scope of this Article, because the issue there relates not to the binding nature of a class action judgment against absent class members, but against the class defendant. Suffice it to remind that the class action was originally filed in the United States and dismissed on a *forum non conveniens* motion filed by the defendant, who demonstrated confidence in the Ecuadorian judicial system and willingness to try the case there. This is commonly referred to as "forum shopper's remorse." *See* Aguinda v. Texaco, Inc., 142 F.

In January 2012, the Amsterdam Court of Appeals approved a global class action settlement.[214] The class included all non-U.S. class members that had been previously excluded from the corresponding U.S. securities class action titled *Morrison v. Nat'l Austl. Bank Ltd.*[215] The class action settlement was approved despite the facts that the cause of action had taken place outside the Netherlands,[216] the defendant was a Swiss company,[217] and only a small percentage of the class members were from the Netherlands.[218] The Amsterdam court declared that the settlement was binding on all class members who did not opt out.[219] This is more worrisome for European than U.S. class members, because internal rules

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Supp. 2d 534, 545–46 (S.D.N.Y. 2001) ("[T]he Court is satisfied on the basis of the record before it that the courts of Ecuador can exercise with respect to the parties and claims here presented that modicum of independence and impartiality necessary to an adequate alternative forum."); Sequihua v. Texaco, Inc. 847 F. Supp. 61, 64 (S.D. Tex. 1994) ("[i]t is clear from the affidavits of two former Ecuadorian Supreme Court justices that an adequate forum is available in Ecuador . . . . Ecuador provides private remedies for tortious conduct and maintains an independent judicial system with adequate procedural safeguards."). *But see* Christopher Whytock & Cassandra Burke Robertson, *Forum Non Conveniens and the Enforcement of Foreign Judgments*, 111 COLUM. L. REV 1444 (2011).

> [U]nder existing law these seemingly inconsistent arguments are not necessarily inconsistent at all. Due to differences between the forum non conveniens doctrine and the judgment enforcement doctrine, it is possible to argue consistently that a foreign court is available, adequate, and more appropriate for dismissal purposes but suffers from inadequacies that preclude enforcement.

Id. The authors also propose suggestions to avoid the access-to-justice gap created with this dubious strategy. For more on this topic see Lucien J. Dhooge, Aguinda v. Chevrontexaco*: Mandatory Grounds for the Non-Recognition of Foreign Judgments for Environmental Injury in the United States*, 19 J. TRANSNAT'L L. & POL'Y 1 (2009–2010); Judith Kimerling, *Transnational Operations, Bi-National Injustice: Chevrontexaco and Indigenous Huaorani and Kichwa in the Amazon Rainforest in Ecuador*, 31 AM. INDIAN L. REV. 445 (2006–2007). Disclaimer: the author of this Article has worked as a consultant in the litigation.

214. *See* STICHTING CONVERIUM SECURITIES COMPENSATION FOUND., http://www.converiumsettlement.com (last visited Apr. 25, 2012) [hereinafter CONVERIUM SETTLEMENT].

215. *See* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010); CONVERIUM SETTLEMENT, *supra* note 214.

216. *See* CONVERIUM SETTLEMENT, *supra* note 214.

217. *Id.*

218. *Id.*

219. *Id.*

within the European Union make recognition of judgments difficult to evade.[220]

Amsterdam is aggressively vying to establish itself as a hub for worldwide class action settlements.[221] This is a particularly serious problem for European class members because of the ease with which European judgments are enforced throughout the European Union. Considering that the Netherlands has a settlement class action device but not the possibility of class-action litigation,[222] it is more probable that the country will become a "judicial hellhole" in which class members' claims will be sucked into.[223]

In 2011, a Canadian court certified a class action including absent U.S. class members.[224] This may suggest a potential problem because the threshold for bringing a class action in Canada is lower than the increasingly stringent U.S. restrictions on class certification. For example, Canadian class action law correctly did not implement the number one killer of class actions in the United States: the predominance requirement. Moreover, its requirement that the class action must be a "preferable" procedure is less demanding than the number two killer of class actions

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220. *See* Convention on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, EC, Dec. 21, 2007, 2007 O.J. (L 339); Council Regulation 44/2001, Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, 2000 O.J. (L 12) (EC).

221. Other legal markets will gladly compete with Amsterdam for a share of the international legal business that the United States may have discarded after *Morrison*. *See* Spender & Tarlowski, *supra* note 208, at 280, 314 (discussing *Morrison* from an international perspective and predicting that Australia could attract transnational class litigation in the aftermath of Morrison: "It is very likely that *Morrison* will have a centrifugal effect on transnational securities litigation, and securities class actions may flow to jurisdictions that have adopted the opt-out procedure. One consequence of this might be that more securities class actions will be commenced in Australia.").

222. *See supra* notes 113–19 and accompanying text (describing and critiquing the Dutch Collective Settlement of Mass Damage Act).

223. *See* Nagareda, *supra* note 2, at 41 ("The remaining question is whether Amsterdam ultimately will emerge as the trans-Atlantic successor to anomalous state courts within the United States—as a kind of procedural 'red-light district' for aggregate dealmaking, like its namesake for other transactions pursued by consenting parties.").

224. *Compare* Silver v. Imax Corp., 2011 ONSC 1035 (Can.) (a Canadian class action including absent U.S. claimants), *with* McCann v. CP Ships Ltd., [2009] O.J. No. 5182 (Ont. Can. S.C.J.) (QL) (excluding non-Canadian class members in the class, even those that had purchased their shares in Canada) *and* McKenna v. Gammon Gold Inc., 2010 ONSC 1591, ¶¶ 96–110, 115–18 (Can.) (same). *See generally* Tanya J. Monestier, *Is Canada the New 'Shangri-La' of Global Securities Class Actions?*, 32 NW J. INT'L LAW & BUS. (forthcoming 2012) ("*Imax* is truly the first case of its kind in this respect—never before has a global class of claimants on such a large scale been certified in a Canadian court.").

in the United States: the requirement of "superiority."[225] Therefore, American plaintiff class action attorneys may try to bypass the more stringent Rule 23 prerequisites established by a conservative federal judiciary by simply crossing the border and filing the same class action a few hundred miles to the north. After that, they would only need to bring the judgment back south and enforce it in the same federal court that had denied class certification months before.[226]

C. Formal Notice through Rogatory Letters is Essential

Finally, even if it were possible for a U.S. court to acquire personal jurisdiction over Latin American nationals with no contacts with the United States,[227] and even if it were possible to provide adequate notice

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225. *See* Garry D. Watson, *Class Actions: The Canadian Experience*, 11 DUKE J. COMP. & INT'L L. 269, 272–73 (2001) (stating that "[i]n certain respects the Canadian legislation is more liberal in facilitating class actions than its American counterpart" and that "[t]he Canadian criteria for certification of a proceeding as a class action are relatively undemanding.") (citations omitted); BRANCH, *supra* note 135, at 4.870 (stating that the "preferable" standard is a lower threshold for certification than "superiority"); DEFENDING CLASS ACTIONS IN CANADA, *supra* note 135, at 13, 14, 30–32, 116, 157, 158, 163, 177 (stating that certification in Canadian class actions is a simpler and less onerous process than in the United States and that the requirements that correspond to numerosity, typicality, and predominance are "generally less burdensome for plaintiffs." The author also states that certain claims that might not satisfy the typicality and predominance requirements of U.S. class action law may satisfy the Canadian class action requirements. The author also cites class actions that have been certified "despite a finding that individual issues predominated over common issues." Even in Quebec, the only Canadian province that adopted the predominance requirement, such requirement is less restrictive than in the United States.). It is symptomatic of the Canadian approach to class actions that the Ontario Law Reform Commission carefully considered and expressly rejected the predominance requirement. *See* ONT. LAW REFORM COMM'N, *supra* note 132, at 344–47. The Report states that the predominance requirement of U.S. FED. R. CIV. P. 23

> has served to prevent the successful assertion of many class action in various substantive law areas . . . . notwithstanding the arguments of commentators and some courts that such actions are, indeed, appropriate for class treatment . . . . Accordingly, we believe that the commonality threshold test for class actions should not be too onerous.

Id.; *see also* Gidi, *The Class Action Code*, *supra* note 22, at 39–40 (not adopting the predominance prerequisite in article 3 of the code).

226. *See* Gidi, *Issue Preclusion*, *supra* note 55, at 1028–56 (discussing whether an order denying class certification has issue preclusive effect in other courts).

227. *See supra* Part II.B. (A U.S. Court Cannot Validly Obtain Personal Jurisdiction over Foreign Absent Plaintiff Class Members) (arguing that U.S. courts cannot acquire personal jurisdiction over Latin American nationals with no contact with the United States).

to Latin American nationals,[228] most Latin American countries would still refuse to recognize and enforce U.S. class action judgments and settlements.

The final obstacle lies in the notice to class members. Similarl to what was discussed above regarding personal jurisdiction,[229] the rules of service of process are usually addressed from the point of view of the defendant. However, in the case of absent class members, it is necessary to notify them of the class action proceeding and of their right to opt out or to participate in the proceeding.[230] Whether a simple notice is sufficient or whether a formal service of process is necessary, absent class members located outside the United States must be informed through internationally acceptable means.

Most Latin American countries will not accept as adequate notice to their domiciliaries anything short of service by rogatory letter as a prerequisite to recognizing or enforcing a foreign judgment.[231] A simple notice, as is required under Rule 23,[232] is insufficient, even if it could be legally adequate. It is not that these countries do not know the concept of notice by publication or by mail in domestic litigation. But the requirements of notice in international litigation are a completely different matter.

CONCLUSION

A judgment or court-approved settlement in a U.S. class action for damages would not be recognized or enforced in Latin American countries. The reasons have to do not only with the peculiarities of the class action device in each Latin American country, but also with adequate

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228. *See supra* Part II.A. (Class Action Notice Would Be Inadequate) (arguing that class action notice would not be adequate).

229. *See supra* Part II.B. (A U.S. Court Cannot Validly Obtain Personal Jurisdiction over Foreign Absent Plaintiff Class Members).

230. *See* Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 811–12 (1985); *see supra* note 196.

231. See FED. R. CIV. P. 4(f) and corresponding state court rules, for example, MASS. R. CIV. P. 4(e), MINN. R. CIV. P. 4.04. *See also* Inter-American Convention on Letters Rogatory, arts. 4–13, Jan. 30, 1975, O.A.S.T.S. No. 43, 1483 U.N.T.S. 288; Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil and Commercial Matters arts. 5, 8–11, 15–16, *opened for signature* Nov. 15, 1965, 20 U.S.T. 361, 658 U.N.T.S. 163 (entered into force Feb. 10, 1969); Sturner, *supra* note 3, at 111–13 (stating that Germany would require individual service of process in "strict compliance with the provisions of the Hague Service Convention" and that notice by publication would probably not be allowed).

232. *See* FED. R. CIV. P. 23(c)(2).

notice, personal jurisdiction, and the requirement of international notice by rogatory letter.

One of the many reasons why so many transnational class actions are brought in the United States is because there is a worldwide dearth of entrepreneurial plaintiff class action attorneys.[233] However, with the rapid proliferation of the class action device in Latin America, Europe, and Asia, litigants will soon have to face the enforceability, in the United States, of foreign class action judgments or settlements. This Article posits that American courts, American defendants, American class members, and American entrepreneurial plaintiff class action attorneys will readily come to the conclusion that foreign courts have no business deciding matters that are of the exclusive interest of American class members.

233. A few other reasons are the existence of discovery, contingency fees, punitive damages, and the opt-out class action device itself in the U.S. legal system. For a broad discussion of Comparative Civil Procedure, see UGO A. MATTEI, TEEMU RUSKOLA & ANTONIO GIDI, SCHLESINGER'S COMPARATIVE LAW 489–563, 684–706, 707–828, 855–62 (2009). *See also* JAMES R. MAXEINER, FAILURES OF AMERICAN CIVIL JUSTICE IN INTERNATIONAL PERSPECTIVE (2011) (comparing civil law and American civil procedure from a critical perspective).

APPENDIX[234]

Argentina. National Constitution[235]

Artículo 43. Toda persona puede interponer acción expedita y rápida de amparo, siempre que no exista otro medio judicial más idóneo, contra todo acto u omisión de autoridades públicas o de particulares, que en forma actual o inminente lesione, restrinja, altere o amenace, con arbitrariedad o ilegalidad manifiesta, derechos y garantías reconocidos por esta Constitución, un tratado o una ley. En el caso, el juez podrá declarar la inconstitucionalidad de la norma en que se funde el acto u omisión lesiva.

Podrán interponer esta acción contra cualquier forma de discriminación y en lo relativo a los derechos que protegen al ambiente, a la competencia, al usuario y al consumidor, así como a los derechos de incidencia colectiva en general, el afectado, el defensor del pueblo y las asociaciones que propendan a esos fines, registradas conforme a la ley, la que determinará los requisitos y formas de su organización.

Argentina. Law 24240 of Consumer Protection (amended 2008)[236]

Artículo 54. . . . La sentencia que haga lugar a la pretensión hará cosa juzgada para el demandado y para todos los consumidores o usuarios que se encuentren en similares condiciones, excepto de aquellos que manifiesten su voluntad en contrario previo a la sentencia en los términos y condiciones que el magistrado disponga.

Argentina. Law 25675 General Environmental Law[237]

Artículo 33. Los dictámenes emitidos por organismos del Estado sobre daño ambiental, agregados al proceso, tendrán la fuerza probatoria de los informes periciales, sin perjuicio del derecho de las partes a su impugnación. La sentencia hará cosa juzgada y tendrá efecto erga omnes, a excepción de que la acción sea rechazada, aunque sea parcialmente, por cuestiones probatorias.

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234. Some statutes below have been heavily edited to include only the excerpts that are relevant to the arguments developed in this argument about the enforceability of a U.S. class action judgment or court-approved class action settlement.

235. Art. 43, CONST. NAC. (Arg.).

236. Law No. 26361, Apr. 3, 2008, [3] B.O. 1378, *amending* Law No. 24240, art. 54 (Arg.).

237. Ley General del Ambiente, Law No. 25675, Nov. 6, 2002, B.O. 28–11–2002, art. 33 (Buenos Aires, Arg.).

Argentina. Conclusions of the Mendoza Conference (2005)[238]

9. Ha de regularse la extensión subjetiva de los efectos de la cosa juzgada erga omnes, excepto cuando la pretensión fuera rechazada por insuficiencia de pruebas, en cuyo caso la cosa juzgada será meramente formal, pudiendo cualquier legitimado intentar otra acción, con idéntico fundamento, valiéndose de nueva prueba.

Asimismo, en la hipótesis de rechazo basado en las pruebas producidas, cualquier legitimado podrá intentar otra acción, con idéntico fundamento, cuando sugiere nueva prueba sobreviviente que no hubiera podido ser producida en el proceso. El reexamen por cuestiones probatorias no podrá fundarse en nuevas tecnologías, ni en supuestos que habiliten la revisión de la cosa juzgada.

Brazil. Law 8078, Consumer Code (enacted 1990)[239]

Artigo 103. Nas ações coletivas de que trata este código, a sentença fará coisa julgada:

I - erga omnes, exceto se o pedido for julgado improcedente por insuficiência de provas, hipótese em que qualquer legitimado poderá intentar outra ação, com idêntico fundamento valendo-se de nova prova, na hipótese do inciso I do parágrafo único do art. 81;

II - ultra partes, mas limitadamente ao grupo, categoria ou classe, salvo improcedência por insuficiência de provas, nos termos do inciso anterior, quando se tratar da hipótese prevista no inciso II do parágrafo único do art. 81;

III - erga omnes, apenas no caso de procedência do pedido, para beneficiar todas as vítimas e seus sucessores, na hipótese do inciso III do parágrafo único do art. 81.[240]

§ 1° Os efeitos da coisa julgada previstos nos incisos I e II não prejudicarão interesses e direitos individuais dos integrantes da coletividade, do grupo, categoria ou classe.

§ 2° Na hipótese prevista no inciso III, em caso de improcedência do pedido, os interessados que não tiverem intervindo no processo como litisconsortes poderão propor ação de indenização a título individual.

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238. XXIII Congreso National de Derecho Procesal [XXIII National Congress of Procedural Law], Mendoza, Arg., Sept. 22–24, 2005, *Conclusiones*, para. 9.

239. Lei No. 8078, de 11 de setembro de 1990, D.O.U. de 11.9.1990 (Braz.). The Brazilian legislation is extensive. *See, e.g.*, Lei No. 7.347, de 24 de julho de 1985, D.O.U. de 25.7.1985 (Braz.).

240. There is no significant difference between the Latin expressions *erga omnes* (against all) and *ultra partes* (beyond the parties). Both mean that the class decree binds all absent members of the class, with the qualification that the decision cannot prejudice their individual rights. *See* Gidi, *Class Actions in Brazil*, *supra* note 36, at 387–88.

§ 3° Os efeitos da coisa julgada de que cuida o art. 16, combinado com o art. 13 da Lei n° 7.347, de 24 de julho de 1985, não prejudicarão as ações de indenização por danos pessoalmente sofridos, propostas individualmente ou na forma prevista neste código, mas, se procedente o pedido, beneficiarão as vítimas e seus sucessores, que poderão proceder à liquidação e à execução, nos termos dos arts. 96 a 99. . . .

Chile. Law 19.496, Consumer Protection Law (amended 2004)[241]

Artículo 54. La sentencia ejecutoriada que declare la responsabilidad del o los demandados producirá efecto erga omnes, con excepción de aquellos procesos que no hayan podido acumularse conforme al número 2) del inciso final del artículo 53, y de los casos en que se efectúe la reserva de derechos que admite el mismo artículo.

La sentencia será dada a conocer para que todos aquellos que hayan sido perjudicados por los mismos hechos puedan reclamar el cobro de las indemnizaciones o el cumplimiento de las reparaciones que correspondan.

Si se ha rechazado la demanda cualquier legitimado activo podrá interponer, dentro del plazo de prescripción de la acción, ante el mismo tribunal y valiéndose de nuevas circunstancias, una nueva acción, entendiéndose suspendida la prescripción a su favor por todo el plazo que duró el juicio colectivo. El tribunal declarará encontrarse frente a nuevas circunstancias junto con la declaración de admisibilidad de la acción dispuesta en el artículo 52.

Colombia. Law 472 Class Action Law (enacted August 5, 1998)[242]

Artículo 56. Exclusión del grupo. Dentro de los cinco (5) días siguientes al vencimiento del término de traslado de la demanda, cualquier miembro de un mismo grupo podrá manifestar su deseo de ser excluido del grupo y, en consecuencia, no ser vinculado por el acuerdo de conciliación o la sentencia. Un miembro del grupo no quedará vinculado a los efectos de la sentencia en dos situaciones:

a) Cuando se haya solicitado en forma expresa la exclusión del grupo en el término previsto en el inciso anterior;

b) Cuando la persona vinculada por una sentencia pero que no participó en el proceso, demuestre en el mismo término que sus intereses no fueron representados en forma adecuada por el representante del grupo o que hubo graves errores en la notificación.

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241. Law No. 19496, Marzo 7, 1997, D.O., art. 54 (Chile).

242. L. 472, agosto 6, 1998, D.O. 43.357, arts. 56, 61, 66 (Colom.). The Colombian Law 472 is extensive, with eighty-six rules written in several dozen pages.

Transcurrido el término sin que el miembro así lo exprese, los resultados del acuerdo o de la sentencia lo vincularán. Si decide excluirse del grupo, podrá intentar acción individual por indemnización de perjuicios.

Artículo 61. Diligencia de conciliación. De oficio el juez, dentro de los cinco (5) días siguientes al vencimiento del término que tienen los miembros del grupo demandante para solicitar su exclusión del mismo, deberá convocar a una diligencia de conciliación con el propósito de lograr un acuerdo entre las partes, que constará por escrito. . . . El acuerdo entre las partes se asimilará a una sentencia y tendrá los efectos que para ella se establecen en esta ley. El acta de conciliación que contenga el acuerdo hace tránsito a cosa juzgada y presta mérito ejecutivo.

Artículo 66. Efectos de la sentencia. La sentencia tendrá efectos de cosa juzgada en relación con quienes fueron parte del proceso y de las personas que, perteneciendo al grupo interesado no manifestaron oportuna y expresamente su decisión de excluirse del grupo y de las resultas del proceso.

Costa Rica. Code of Administrative Procedure (enacted 2008)[243]

Artículo 48 inc. 5) La sentencia dictada en este proceso - intereses de grupo, corporativos, difusos o procesos grupales - de conformidad con las reglas establecidas en el presente Código, producirá con su firmeza, cosa juzgada material respecto de todas las partes que haya concurrido en él.

Costa Rica. Bill 15979, Proposed Code of Civil Procedure (published 2010)[244]

Artículo 128. Efectos de la sentencia. Los efectos de las sentencias que se dicten en procesos para la tutela de intereses supraindividuales, se regirán por las siguientes disposiciones:

1) En tutela de intereses difusos, tendrá efecto de cosa juzgada material respecto de cualquier persona, salvo que la demanda se declare sin lugar por insuficiencia de pruebas. No se perjudicarán las acciones de indemnización por daños personalmente sufridos, reclamados individualmente, pero si la demanda es declarada con lugar beneficiará a las víctimas y a

243. CÓDIGO PROCESAL CONSTENCIOSO ADMINISTRATIVO, Ley No. 8508 de 4 de abril de 2006, art. 48 (Costa Rica).

244. Proyecto de Codigo General, Expediente No. 15979, de 11 de agosto de 2005, art. 128 (Costa Rica).

sus sucesores, que podrán proceder a la liquidación en la etapa de ejecución.

2) En tutela de intereses colectivos, tendrá efectos de cosa juzgada material respecto de quienes no hayan figurado como parte, pero limitadamente al grupo, categoría o clase, salvo improcedencia por insuficiente de pruebas. Los efectos de cosa juzgada que aquí se establecen, quedan limitados al plano colectivo, no perjudicando intereses individuales.

3) Tratándose de intereses individuales homogéneos, tendrá efecto de cosa juzgada material respecto de cualquier persona afectada, cuando se declare con lugar la demanda. Si fuere desestimatoria, los interesados no litigantes podrán demandar a título individual.

4) Los sujetos no litigantes a quienes se extiendan los efectos de una sentencia estimatoria, deberán hacer valer sus derechos en ejecución del proceso para la tutela de intereses supraindividuales.

5) Los efectos de cosa juzgada que aquí se establecen, quedan limitados al plano colectivo, no perjudicando intereses individuales.

6) En las relaciones jurídicas continuadas, si sobreviniera modificación en el estado de hecho o de derecho, la parte podrá pedir la revisión de lo que fue decidido por sentencia.

7) Cuando la demanda hubiere sido denegada, con base en las pruebas producidas, cualquier legitimado podrá intentar una acción, con idéntico fundamento, cuando surgiere prueba nueva, sobreviniente, que no podía haber sido producida en el proceso.

Mexico. Federal Code of Civil Procedure (amended 2011)[245]

Artículo 594. Los miembros de la colectividad afectada podrán adherirse a la acción de que se trate, conforme a las reglas establecidas en este artículo.

En el caso de las acciones colectivas en sentido estricto e individuales homogéneas, la adhesión a su ejercicio podrá realizarse por cada individuo que tenga una afectación a través de una comunicación expresa por cualquier medio dirigida al representante a que se refiere el artículo 585 de este Código o al representante legal de la parte actora, según sea el caso.

Los afectados podrán adherirse voluntariamente a la colectividad durante la substanciación del proceso y hasta dieciocho meses posteriores a que la sentencia haya causado estado o en su caso, el convenio judicial adquiera la calidad de cosa juzgada.

Dentro de este lapso, el interesado hará llegar su consentimiento expreso y simple al representante, quien a su vez lo presentará al juez. El

245. CFPC art. 594, *as amended*, DO, 30 de Agosto de 2011 (Mex.).

juez proveerá sobre la adhesión y, en su caso, ordenará el inicio del incidente de liquidación que corresponda a dicho interesado.

Los afectados que se adhieran a la colectividad durante la substanciación del proceso, promoverán el incidente de liquidación en los términos previstos en el artículo 605 de este Código.

Los afectados que se adhieran posteriormente a que la sentencia haya causado estado o, en su caso, el convenio judicial adquiera la calidad de cosa juzgada, deberán probar el daño causado en el incidente respectivo. A partir de que el juez determine el importe a liquidar, el miembro de la colectividad titular del derecho al cobro tendrá un año para ejercer el mismo.

En tratándose de la adhesión voluntaria, la exclusión que haga cualquier miembro de la colectividad posterior al emplazamiento del demandado, equivaldrá a un desistimiento de la acción colectiva, por lo que no podrá volver a participar en un procedimiento colectivo derivado de o por los mismos hechos.

Tratándose de acciones colectivas en sentido estricto e individuales homogéneas sólo tendrán derecho al pago que derive de la condena, las personas que formen parte de la colectividad y prueben en el incidente de liquidación, haber sufrido el daño causado.

El representante a que se refiere el artículo 585 de este Código tendrá los poderes más amplios que en derecho procedan con las facultades especiales que requiera la ley para sustanciar el procedimiento y para representar a la colectividad y a cada uno de sus integrantes que se hayan adherido o se adhieran a la acción.

Panama. Law 45 (2007)[246]

Artículo 129. Reglas Procesales. El ejercicio de las acciones de clase, en materia de consumo, corresponde a uno o más miembros de un grupo o clase de personas que han sufrido un daño o perjuicio derivado de un producto o servicio. Tal ejercicio se entiende en beneficio del respectivo grupo o clase de personas. La Autoridad, las asociaciones de consumidores organizados o un grupo de consumidores que nombre un representante están legitimados para demandar.

Las acciones de clase se rigen de acuerdo con las siguientes reglas:

El miembro de la clase que desee excluirse podrá hacerlo antes de que se fije fecha para la audiencia preliminar.

7. Las transacciones quedan sujetas a la aprobación del juez, quien velará por que los derechos concedidos en la presente Ley queden debidamente protegidos.

246. Ley 45, de 31 de Octobre de 2007, art. 129 (Pan.).

8. La sentencia afectará a todos los miembros que pertenezcan a la clase, aunque no hayan intervenido en el proceso.

Panama. Law 29 (1996)[247]

Artículo 172. Reglas Procesales. El ejercicio de las acciones de clase corresponden a uno o más miembros, de un grupo o clase de personas que han sufrido un daño o perjuicio derivado de un bien o producto; tal ejercicio se entiende en beneficio del respectivo grupo o clase de personas. La Comisión y las asociaciones de consumidores organizadas están legitimadas para demandar. Las acciones de clase se rigen de acuerdo con las siguientes reglas:

1. Uno o varios miembros de una clase podrán demandar, como representantes de todos los miembros de la clase, en cualquiera de los siguientes casos: si el grupo fuere tan numeroso que la acumulación de todos los miembros resultare impracticable; si existieren cuestiones de hecho o de derecho común al grupo; si las pretensiones de los representantes fueren típicas de las reclamaciones de la clase; si las reclamaciones, de tratarse separadamente, fueren susceptibles de sentencia, incongruentes y divergentes; si las reclamaciones, de tratarse individualmente, resultaren ilusorias;

3. El tribunal, al acoger la demanda, la fijará en lista y publicará edicto por cinco (5) días consecutivos en un diario de reconocida circulación nacional, para que, en el término de diez (10) días, contados a partir de su última publicación, el demandante y todas las personas pertenecientes al grupo comparezcan a hacer valer sus derechos, a formular argumentos o a participar en el proceso. Una vez surtido su trámite, se procederá a la notificación de la demanda;

5. Mediante la presentación de poderes al tribunal, a favor del abogado que promovió la demanda, o de un apoderado de su elección, el interviniste se adhiere a la demanda, asumiendo con ello la obligación de cubrir los honorarios correspondientes, conforme lo señale el juez, que se pagarán de acuerdo con la cuantía de la condena;

6. La sentencia afectará a todos los demandantes que pertenezcan a dicho grupo, aunque no hayan intervenido en el proceso;

7. Las partes que no hubieren comparecido como terceros, podrán formular sus reclamaciones en la fase de ejecución, mediante el procedimiento de liquidación previsto en los artículos 983, 984 y 985 del Código Judicial, y obtener la indemnización correspondiente;

247. Ley 29, de 1 de Febrero de 1996, art. 172 (Pan.).

Panama. Judicial Code (amended in 2008)[248]

1421-I. Si hubiera un gran número de actores o demandados, el tribunal podrá consolidar las acciones utilizado su discreción en implementar medidas prácticas para que el caso se desarrolle con rapidez, dentro de los límites del debido proceso. La prueba que sea común a las partes podrá producirse una sola vez, para evitar repeticiones inútiles.

En estos procesos podrán intervenir terceros coadyuvantes por hechos ocurridos en el extranjero, que guarden conexión con los hechos o las partes en la demanda instaurada en Panamá, aunque los efectos de aquellos hechos no se hubieran producido en Panamá.

Cuando se lesionen derechos subjetivos individuales, provenientes de origen común y tengan como titulares a los miembros de un grupo, categoría o clase, los afectados, los colectivos de afectados o las organizaciones no gubernamentales constituidos para la defensa de derecho colectivos estarán legitimados para promover la acción en defensa de los derechos individuales homogéneos.

Peru. Code of Civil Procedure (enacted 1995, amended 2002)[249]

Artículo 82. Patrocinio de intereses difusos. Interés difuso es aquel cuya titularidad corresponde a un conjunto indeterminado de personas, respecto de bienes de inestimable valor patrimonial, tales como el medio ambiente o el patrimonio cultural o histórico o del consumidor.

Pueden promover o intervenir en este proceso, el Ministerio Público, los Gobiernos Regionales, los Gobiernos Locales, las Comunidades Campesinas y/o las Comunidades Nativas en cuya jurisdicción se produjo el daño ambiental o al patrimonio cultural y las asociaciones o instituciones sin fines de lucro que según la Ley y criterio del Juez, este último por resolución debidamente motivada, estén legitimadas para ello.

En estos casos, una síntesis de la demanda será publicada en el Diario Oficial El Peruano o en otro que publique los avisos judiciales del correspondiente distrito judicial. Son aplicables a los procesos sobre intereses difusos, las normas sobre acumulación subjetiva de pretensiones en lo que sea pertinente.

En caso que la sentencia no ampare la demanda, será elevada en consulta a la Corte Superior. La sentencia definitiva que declare fundada la demanda, será obligatoria además para quienes no hayan participado del proceso.

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248. Ley 32, de 1 de Agosto de 2006, art. 1421-I (Pan.).

249. CÓD. PROC. CIV., Law No. 10 de 1 de agosto de 1993, art. 82.6 (Peru).

La indemnización que se establezca en la sentencia, deberá ser entregada a las Municipalidades Distrital o Provincial que hubieran intervenido en el proceso, a fin de que la emplee en la reparación del daño ocasionado o la conservación del medio ambiente de su circunscripción.

Uruguay. General Code of Procedure (enacted 1998)[250]

Artículo 220. Efectos de la cosa juzgada en procesos promovidos en representación de intereses difusos. La sentencia dictada en procesos promovidos en defensa de intereses difusos (artículo 42) tendrá eficacia general, salvo si fuere absolutoria por ausencia de pruebas, en cuyo caso, otro legitimado podrá volver a plantear la cuestión en otro proceso.

Venezuela. Consumer Protection Law[251]

Artículo 80. Acciones individuales o colectivas. La defensa de los derechos establecidos en esta Ley podrá ser ejercida tanto a título individual como colectivo. Podrá ser ejercida colectivamente cuando se encuentren involucrados intereses o derechos colectivos o difusos.

El reclamo administrativo de indemnización por parte de todos los representados colectivamente podrá negociarse también de manera colectiva o individual, según sean los intereses de los representados.

250. CÓDIGO GENERAL DEL PROCESO, art. 220 (1998) (Uru.).

251. Ley No. 37.930 de Protección al consumidor y al usuario, de 4 de mayo de 2004, art. 80 (Venez.).

SECURITIES LITIGATION AND ENFORCEMENT: THE CANADIAN PERSPECTIVE

Poonam Puri[·]

INTRODUCTION

Achieving the proper balance between public and private securities enforcement is critical for promoting investor confidence and robust capital markets. There has been extensive research to determine whether public or private enforcement provides more effective market discipline and investor protection. These studies generally approach the question in terms of efficiency, accountability, ability to provide comprehensive market discipline, deterrence, and the best interests of the public. As a result, the traditional debate pits public and private enforcement against each other in an attempt to suggest that one offers an all-around superior approach.[1] This Article suggests that public and private enforcement each serve important and complimentary roles in protecting the interests of the investing public. Thus, it cannot be said that one is necessarily more important or capable than the other, rather that they should be understood as part of a unitary regime.

Although a comparative approach is used, the primary focus of this article is how recent legislative changes and market events have influenced the Canadian securities landscape. In doing so, this Article contributes to the ongoing debate on public and private enforcement by evaluating securities enforcement from a systemic perspective, focusing on the relationship between public and private enforcement and synergies that exist in the Canadian environment. This analysis of recent trends and literature on securities enforcement in Canada highlights the interrelationship between public and private enforcement in Canada and supports the con-

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· LL.B. (University of Toronto), LL.M. (Harvard). Associate Dean (Research, Graduate Studies & Institutional Relations) Osgoode Hall Law School, and Co-Director, Hennick Centre for Business and Law, York University. Thanks are acknowledged to Sarika Chhabra, Andrew Nichol, and Arkady McCourt for their excellent research assistance. This Article was prepared following my participation in Brooklyn Law School's symposium on Globalization of U.S. Securities Law. My presentation discussed the influence of the U.S. enforcement system on Canada's approach to public and private securities regulation and is current as of April 2012.

1. *See* Rafael La Porta et al., *Investor Protection: Origins, Consequences, Reform* 5–6 (World Bank Fin. Sector, Discussion Paper No. 1, 1999), *available at* http://www1.worldbank.org/finance/assets/images/Fs01_web1.pdf; Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207, 207–08 (2009).

clusion that any legislative changes must consider the securities regulatory framework as a whole as opposed to affecting changes on a piecemeal basis.

Part I of this Article begins with an overview of Canadian capital markets in comparison to those in the United States. This Part highlights the disproportionately high number of reporting issuers in Canada given the size of Canadian capital markets, the difficulties inherent in Canada's provincially regulated securities environment, and the traditionally more conservative behavior of Canadian regulators in respect of enforcement.

Part II discusses public enforcement in Canada and the traditional criticism that Canadian regulators are less aggressive than their American counterparts. However, examination of this claim suggests that these distinctions are primarily due to Canada's differing philosophical approach to securities regulation relative to the United States, rather than a reduced capacity. Also considered in Part II are three recent developments in Canadian securities regulation. First, there is the introduction of no-contest settlements in Ontario. Unlike securities regulators in the United States, Canadian regulators historically do not allow no-contest settlements. However, in late 2011, the Ontario Securities Commission ("OSC") began public consultations to allow this form of settlement.[2] Second, is the public regulators' initiative to provide compensation to investors. The OSC decided to provide investors with the proceeds from large public settlements following the asset-backed commercial paper ("ABCP") crisis in 2007[3] as well as settlements from the 1999–2003 Canadian mutual funds market timing scandal.[4] Although these changes are positive developments for Canadian securities regulation and provide a dynamic balance between public and private enforcement, regulators should establish clear policies to ensure that investors' expectations are protected. This Part of the Article concludes with a discussion of Canada's effort to introduce a national securities regulator and the options available follow-

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2. *OSC Staff Notice 15-704 Request For Comments on Proposed Enforcement Initiatives*, 34 O.S.C. BULL. 10720, 10720–26 (2011) [hereinafter *OSC Staff Notice 15-704*], *available at* http://www.osc.gov.on.ca/documents/en/Securities-OSCB/oscb_20111021_3442.pdf.

3. Notice of Application, *In re* Ont. Sec. Comm'n & Inv. Indus. Regulatory Ass'n of Can. & *In re* Declaration Concerning the Interpretation of the Order of June 5, 2008 by the Honourable C. Campbell J. Approving the Plan of Compromise and Arrangement Involving Metcalfe & Mansfield Alternative Investments Corp et al., Toronto CV 12-9606-OOCL (Ont. Sup. Ct., Feb. 15, 2012) (Can.), *available at* http://www.osc.gov.on.ca/documents/en/News/nr_20120216_osc-irroc-notice-application.pdf.

4. Settlement Agreement, *In re* Sec. Act R.S.O. 1990, c.S.5, as amended & AGF Funds Inc., OSC PROC. (Dec. 12, 2004).

ing a recent decision by the Supreme Court of Canada that the federal government lacks jurisdiction to establish a national securities regulator.

Finally, Part III reviews the development of private enforcement in Canada. Unlike private enforcement in the United States, Canada's private enforcement regime is a relatively recent development. Class action legislation was introduced in 1993 and secondary market statutory liability came into force in 2005.[5] Another factor distinguishing Canada from the United States is the Canadian cap on secondary market statutory liability. Canada's private enforcement regime is less developed than the United States. The reduced amount of litigation in Canada is partially attributable to the balance between public regulation and private enforcement, as demonstrated by the court's sanctioned release from private liability in the ABCP crisis in 2007.[6] Part III concludes with a review of Canada's class action regime and the growing number of global class actions certified in Canada. Although Canada's private enforcement regime is less litigious than the U.S. regime, this appears to be changing now that Canadian securities legislation makes it easier for plaintiffs to bring private actions and the securities class action bar is becoming more developed.

I. CANADIAN CONTEXT

Canadian capital markets are closely integrated with the United States and have generally followed its lead on major legislative reforms. This Part provides a brief context on the structure of and development of Canadian capital markets, reviews the tendency for Canadian regulators to follow the lead of the United States, and finally, introduces challenges that exist in Canada's provincially regulated securities environment.

A. The Nature of Canadian Capital Markets

First, Canadian capital markets are relatively small in relation to international equity markets. As of 2004, the size of Canadian markets was approximately CAD $1.178 trillion, comprising about 3.2% of worldwide market capitalization.[7] In stark comparison, the combined market

5. Class Proceedings Act, S.O. 1992, c. 6 (Can.); Ont. Bill 198, An Act to implement Budget measures and other initiatives of the Government, 4th Sess., 37th Parl., § 185 (2005) (Can.).

6. Pan-Canadian Investors Comm. for Third-Party Structured Asset-Backed Commercial Paper v. Metcalfe & Mansfield Alternative Investments II Corp., 2008 CanLII 23497 (Can. Ont. Sup. Ct. J.) [hereinafter Metcalfe & Mansfield].

7. Christopher Nicholls, *The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to Sarbanes-Oxley*, *in* 4

capitalization of the New York Stock Exchange ("NYSE"), the American Stock Exchange, and the NASDAQ Stock Market was approximately 43.9%.[8] While Canada's total market capitalization is not very large, it hosts a disproportionately large number of public companies, meaning there are a high number of smaller companies. In 2004, there were approximately 3,500–4,000 public companies;[9] a large number when compared to the 9,400 public companies in the United States at that time.[10] In fact, at this time, Canada appeared to have more public companies per capita.[11] Another important feature of the Canadian public company landscape is that it has a relatively small number of very large issuers. For example, the 100 largest companies on the Toronto Stock Exchange ("TSX") account for over 70% of the market capitalization of all TSX-listed companies.[12] By contrast, the 1,000 smallest issuers on the TSX account for less than 5% of its total market capitalization.[13] There is a disparity between the United States and Canada's perspectives as to what characteristics define a "small" or "large" company, with Canada's small issuers being significantly smaller than those in the United States.[14] This results in a bifurcation in Canada's issuer base, which might suggest that Canada needs, in some instances, different policies and enforcement strategies to accommodate for the unique range of issuers.[15] Also, this data suggests that some Canadian public companies go public too early, that the venture capital market is underdeveloped, and that there are opportunities for consolidation.[16]

Another important feature of Canada's capital market landscape is that many of the largest issuers, representing over 50% of the TSX's market capitalization, are cross-listed on American exchanges.[17] Data shows that

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CANADA STEPS UP 129, 149 (June 15, 2006), *available at* http://www.tfmsl.ca/docs/V4%283A%29%20Nicholls.pdf.

8. *Id.* at 149.

9. *Id.*

10. *Id.* at 153.

11. *Id.*

12. *Id.* at 154.

13. *Id.*

14. *Id.* at 162.

15. *See generally id.* (suggesting that the "lighter" regulations set up for small-cap companies in the U.S. could still "prove overly burdensome" for the even smaller small-cap companies in Canada).

16. *See id.* at 157. Nicholls suggests that this information is at least evident of the fact that less consolidation of firms occurs in Canada than in the United States and that companies in Canada are going public at an earlier stage—from 1995–2005, over half of the companies that made initial public offerings in Canada had market caps of less than $100 million and less than 5% had market caps of over $500 million.

17. *Id.* at 158.

eighty-six issuers on the TSX were also listed on the New York Stock Exchange ("NYSE"), with fifty-one of the largest issuers falling into this category.[18] NASDAQ's exchanges feature fifty-one TSX-listed issuers.[19] Practically speaking, cross-listed companies are subject to the rules and regulations of both Canada and the United States, with possible enforcement oversight by both the U.S. Securities and Exchange Commission ("SEC") and Canadian securities regulators.[20] This "double oversight" causes concerns about the potential confusion in accountability between Canadian and U.S. regulators and duplication of regulatory actions, and raises the broader question of whether both jurisdictions should be involved in enforcement activities. Indeed, some suggest that Canada should maintain its focus on Canadian-only companies and leave the oversight of enforcement activities for cross-listed issuers to the SEC.[21] If this suggestion were followed however, many of the larger issuers in Canada would be excluded from Canadian oversight, even though a significant number of their investors would likely be Canadian. From a policy perspective, the independence and autonomy of Canadian regulators would also be greatly undermined.

The Canadian exchanges are often associated with various categories of listed public companies including the natural resource industry. In 2004, Canadian exchanges were most active in mining, oil and gas, manufacturing, technology, and financial services.[22] Today, the TMX Group, which is the umbrella organization for the TSX and the Toronto Stock Venture Exchange, notes that these two exchanges list the highest number of oil and gas companies than any other exchange in the world.[23]

An important feature of the Canadian corporate governance landscape is that Canadian public companies are allowed to maintain a dual-class share structure. This structure enables companies to issue multiple classes of shares with differential voting rights attached to the shares and

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18. *Id.*

19. *Id.*

20. ONT. SEC. COMM'N [O.S.C.], NATIONAL INSTRUMENT 71-101 TRANSACTIONS OUTSIDE THE JURISDICTION (1999).

21. Warren Grover, Q.C., Blake, Cassels & Graydon LLP, Falconbridge Lecture in Commercial Law at Osgoode Hall Law School: Corporate Governance of Greed 18 (Oct. 7, 2004), *transcript available at* http://osgoode.yorku.ca/media2.nsf/events/612468A480B1787885256F2C006DEAAB.

22. Nicholls, *supra* note 7, at 164.

23. *See Energy, Oil & Gas*, TMXMONEY, http://www.tmxmoney.com/en/sector_profiles/energy.html (last updated Feb. 24, 2012).

often rests significant control in the hands of few people.[24] In these situations, minority (by votes) shareholders may be less able to exercise influence, and thus, shareholder approval may not always be demonstrative of appropriate governance practices.[25] Dual-class share structures are more common in Canada than in the United States.[26] Any discussion of corporate governance must proceed with the understanding that the challenge is not only to ensure that professional managers act in the best interests of the organization, its shareholders, and stakeholders, but also to implement practices that minimize the ability of controlling shareholders to extract private benefits for their advantage and to the detriment of public shareholders.[27]

B. Geographic and Other Proximities to the United States

The United States has an undeniable influence on Canadian capital markets and securities regulation. While the Canadian and U.S. regimes are quite different, there is no doubt that geographical proximity and cultural, political, economic, and legal developments in the United States impact Canadian practices. First and most obviously, the geographic proximity of the United States and the size of its markets make American legislation relevant to Canadian companies that are cross-listed on U.S. exchanges and to companies that plan to be in the future.[28] Second, the proximity and resulting similarities in terms of cultural, political, and economic norms have created interdependencies between the two jurisdictions with regard to trading and many other facets of business. While Canadian autonomy will always be a concern, the reality in the securities industry is that the relative sizes of the Canadian and U.S. markets alone will significantly influence how autonomous Canada can truly be.[29]

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24. Anita Anand, Frank Milne & Lynnette Purda, *Voluntary Adoption of Corporate Governance Mechanisms* 13 (Queen's Univ. Econs. Dept., Working Paper No. 1112, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=921450.

25. Anita Anand, *Towards Effective Balance Between Investors and Issuers in Securities Regulation*, *in* 3 CANADA STEPS UP 25 (Aug. 1, 2006), *available at* http://www.tfmsl.ca/docs/v3%281%29%20anand.pdf.

26. Houlihan Lokey, *Dual Class Stock Structures*, AM. BAR ASSOC. 1 (Aug. 2011), http://www2.americanbar.org/calendar/2011-aba-annual-meeting-business-law/Meeting%20Materials/1986.pdf. Companies are not allowed to adopt dual-class structures once they have been registered on the NYSE. *Id.*

27. Stephanie Ben-Ishai & Poonam Puri, *Dual Class Shares in Canada: An Historical Analysis*, 29 DALHOUSIE L.J. 117, 126–32 (2006).

28. Anand, *supra* note 25, at 42.

29. *See* Nicholls, *supra* note 7, at 149 (Canada has approximately 3.2% of worldwide market capitalization).

An example of the convergence to U.S. policies and practices is Canada's adoption of new, stricter corporate governance rules following the enactment of the Sarbanes-Oxley Act of 2002 ("SOX").[30] In response to the various corporate scandals making their way through North America, the United States enacted the SOX legislation to tighten up their corporate governance rules and address issues such as accounting fraud and top-level mismanagement.[31] Following this development, Canada faced pressure to adopt similar changes and in 2004 implemented National Instrument 58-101,[32] National Policy 58-201,[33] and National Instrument 52-110,[34] all of which addressed the need for stricter corporate governance guidelines.[35] Regardless of whether this new legislation in the United States was adopted by Canadian regulators, many Canadian companies were forced to comply with the SOX requirements given the high proportion of companies cross-listed on U.S. exchanges. From this perspective, U.S. rules and legislation became just as relevant as Canadian laws.[36] Additionally, Canadian corporate governance policy may converge with U.S. rules and regulations even when they are only listed in Canada because of global competition. Specifically, Canadian companies may feel pressure to adopt U.S. guidelines to match what many of their competitors have already done.[37]

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30. *See generally* Tara Gray, Econ. Div., Canadian Response to the U.S. Sarbanes-Oxley Act of 2002: New Directions for Corporate Governance, PRB 05–37E (2005) (Can.).

31. Erinn B. Broshko & Kai Li, *Corporate Governance Requirements in Canada and the United States: A Legal Empirical Comparison of the Principles-Based and Rules-Based Approaches* 1 (Sauder Sch. of Bus. Working Paper, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892708##; *see also* Poonam Puri & Anindya Sen, *A Cost Benefit Analysis of the Multi-Jurisdictional Disclosure System*, OSGOOD HALL L. SCH. 19–20 (June 10, 2003), http://osgoode.yorku.ca/osgmedia.nsf/0/1D216EBEABA2FCFA852571CC00596068/$FILE/Cost_Benefit_MJDS.pdf.

32. O.S.C., NATIONAL INSTRUMENT 58-201 DISCLOSURE OF CORPORATE GOVERNANCE PRACTICES (2008).

33. O.S.C., NATIONAL INSTRUMENT 58-201 CORPORATE GOVERNANCE GUIDELINES (2005), *available at* http://www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20050617_58-201_corp-gov-guidelines.pdf.

34. O.S.C., MULTILATERAL INSTRUMENT 52-110 AUDIT COMMITTEES (2011).

35. Broshko & Li, *supra* note 31, at 1; *see also* POONAM PURI, CAPITAL MARKETS INSTITUTE, ENFORCEMENT EFFECTIVENESS IN CANADIAN CAPITAL MARKETS 6–7 (Dec. 1, 2005) [hereinafter PURI, ENFORCEMENT EFFECTIVENESS], *available at* http://www.investorvoice.ca/Research/Puri_Enforcement_Effectiveness_01Dec05.pdf.

36. Anand, *supra* note 25, at 44.

37. *Id.*

Most importantly, the proximity and similarity to the larger, and arguably more sophisticated, U.S. market has prompted criticism of Canada's comparatively lax securities enforcement efforts.[38] While there are many factors to consider when evaluating the comparative effectiveness of the two regimes, including the types of remedies available to regulators and the timing of the development of each regime, many assert the relative effectiveness of the U.S. regime over the Canadian one.[39] One reason for this perception that the United States is a more effective enforcer is the SEC's aggressive pursuit of high-profile cases. The Hollinger scandal provides a good example. Conrad Black was removed as the Chairman of Hollinger in January 2004 and was aggressively investigated by the SEC thereafter, resulting in a civil fraud lawsuit in November of that year.[40] It was not until March of 2005 that the OSC launched proceedings against Black and Hollinger Inc.[41] In 2004, after mounting pressure in the face of the SEC's swift pursuit, the OSC was forced to depart from standard practice and announced that an investigation into the activities surrounding the alleged fraud was, in fact, under way.[42] Addressing the difference between the OSC and SEC pursuit of the matter, former Premier of Ontario Bob Rae stated, "For me, the hardest part about the Conrad Black trial has been explaining why it happened in Chicago and not Toronto."[43]

As mentioned above, the convergence toward U.S. policies is a discernable trend, and will be further discussed below in the context of a

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38. *See, e.g.*, Peder de Carteret Cory & Marilyn L. Pilkington, *Critical Issues in Enforcement*, *in* 6 CANADA STEPS UP 167, 196–97 (Sept. 2006), *available at* http://www.investorvoice.ca/Research/CanadaStepsUp_Critical_Issues_Sept06.pdf; PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 4.

39. A more in depth discussion takes place in the following section on Public Enforcement in Canada. *See infra* Part II.

40. Press Release, U.S. Sec. & Exch. Comm. [S.E.C.], SEC Files Fraud Charges against Conrad Black, F. David Radler and Hollinger Inc. (Nov. 15, 2004) [hereinafter SEC Press Release], *available at* http://www.sec.gov/news/press/2004-155.htm; *see also OSC Launches Proceedings Against Black, Hollinger Inc.*, CBC NEWS (Mar. 18, 2005, 8:56 PM), http://www.cbc.ca/news/canada/story/2005/03/18/oscblack-050318.html [hereinafter CBC NEWS].

41. Statement of Allegations of Staff of the O.S.C. at 1, *In re* Sec. Act R.S.O. 1990, c. S.5, & Hollinger Inc., OSC PROC. (Mar. 18, 2005) (Can.) [hereinafter *Hollinger*], *available at* http://www.osc.gov.on.ca/documents/en/Proceedings-SOA/soa_20050318_hollinger-inc.pdf.

42. *OSC Says Hollinger Investigation Underway*, OTTAWA BUS. J. (Jan. 22, 2004), http://www.obj.ca/Other/Archives/2004-01-22/article-2129056/OSC-says-Hollinger-investigation-underway/1.

43. Tyler Hamilton, *Why the OSC so rarely gets its man*, TORONTO STAR (Dec. 1, 2007), http://www.thestar.com/printArticle/281645.

very recent proposal by the OSC, which, if implemented, will have a considerable impact on the ease and frequency with which settlements can be reached in Canada.

C. Provincial and Territorial System of Securities Regulation

As alluded to earlier, the structures of the Canadian and U.S. regulatory regimes are quite different. To start, while the United States has one national regulator governing the activities of capital markets and state regulators addressing local needs, Canada employs regulators only at the provincial and territorial level.[44] As a result, the securities regulation landscape is divided into thirteen jurisdictions. Many commentators have suggested that the current regulatory structure in Canada may increase noncompliance and impose unnecessary costs on investors and market participants. The number of regulators combined with criminal enforcement efforts and self-regulatory organizations ("SROs") increases the need for coordination and cooperation, and may cause jurisdictional overlap and accountability issues.[45]

Variations in remedies and underlying policies across regulators also raise the question of whether a more centralized body is needed to regulate Canada's capital markets.[46] Currently, the Canadian Securities Administrators ("CSA") undertakes coordination efforts across provinces and territories, and aligns policy goals across jurisdictions.[47] The CSA is also tasked with releasing annual reports to communicate relevant information regarding enforcement and sanctions to the public.[48]

Securities experts in Canada have been deliberating over the transition to a national regulator for approximately forty years, with no success to date. [49] Various expert panels and task forces have been established to explore the issue and what such a shift would mean for the future of securities regulation in Canada.[50] Indeed, the move towards a national

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44. Constitution Act, 1867, 30 & 31 Vict., c. 3, § 92(13) (U.K.), *reprinted in* R.S.C. 1985, app. II, no. 5 (Can.).

45. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 9.

46. *Id.* at 21–22.

47. *See generally* CANADIAN SEC. ADM'RS, http://www.securities-administrators.ca/aboutcsa.aspx?id=77 (last visited Apr. 9, 2012) (the Canadian Securities Administrators are comprised of regulators from each province and territory in Canada and are "primarily responsible for developing a harmonized approach to securities regulation across [Canada]").

48. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 23.

49. Poonam Puri, *Legal Origins, Investor Protection, and Canada*, 2009 BYU L. REV. 1671, 1688 [hereinafter Puri, *Legal Origins*].

50. For example, the Task Force to Modernize Securities Legislation was established in 2005 in order to make recommendations for modernizing Canadian legislation to in-

regulator may be seen as another choice by Canada to converge to the U.S. approach. Some would argue that Canada is closer than ever to making this proposition a reality.

The latest attempt to establish a national regulator resulted in the creation of the Canadian Securities Transition Office as of June 2009, as per the report and recommendations of the Expert Panel on Securities Regulation.[51] Further, a proposed federal securities act was tabled in the House of Commons on May 26, 2010 and referred to the Supreme Court of Canada for a reference decision on whether the federal government had jurisdiction to introduce this legislation.[52] The initiative has received pushback from some Canadian provinces, notably Quebec and Alberta, which have questioned the constitutionality of the proposed legislation, citing an infringement of the federal government on provincial powers.[53] Reference hearings took place in April 2011, and the Supreme Court rendered its decision in December 2011, holding that the federal government lacks the jurisdiction to unilaterally create a national securities regulator.[54] Accordingly, a deeper look at the current structure of the Canadian capital market regime and some of the proposed changes to it are discussed in Part II below.

D. Canada Comes Out of the Global Financial Crisis Unscathed, or Not?

Amidst the economic turbulence that the world has experienced since 2008, Canada is perceived to have a safe and stable regulatory system and a conservative banking industry.[55] Indeed, the *Washington Post* writes that, "While the United States reels from the global financial crisis, with credit markets still frozen and stock prices careening from highs

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crease Canada's competitiveness and maintain investor protection. *See* Paul Halpern & Poonam Puri, *"Canada Steps Up"—Task Force to Modernize Securities Legislation in Canada: Recommendations and Discussion*, 2 CAPITAL MARKETS L.J. 191 (2007).

51. Puri, *Legal Origins*, *supra* note 49, at 1693; *see* CAN. SEC. TRANSITION OFF., http://csto.ca (last visited Apr. 9, 2012).

52. Reference re Securities Act, 2011 SCC 66, ¶ 134 (Can.), *available at* http://scc.lexum.org/en/2011/2011scc66/2011scc66.pdf.

53. Nigel Campbell & Doug McLeod, *Supreme Court Hears Arguments on National Securities Regulator*, BLAKES BULL. (Apr. 20, 2011), http://www.blakes.com/english/view_bulletin.asp?ID=4714.

54. *Re Securities Act*, 2011 SCC 66, ¶ 134 (Can.).

55. Caroline Hepker, *G20: Why we all want to be Canadian now*, BBC NEWS (June 25, 2010), http://www.bbc.co.uk/news/10409354.

to lows, Canada has remained relatively insulated."[56] In 2010, the World Economic Forum touted Canada as having the soundest banking system in the world for the third consecutive year.[57] On this achievement, Finance Minister Jim Flaherty commented that the stability of Canada's financial sector "is the result of a sound regulatory regime, including capital requirements for financial institutions that are well above minimum international standards and higher than in many other jurisdictions, and a more conservative risk appetite among financial institutions."[58] He also emphasized, however, that regulation is not enough to maintain a safe financial environment—effective supervision is also essential.[59] The Canadian market is seen to be so stable that Mark Carney, Governor of the Bank of Canada, was appointed chairman of the Financial Stability Board on November 4, 2011, most likely due to "Canada's global reputation for strong financial services regulation, and the strength of Canada's banks."[60]

This perception that Canada's stable regulatory environment allowed it to escape the catastrophic effects of the credit crisis serves as a direct contradiction to the criticism that Canada's fragmented regulatory regime is inadequate for the challenges faced by financial markets. The fact remains that Canada *did* face a crisis, albeit smaller in scale than the rest of the world. Following the subprime crisis in the United States, Canadian holders of commercial paper questioned the value of the assets behind their paper and, to protect themselves, discontinued investing in the ABCP market; the result being that conduits were not able to pay out maturing ABCP.[61]

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56. Keith B. Richburg, *Worldwide Financial Crisis Largely Bypasses Canada*, WASH. POST (Oct. 16, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/10/15/AR2008101503321.html.

57. Press Release, Dep't Fin. Can., World Economic Forum Ranks Canadian Banks Soundest in the World for the Third Consecutive Year (Sept. 9, 2010), *available at* http://www.fin.gc.ca/n10/10-078-eng.asp.

58. *Id.*

59. *Id.* Although a full discussion of this issue is beyond the scope of this Article, it should be noted that Canada's ability to escape relatively unscathed can be attributed to Canada's use of a non-risk adjusted leverage ratio in addition to the Basel II's requirements on Tier I capital, the high degree of concentration in Canada's financial system, and the risk-averse culture in the Canadian banking industry For more information see Puri, *Legal Origins*, *supra* note 49.

60. Eric Reguly, *Carney Takes Reins of Global Banking Watchdog*, GLOBE & MAIL, Nov. 3, 2011, at B1, *available at* http://www.ctv.ca/generic/generated/static/business/article2225184.html.

61. Leanne Williams, *ABCP Crisis: The Canadian Solution*, 5 ECONOMISTS' OUTLOOK 370, 370 (2008), *available at* http://www.tgf.ca/Libraries/Publications/ABCP_Crisis_The_Canadian_Solution.sflb.ashx.

In 2007, $32 billion of third-party sponsored ABCP was frozen because of the inability of the issuers to rollover maturing notes.[62] After meeting in August 2007, key market players entered what has become known as the "Montreal Accord." The agreement froze the market while a long-term solution was developed.[63] A successful restructuring of the markets followed, using the Companies' Creditors Arrangement Act.[64] Third party releases were also included in the restructuring plan, which largely eliminated private litigation, though actions for fraud could still be pursued.[65] The solution reached had implications for both public and private enforcement. As will be explored in both Part II and III, compared to the United States, Canada saw very few securities class action cases related to the credit crisis. The implementation of a plan that addressed issues in both the public and private realms allowed for the building of a long-term plan, the avoidance of frivolous litigation, and for the focus to be placed on the recovery of the financial markets, rather than individual claims.

II. PUBLIC ENFORCEMENT

Public enforcement in the Canadian securities markets is the primary responsibility of provincial regulators, with the federal government's involvement limited to investigating and prosecuting criminal offenses. This disjointed approach to securities regulation in Canada offers a stark contrast to the United States, which nationally administers securities regulation through the SEC. Unlike the United States, which has pursued numerous, highly publicized securities enforcement cases, Canadian regulators are frequently criticized for being too passive in their enforcement activities.[66] However, this Article contends that public enforcement in Canada is robust and provides effective protection for participants in Canadian capital markets even though its capacity is limited by the fragmentation and duplication of enforcement resources across thirteen independent securities regulators.

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62. John Chant, *The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets*, EXPERT PANEL ON SEC. REG. 18–24, http://www.expertpanel.ca/documents/research-studies/The%20ABCP%20Crisis%20in%20Canada%20-%20Chant.English.pdf (last visited Apr. 9, 2012).

63. Williams, *supra* note 61, at 371.

64. Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 (Can.). The Act is structured similar to Chapter 11 in the United States.

65. Williams, *supra* note 61.

66. Cory & Pilkington, *supra* note 38, at 186–88, 201.

This Part examines the effectiveness of public securities regulation in Canada by evaluating the regulatory framework and recent enforcement data from the CSA, and comparing the funding for securities enforcement in Canada and the United States. This Part will also consider the OSC's recent decision to introduce no-contest settlement funds in Ontario and distribute public settlements to investors for their losses in the 2007 ABCP crisis, as well as the market timing scandal in the Canadian mutual funds industry from 1999–2003.[67] These decisions are evaluated to assess how they impact the balance between public and private enforcement in Ontario. Finally, the Part concludes with a discussion of Canada's recent attempt to create a national securities regulator and identifies options following the Supreme Court's ruling that the federal government lacks jurisdiction to create a national regulator without the consent of the provinces. The options to be discussed given this ruling, are to continue with provincially regulated securities markets; to introduce a national regulator that focuses on systemic risk; or to encourage the provincial and federal cooperation in the development of a single securities regulator.

A. The Effectiveness of Public Securities Regulation in Canada

1. The Effectiveness of Canadian Securities Regulation

Canadian securities regulators conventionally assume a low profile in their securities enforcement activities and emphasize deterrence over punitive sanctions. This has fostered a belief that "enforcement in Canada is lax in comparison to the United States,"[68] and consequently is less effective.[69] Specifically, provincial regulators have been unwilling or unable to optimally exercise the quasi-criminal powers available to them, possibly because of institutional and financial constraints. Fines and other civil sanctions are used infrequently and tend to be far less than the damages sustained by investors.[70] However, regulators have recently begun exploring alternative approaches, such as no-contest settlements as well as regulatory fines, to provide partial compensation for losses suffered by investors.[71] Although these strategies will certainly assist regulators in maximizing the utility of their scarce resources, more effective

67. Settlement Agreement, *In re* Sec. Act R.S.O. 1990, c.S.5, as amended & AGF Funds Inc., OSC PROC. (Dec.12, 2004).

68. MICHAEL E.J. PHELPS ET AL., DEP'T FIN. CAN., IT'S TIME 7 (Dec. 2003) [hereinafter IT'S TIME], *available at* http://www.wise-averties.ca/reports/WPC%20Final.pdf.

69. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 24.

70. Cory & Pilkington, *supra* note 38, at 228.

71. *OSC Staff Notice 15-704*, *supra* note 2.

cooperation between federal and provincial regulators would help reduce duplicative costs. Further, the continued development of private enforcement mechanisms would help ensure that investors are adequately protected and compensated for losses.

Securities regulation in Canada is modeled on a regulatory pyramid that places significant resources on proactive compliance and strategically allocates resources in areas, such as enforcement, to deter improper conduct. A primary challenge for regulators is the large number of public companies per capita in Canada. Canada has almost half as many publicly traded companies as the United States, but a market capitalization ten times smaller than the United States.[72] The difficulties inherent in effectively monitoring and sanctioning smaller issuers perpetuate the tendency of securities regulators to focus on proactive regulation to the detriment of their public enforcement mandate. However, the effective use of a pyramid approach to regulate still requires the use of fines and other more aggressive penalties, like quasi-criminal sanctions, in order to provide effective deterrence.[73]

Canadian securities regulators are not as aggressive as their American counterparts in enforcing violations against high profile individuals or seeking highly punitive penalties to deter to illegal conduct.[74] However, as noted by Justice Peter de Cory and Professor Marilyn Pilkington, focusing narrowly on the number or value of penalties does not disclose whether the right matters are being prosecuted, nor will it identify institutional barriers to effective securities enforcement.[75] Under this pyramid approach to securities regulation, fines and other administrative sanctions should provide the basis for the securities commission's enforcement activities. Jurisdictional barriers and the large number of public issuers in Canada present challenges for administrative enforcement. In their report to the Task Force to Modernize Securities Legislation in Canada, Cory and Pilkington found that the fines levied by the securities commissions were minimal and only accounted for a small portion of the investors' total losses.[76]

Unlike other regulatory contexts where regulators often have comparable or greater resources than the parties being regulated, provincial securities commissions usually have far smaller annual budgets than the par-

72. Nicholls, *supra* note 7, at 149.
73. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 9.
74. *See, e.g.*, SEC Press Release, *supra* note 40; CBC NEWS, *supra* note 40.
75. Cory & Pilkington, *supra* note 38, at 188.
76. *Id.* at 228.

ties they regulate.[77] In part to maximize the securities commissions' limited resources, securities commissions recognized SROs to provide an additional layer of regulatory oversight. In Canada, the three most important SROs are the Investment Industry Regulatory Organization of Canada ("IIROC"),[78] the Mutual Fund Dealers Association of Canada,[79] and the Chambre de la Sécurité Financière,[80] IIROC resulted from the consolidation of the Investment Dealers Association of Canada ("IDA") and Market Regulation Services Inc., which occurred in 2008.

Again differing from the United States, Canadian securities regulators and SROs conventionally insist that parties accept liability as a condition of settlement.[81] This principle greatly increases the time, human resources, and amount of money that regulators must devote to a particular file. Consequently, regulators resort to risk-based enforcement. In determining whether to pursue a matter, the OSC considers the degree of harm to the integrity of capital markets and the amount of resources required to pursue the case to a successful resolution.[82] Therefore, to maximize the impact of their enforcement activities and provide the greatest deterrent effect, regulators may be inclined to pursue higher profile targets to the exclusion of smaller issuers.[83]

Over the past ten years, there has been a move to strengthen criminal and quasi-criminal legislation governing capital market offenses by increasing maximum sentences and adding a list of aggravating factors

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77. O.S.C., 2011 OSC ANNUAL REPORT 37 (2011), *available at* http://www.osc.gov.on.ca/static/_/AnnualReports/2011/pdf/OSC_AR2011_Full_ENG.pdf. The Ontario Securities Commission had an operating budget of $84 million in 2011. *Id.* at 47.

78. *See* INV. INDUS. REG. ORG. OF CAN., http://www.iiroc.ca (last visited Apr. 10, 2012).

79. *See* MUT. FUND DEALERS ASS'N OF CAN., http://www.mfda.ca (last visited Apr. 10, 2012).

80. *See* CHAMBRE DE LA SÉCURITÉ FINANCIÈRE, http://www.chambresf.com/en/ (last updated Apr. 10, 2012) (Can.).

81. *OSC Staff Notice 15-704*, *supra* note 2.

82. *OSC Staff Notice 11-719 A Risk Based Approach for More Effective Regulation*, 25 O.S.C. BULL. 8410, 8410 (2002) (Can.) [hereinafter *OSC Staff Notice 11-719*], *available at* http://www.osc.gov.on.ca/documents/en/Securities-OSCB/oscb_20021220_2551.pdf.

83. *See* Susan Wolburgh Jenah, Acting Chair, O.S.C., Presentation at the Council of Securities Regulators of the Americas (COSRA) Meeting: A Risk-Based Approach to Securities Regulation 9–11 (Aug. 31–Sept. 2, 2005), *available at* http://www.superfinanciera.gov.co/seminarios/RISK%20BASED%20APPROACH%20-OSC.pdf.

under the criminal code.[84] However, judges are often reluctant to pursue maximum sentences and, as a result, this greatly diminishes the impact of these reforms. The limited use of criminal and quasi-criminal sanctions by federal and provincial regulators is partially attributable to the overlap in jurisdiction and complexities of seeking a conviction through the courts, as opposed to a regulatory sanction imposed by an administrative body. Judicial proceedings tend to be more resource intensive than regulatory proceedings because of delays, constitutional protections, an elevated burden of proof, and time spent educating judges who may not have capital markets expertise.[85] Although criminal and quasi-criminal sanctions should be reserved for the most egregious cases and as a last resort, when a case involves criminal or quasi-criminal sanctions, the court should be open to imposing the maximum sentence, where appropriate, in order to send a clear signal that white collar crimes will be treated similarly to other criminal offenses.[86]

The allocation of police resources also presents a major barrier to investigating capital market offenses. White collar crime has traditionally been a low priority for law enforcement and, given the highly technical and specialized nature of capital market offenses, generally perceived not to be career building for law enforcement officials.[87] In response, the federal government established Integrated Market Enforcement Teams ("IMET") in 2003 to investigate high-profile criminal capital markets offenses.[88] Some issues however, still persist, such as the problem of attracting and retaining expert investigators.[89]

Additionally, the original mandate of IMET was to tackle "high-profile" criminal cases, but it has been argued that this mandate does not necessarily align with the issues or enforcement objectives in each provincial jurisdiction.[90] Thus, some recommend that either the IMET's mandate be expanded or the capacity of other police forces be enhanced

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84. *See* An Act to Amend the Criminal Code (Capital Markets Fraud and Evidence-Gathering), Bill C-13, 37th Parl., 3d Sess. (2004) (Can.); An Act to Amend the Criminal Code (Sentencing for Fraud), Bill C-52, 40th Parl., 2d Sess. (2009) (Can.).

85. Cory & Pilkington, *supra* note 38, at 228. See PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 14, where I suggest the development of specialized courts to deal with white collar capital market offenses.

86. *See* PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 12–14.

87. Cory & Pilkington, *supra* note 38, at 228.

88. *Backgrounder: Integrated Market Enforcement Team Program*, ROYAL CAN. MOUNTED POLICE (Oct. 21, 2011), http://www.rcmp-grc.gc.ca/imet-eipmf/backgrounder-information-eng.htm.

89. Cory & Pilkington, *supra* note 38, at 204.

90. *Id.* at 204–05.

to tackle those cases that do not fit into the definition of "high-profile."[91] In response to these difficulties, the federal government has committed to aggressively pursue white collar crime and has worked to integrate securities enforcement among provincial and territorial regulators.[92] Moreover, criminal enforcement would be within the authority of the proposed national securities regulator. However, the Supreme Court's recent decision that the federal government lacks jurisdiction to unilaterally create a national regulator means that the jurisdictional divide between federal and provincial enforcement will continue.

2. Data on Securities Enforcement in Canada

This section provides an overview of enforcement activities and sanctions issued by Canadian securities commissions from 2006 to 2011. Consistent with the increased emphasis on prosecuting capital market offenses, the number of proceedings commenced has increased, along with the total value of fines and administrative penalties, and the number of cases concluded outside of the tribunal and the court processes.[93] However, the length of jail sentences has not significantly changed,[94] which demonstrates a continued reluctance by the courts to treat white-collar crime as seriously as other criminal and quasi-criminal offenses.

As previously indicated, quantitative data on securities enforcement provides a limited picture of the effectiveness of capital markets regulation in Canada. Although useful for identifying general trends, this data provides limited insight into which cases are being chosen for prosecution and why.

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91. *Id.* at 208; Poonam Puri, Assoc. Dean, Osgood Hall Law Sch., Research Study prepared for the Expert Panel on Securities Regulation: Of Regulatory Reform and Enforcement Effectiveness: Models for a Common Enforcement Agency for Canada (June 30, 2008) (Can.), *available at* www.rotman.utoronto.ca.

92. Press Release, Pub. Safety Can., Integrated Market Enforcement Teams (IMETs) (Dec. 5, 2008) [hereinafter IMET Press Release], *available at* http://www.publicsafety.gc.ca/media/nr/2007/nr20070514-1-eng.aspx.

93. CAN. SEC. ADM'RS, 2008 ENFORCEMENT REPORT 6 (2008), *available at* http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA_Enforcement_Report_English_2008.pdf [hereinafter 2008 ENFORCEMENT REPORT]; CAN. SEC. ADM'RS, 2009 ENFORCEMENT REPORT 4–8 (2009), *available at* http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSAReportENG09[FA].pdf [hereinafter 2009 ENFORCEMENT REPORT]; CAN. SEC. ADM'RS, 2010 ENFORCEMENT REPORT 8 (2010), *available at* http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA2010EnforcementReportEng.pdf [hereinafter 2010 ENFORCEMENT REPORT].

94. 2008 ENFORCEMENT REPORT, *supra* note 93; 2009 ENFORCEMENT REPORT, *supra* note 93; 2010 ENFORCEMENT REPORT, *supra* note 93.

The general data on enforcement cases from 2006 to 2010 is considered in Table 1:

Year	Proceedings Commenced	Reciprocal Orders	Total Cases Concluded	Cases Concluded Via…		
				Court Proceedings	Tribunal Hearings	Settlement Agreements
2006	118	7	95	18	28	49
2007	104	18	130	31	54	45
2008	171	90	123	28	55	40
2009	124	77	141	35	37	69
2010	178	74	174	64	39	71

Table 1: General Enforcement Data[95]

Three observations are apparent from the data above. First, and perhaps most noteworthy, is the demonstrated commitment to coordination among provinces evidenced by the number of reciprocal orders issued. In 2008, amendments were passed by provincial legislatures to expand the use of reciprocal orders, which are used to prevent individuals or companies sanctioned by one jurisdiction, such as a cease trade order, from engaging in the prohibited conduct in the reciprocating jurisdiction.[96] The high number of reciprocal orders also illustrates the patchwork approach to securities regulation that exists among the Canadian provinces.

Second, although the raw number of settlement agreements has increased significantly in recent years, the percentage of cases concluded varies greatly from a high of 52% in 2006 to a low of 33% in 2008. As the OSC contemplates a move towards the no-contest settlement program, it will be interesting to observe whether the number and percentage of actions resolved through settlement agreements increases over the coming years.

Third, while the number of court proceedings is rising, the number of tribunal hearings has decreased by approximately 30% from 2008 to 2010. Although the change is not drastic, it is significant and could be indicative of a shift in case management strategy, kind of allegations, and the parties targeted by the securities commissions.

The most common types of violations have remained fairly consistent over the last few years. From 2008 to 2010, illegal distributions—that is, distributing securities without registration or a prospectus—formed the

95. 2008 ENFORCEMENT REPORT, *supra* note 93; 2009 ENFORCEMENT REPORT, *supra* note 93; 2010 ENFORCEMENT REPORT, *supra* note 93.

96. O.S.C., 2009 OSC ANNUAL REPORT 49–50 (2009), *available at* http://www.osc.gov.on.ca/static/_/AnnualReports/2009/enf.html.

largest category of violations.[97] The next most prominent category was misconduct by registrants,[98] and illegal insider trading was consistently present over the years as well.

The total fines and administrative penalties levied against market participants from 2008 to 2010 are illustrated in Table 2.

Year	Total Fines and Administrative Penalties
2008	$12,469,117
2009	$153,673,008
2010	$63,827,006

Table 2: Fines and Administrative Penalties[99]

Although the extremely large amount in 2009 was caused by settlements related to the ABCP crisis,[100] the increase between 2008 and 2010 is significant and may indicate a change in the enforcement priorities of public regulators.[101]

The statistics found in Table 3 below represent the number and term of prison sentences issued by courts in Alberta, British Columbia, Ontario, Quebec, and Manitoba.

97. In the Canadian Securities Administrators' 2010 Enforcement Report, illegal distributions are defined as: "a sale of securities to investors that does not comply with securities law registration, trading and disclosure requirements." 2010 ENFORCEMENT REPORT, *supra* note 93, at 10.

98. The Canadian Securities Administrators' 2010 Enforcement Report explains that "misconduct by registrants occurs when a person or company violates securities laws . . . . [,] fail[s] to register when required to do so, or . . . fail[s] to adhere[] to the conditions of a registration exemption." *Id.* at 13.

99. 2008 ENFORCEMENT REPORT, *supra* note 93, at 6; 2009 ENFORCEMENT REPORT, *supra* note 93, at 6; 2010 ENFORCEMENT REPORT, *supra* note 93, at 10.

100. The Canadian Securities Administrators' 2009 Enforcement Report lists the institutions that paid out settlements related to the ABCP crisis: National Bank Financial Inc., Scotia Capital Inc., Canadian Imperial Bank of Commerce and CIBC World Markets Inc., HSBC Bank Canada, Laurentian Bank Securities Inc., Canaccord Financial Ltd., and Credential Services Inc. 2009 ENFORCEMENT REPORT, *supra* note 93, at 11.

101. Enforcement activities related to the 2007 ABCP crisis were still ongoing when these figures were calculated, thus the figures for 2010 may also reflect this fact.

Year	Number of Jail Sentences	Minimum Sentence	Maximum Sentence
2008	6	6 months	8.5 years
2009	4	3 months	2.5 years
2010	15	3 months	3 years

Table 3: Jail Sentences Issued by Courts[102]

Despite amendments increasing the maximum jail sentence for capital market offenses, courts appear hesitant to issue long sentences for securities law violations. At this point, it is difficult to determine whether the dramatic increase in the number of prison sentences in 2010 was either a statistical anomaly or the start of a trend. Moreover, the wide variation in the range and number of sentences each year reflects the disjointed approach to criminal and quasi-criminal enforcement in Canada. This is particularly pronounced given that only two of the fifteen sentences issued in 2010 were from Ontario.[103] As Canada's largest capital market, it is surprising that Ontario did not issue more jail sentences and this gap may reflect the differing priorities in securities enforcement across Canada.

3. Comparison of the Canadian and American Enforcement Regimes

Canadian and American securities regulators approach compliance and enforcement from different philosophical underpinnings. Canada's preference for compliance based strategies and a provincially regulated securities environment has resulted in fewer high profile public securities cases in Canada. In the past ten years, various studies attempt to understand how Canadian and American regimes compare with one another. Despite the common perception that Canadian securities enforcement is less robust than that of the United States, funding and staffing for enforcement activities appears to be comparable. Thus many of the differences apparent between the two systems may be rooted in different enforcement priorities.

Statistics on enforcement activity generally provide a limited picture of the capacity and effectiveness of securities regulation in a particular jurisdiction. Every year, securities regulators are confronted with hundreds of potential enforcement matters, yet only have sufficient resources to examine and commence an investigation of a very small number of these

102. 2008 ENFORCEMENT REPORT, *supra* note 93, at 6; 2009 ENFORCEMENT REPORT, *supra* note 93, at 6; 2010 ENFORCEMENT REPORT, *supra* note 93, at 8.

103. 2011 OSC ANNUAL REPORT, *supra* note 77, at 10.

claims.[104] Consequently, there is little information available to identify those matters which are not being pursued by regulators or have evaded any type of review. In addition, the high number of small public issuers in Canada significantly complicates enforcement in Canada relative to the United States.

Howell Jackson's 2005 study on regulatory intensity for the Task Force to Modernize Securities Legislation suggested that although budgets may not be the perfect proxy, "a reasonable level of regulatory staffing is perhaps a necessary condition for effective enforcement in financial markets."[105] Overall, Jackson concluded that when economic deflators were taken into consideration, Canada and the United States were very similar in enforcement intensity, and found Canada to have a more intense staffing budget as a percentage of GDP and market capitalization.[106] Although the gap between the number of enforcement actions in Canada and the United States was once significant, it has become progressively narrower in recent years.[107] Jackson concludes that from a structural perspective, Canadian and American securities enforcement efforts tend to be largely similar.[108]

Jackson's conclusions challenge the traditional assumption that American enforcement is more intense than in Canada. However, since his study does not control for differences in capital market activity, it is not possible to evaluate whether the discrepancy in enforcement activity is the product of the regulatory environment or a different propensity for capital market offenses in the two jurisdictions.[109] Given that staffing budgets are similar, the differences in enforcement activity could be the product of systemic inefficiencies or unique regulatory priorities and challenges.

The primary difference between Canadian and American enforcement activity appears to be the differing philosophical approaches to securities regulation. Canadian securities regulators spent between 13% and 19% of their total operating budget on enforcement, whereas the SEC spent

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104. *Id.* at 15. In the 2010–2011 fiscal year, the Ontario Securities Commission assessed 348 matters and brought a total of 32 actions before the Commission and 2 before the Ontario Court of Justice. *Id.* at 15–16.

105. Howell E. Jackson, *Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches*, 6 CANADA STEPS UP 77, 87 (July 30, 2006), *available at* http://www.tfmsl.ca/docs/V6(2)%20Jackson.pdf.

106. *Id.* at 81.

107. *Id.* at 111–12.

108. *Id.* at 98. Jackson cautions that the limited time frame and lack of precise enforcement data limits the robustness of any conclusions drawn from this data. *Id.* at 85–86.

109. *Id.* at 84.

29% of its budget on enforcement during the same period.[110] There were also significant staffing increases in the enforcement branches of the Ontario and Quebec securities commissions from 1998 to 2005 without a corresponding increase in the number of cases brought.[111] This may suggest a decrease in the efficiency of Canadian securities enforcement activity, or that the same number of cases are being pursued but are more complex and greater resources are being devoted to them.

While not a perfect comparison, the SEC data for 2010 and 2011, as well as projections for 2012, demonstrate the gradual growth in the SEC's enforcement budget. In 2010, enforcement comprised 33% of the SEC's total budget, and was expected to remain between 32% and 34% for 2011 and 2012.[112] With regard to staffing, the SEC dedicated 32% of its staff to enforcement in 2010. This number was expected to remain constant through 2011 and drop slightly to 30% through 2012.[113] The up-to-date data for budget and resource allocation for the OSC was not readily available as the Ontario Securities Commission's has changed its annual reporting format since 2005. This highlights a gap in information disclosure; this information should be more easily available to the public.

While these indices do not provide a precise measure of Canadian enforcement intensity, they do suggest that the mechanisms in place provide Canada with a relatively robust regulatory environment. However, quantitative data on enforcement only allows for prospective analysis—it is not capable of monitoring changes in the actual behavior of market participants to evaluate the deterrent effect of enforcement activities.[114] Although more difficult to measure, securities commissions and the CSA would benefit from undertaking a qualitative analysis of this nature.

B. New Public Enforcement Strategies

Although Canadian securities regulators are conventionally regarded as more reserved than their American counterparts, recent experience demonstrates their clear willingness to adopt new enforcement and investor protection strategies. In October 2011 the Ontario Securities Commission released Staff Notice 15-704, which proposes to allow regulators to offer no-contest settlements without requiring respondents to make an admis-

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110. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 25. This study examined the total operating budgets of Canadian and American securities regulators in relation to the percentage dedicated to enforcement activities.

111. *Id.* at 23.

112. S.E.C., IN BRIEF FY 2012 CONGRESSIONAL JUSTIFICATION 11 (Feb. 2011), *available at* http://www.sec.gov/about/secfy12congbudgjust.pdf.

113. *Id.* at 9.

114. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 24.

sion of liability.[115] No-contest settlements will help strengthen securities enforcement in Ontario and will enable regulators to pursue a greater number of claims. However, no-contest settlements must be properly managed to avoid commoditizing damages and discounting the role of public regulators in ensuring accountability.

As part of its enforcement activities, the OSC entered into substantial settlements following the ABCP crisis in 2007 and the investigation into market timing in Canadian mutual funds in 2005.[116] The OSC is now attempting to return the ABCP funds to investors to help offset their losses. These developments suggest a shift in the role and objectives of the OSC to the use of public penalties and fines to compensate investors. This shift demonstrates recognition of the diverse nature of Canadian public markets. It also provides enhanced investor protection by enabling securities regulators to provide restitution for investors on losses sustained from smaller issuers against whom it may not be economical or feasible to pursue a private remedy. However, for this strategy to be effective, greater clarification is required from the OSC and it must detail how, and under what circumstances, a public settlement will be distributed to investors.

1. No-Contest Settlements

On October 21, 2011 the OSC released Staff Notice 15-704 and requested comments from participants in Canadian capital markets, as required under the OSC's notice and request for comment procedure for rule making.[117] This proposal stems from the OSC's broader "credit for cooperation" program, which seeks to reward market participants who self-report regarding their roles in illegal activities.[118] Two of the most noteworthy elements of Staff Notice 15-704 are (1) No-Enforcement Action Agreements, which protect self-reporters from liability; and (2) the No-Contest Settlement Program that eliminates the existing requirement for a person or company to admit guilt before a settlement can be reached.[119] Elimination of the long-standing requirement that parties admit liability is controversial and considered by some to represent the "Americanization" of Canadian securities enforcement.[120]

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115. *OSC Staff Notice 15-704*, *supra* note 2, at 10720–21.

116. *Metcalfe & Mansfield*, 2008 CanLII 23497 (Can. Ont. Sup. Ct. J.).

117. *OSC Staff Notice 15-704 supra* note 2, at 10720; Ontario Securities Act, R.S.O. 1990, c. S-5, § 143.2 (Can.).

118. *OSC Staff Notice 15-704*, *supra* note 2, at 10720–21.

119. *Id.* at 10721–24.

120. Barbara Shecter, *New Rules Urged for Rise in Class Actions*, FIN. POST, Oct. 25, 2011, at FP4.

The primary impetus for introducing no-contest settlements is to facilitate the efficient resolution of public enforcement proceedings while striking a proper balance with concurrent private litigation. In the background to the staff notice, the OSC notes that issuers are often concerned about the implications of an admission of public liability for ongoing private liability.[121]

Recognizing the controversy and potential for abuse surrounding no-contest settlements, the current proposal from the OSC is cautious and tightly circumscribed. To be eligible for a no-contest settlement, Staff Notice 15-704 would require the participant to have fully complied with the OSC's investigation.[122] This may include self-reporting and remedial steps to address non-compliance including, where appropriate, provision of compensation to affected third parties. The no contest settlement must also be deemed to be in the public interest pursuant to *Ontario Securities Act* §127 and will only be available if the respondent has not been the subject of previous enforcement activities.[123]

The use of no-contest settlements draws heavily on the U.S. approach to securities enforcement, which traditionally did not require regulators to obtain an admission of liability as part of a settlement agreement. However, the more guarded approach taken by the OSC reflects Canada's traditional preference for compliance based strategies and its contemporary shift to incorporate more aggressive enforcement activities.[124] The discretion to offer no-contest settlements in appropriate circumstances will provide regulators with a more tailored range of enforcement options. In a submission to the OSC on Staff Notice 15-704, two lawyers from a firm experienced in class actions contend that no-contest settlements diminish the role of public regulators in ensuring accountability and providing the basic evidence of corporate wrongdoing necessary to predicate a private action.[125] However, forcing public regulators to impose a finding of liability limits regulators' ability to develop proportionate penalties tailored to the circumstances.

Securities regulators already exercise a degree of selectivity in deciding which cases to pursue.[126] Settlement agreements reached with a re-

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121. *OSC Staff Notice 15-704*, *supra* note 2, at 10721.

122. *Id.*

123. *Id.*; R.S.O. 1990, c. S-5, § 143.2 (Can.).

124. Mary Condon & Poonam Puri, *The Role of Compliance in Securities Regulatory Enforcement*, 6 CANADA STEPS UP 3, 14 (June 28, 2006).

125. Response to Request for Comments on Proposed Enforcement Initiatives from Douglas M. Worndl & A. Dimitri Lascaris, Siskinds LLP, to John Stevenson, O.S.C. 2–3 (Dec. 6, 2011).

126. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 15.

spondent commonly negotiate the amount of the fine, terms of the agreement, and the manner in which the admission of liability is framed.[127] Allowing regulators to offer no-contest settlements for less significant offenses represents sound regulatory policy and will enable regulators to conserve their limited enforcement resources. Contrary to the suggestion that no-contest settlements will undermine public securities enforcement, the wider range of settlement options could expand the number and range of cases that regulators are prepared to pursue. Given the finite financial resources of public regulators, it is not practical to seek full public vindication in every case. However, the ability to obtain a no-contest settlement agreement may still offer a significant deterrent effect as regulators can resolve a greater number of cases.

Therefore, provided no-contest settlements are used in a tailored and proportionate manner to complement the existing enforcement activities, their introduction will provide a net benefit for investors and the Canadian capital markets.

2. Using Public Settlements to Compensate Investors

Following an extensive investigation into market timing in Canadian mutual funds, the OSC entered into settlements with five Canadian mutual funds, where they agreed to pay $205.6 million to their investors.[128] This public settlement agreement was deemed to be without prejudice to any other private right of action held by investors.[129] However, the decision of public regulators to recover damages on behalf of private investors marks a major shift in the role and mindset of the public regulators, whose primary mandate has traditionally been one of compliance and deterrence.[130]

One of the principal challenges for effective securities regulation is determining the proper approach to assure investor protection. Public regulators traditionally perceive their role as protecting the integrity of capital markets through deterrence and compliance initiatives. By contrast, private investors are chiefly concerned with being compensated for their losses. Public regulators should also "assist investors in receiving compensation for harms suffered in the capital markets."[131] In particular, se-

127. James Langton, *Taking aim at "no contest" settlements*, INV. EXEC. (Jan. 2012), http://www.investmentexecutive.com/-/taking-aim-at-no-contest-settlements.

128. *Metcalfe & Mansfield*, 2008 CanLII 23497 (Can. Ont. Sup. Ct. J.).

129. Fischer v. IG Inv. Mgmt. Ltd., 2012 ONCA 47, ¶ 2 (Can.). A more detailed discussion of the private market dimensions of these settlement agreements for private investors takes place in Part III of this Article.

130. O.S.C., STATEMENT OF PRIORITIES FOR FISCAL 2011–12, at 6 (2012).

131. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 3.

curities regulators should seek restitution for investors where it is more efficient to do so, provided that investors are given adequate opportunity to participate in the enforcement process and have their positions heard. Such an approach may be particularly effective when pursuing claims against smaller issuers and where it is not economical for an individual or class given the statutory limits on private secondary market liability under section 138.1 of the Ontario Securities Act.[132] However, such a shift may require an amendment to the Ontario Securities Act. The OSC has jurisdiction under the Ontario Securities Act to apply to the Ontario Superior Court for an order compelling respondents to make restitution or compensation directly to an aggrieved party, but the Commission appears to lack jurisdiction to distribute directly the proceeds of a public settlement to investors.

The OSC's decision to require parties involved in the OSC's market timing settlement to compensate investors was relatively uncontroversial.[133] However, more significant policy concerns were raised by the OSC's initiative to distribute $60 million to investors using public settlement funds received following the ABCP crisis in 2007.[134] As part of the court supervised ABCP restructuring, the Pan Canadian Investor Committee agreed to provide investors who had less than $1 million invested in the ABCP market with a full return on their investment, in exchange for a full release from private liability with the exception of claims for fraud.[135] This agreement stipulated that the OSC would "not make any order or award to compensate or make restitution to an aggrieved person or company or to pay general or punitive damages."[136] Further, it stated that the settlement would be used in a "fair and appropriate" manner to be "determined in accordance with applicable laws, court orders, and the public interest."[137] Since the majority of retail investors received a full return on their investments, the OSC's distribution

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132. R.S.O. 1990, c. S-5, § 138.1 (Can.).

133. Following the public settlement with the O.S.C., investors launched a private class action to recover funds not accounted for in the public settlement. The courts decision to certify this class action is discussed in greater detail later in this Article. *See infra* Part III.C.

134. Applicants' Factum ¶ 2(a), *In re* Ont. Sec. Comm'n & Inv. Indus. Regulatory Ass'n Can., CV-12-9606-00CL (Can. Ont. Sup. Ct. J. 2012) [hereinafter Applicant's Factum]; Barbara Shecter, *Watchdogs Push to Return $60-Million to ABCP Investors*, FIN. POST (Feb. 16, 2012, 4:33 PM), http://business.financialpost.com/2012/02/16/watchdogs-want-to-return-60-million-to-abcp-investors/.

135. Applicants' Factum, *supra* note 134, ¶ 21.

136. *Id.* ¶ 5.

137. *Id.* ¶ 21; *Metcalfe & Mansfield*, 2008 CanLII 23497 (Can. Ont. Sup. Ct. J.).

of these settlement funds will likely go to institutional investors such as large pension funds and other sophisticated parties.

A second concern is whether the distribution of public settlement funds is commensurate with the reasonable expectations of the Canadian capital markets financial industry and the general public when the Pan-Canadian Investors Committee for Third-Party Structured Asset-Backed Commercial Paper entered a settlement with the IIROC and the OSC. Although debate surrounding the legitimacy of the OSC's move is beyond the scope of this paper, the Ontario Superior Court's recent decision upholding the OSC's use of the ABCP settlement funds may impact future negotiations on the use of a general release from private liability.[138]

If the OSC's decision to compensate investors by using public settlements is part of a broader policy shift, the OSC should develop clear policies to help manage the expectations of investors and define which settlements would be distributed to investors. Although it may be politically uncomfortable for public regulators like the OSC to justify retaining multi-million dollar fines, regulators should be mindful of the positive role of private litigation in obtaining remuneration for investors. If the OSC is moving towards a policy of distributing settlements to investors, empirical research should be conducted to examine the capacity of private litigation to obtain comparable or superior settlements and efficiently distribute funds back to investors. Ultimately, any shift in enforcement activity of the OSC should be fully articulated and applied consistently to safeguard the expectations of market participants and the public.

3. Balancing Public Enforcement Strategies

The OSC's decision to distribute the ABCP settlement to investors and consider the use of no-contest settlements demonstrates alignment between public and private enforcement activities. Where investors are incapable of bringing a private action, distributing settlements to investors may offer a more efficient process and provide greater recognition of the rights of private investors in the public enforcement process. However, this approach must be carefully tailored so as not to create the expectation that the OSC will or should obtain compensation for private parties in all instances. No-contest settlements will also enhance the public en-

138. *OSC Proceedings: Proposed distribution of ABCP settlement funds permitted by Court Order*, O.S.C. (Mar. 13, 2012), http://www.osc.gov.on.ca/en/Proceedings_nr_20120313_osc-iiroc-abcp-settlement-funds.htm.

forcement process by allowing regulators to fashion a more proportionate sanction for each particular offence. Accordingly, no-contest settlements represent sound regulatory policy and offer a more balanced approach to public enforcement that views deterrence and market discipline as end goals of effective securities regulation, rather than high-profile findings of liability.

Both initiatives are positive developments for securities regulation in Ontario. Nevertheless, regulators must ensure that this expanded role for public enforcement does not usurp the rights of private litigants. It is important to allow private parties to manage their own claims and to have meaningful participation in the process.

B. Canada's Pursuit of a National Securities Regulator

In Canada, securities are regulated at the provincial and territorial level through thirteen independent regulatory bodies, each with their own capabilities and priorities. This fragmented regulatory framework causes significant concern for Canadian capital markets and prompted the Wise Persons' Committee's recommendation in 2003 that Canada harmonize its securities legislation and enforcement activities.[139] In 2004, twelve of the provinces and territories, Ontario the lone hold-out, introduced a passport system for securities regulation.[140] The system attempted to harmonize securities legislation and policies by providing for mutual recognition of reporting issuers in each of the passport jurisdictions. Each province, however, continues to retain its own, independent enforcement agencies.

Following a report of the Expert Panel on Securities Regulation in 2009, the Government of Canada drafted legislation to create a national securities regulator and referred the proposed bill to the Supreme Court for a reference decision on its constitutionality.[141] In December 2011, the Supreme Court unanimously held that the federal government does not have jurisdiction to enact the legislation in its current form under the federal trade and commerce power of the Constitution.[142] Rather, securities

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139. MARY CONDON, ANITA ANAND, & JANIS SARRA, SECURITIES LAW IN CANADA: CASES AND COMMENTARY 589 (2005).

140. A Provincial/ Territorial Memorandum of Understanding Regarding Securities Regulation (2004) (Can.), *available at* http://www.securitiescanada.org/2004_0930_mou_english.pdf.

141. Reference re Securities Act, 2011 SCC 66, ¶ 134 (Can.); Order in Council P.C. 2010-0667 (Securities Act) (May 26, 2010) (Can.).

142. *Re Securities Act*, 2011 SCC 66, ¶ 8 (Can.).

regulation is provincial jurisdiction under provincial property and civil rights powers.[143]

1. Structure of the Proposed National Securities Regulator & Supreme Court's Decision

Under the proposed securities act, the federal government sought to establish the Canadian Securities Regulatory Authority to advance the objectives of increased accountability and stability in Canadian capital markets.[144] Responsibility was to be divided between a regulatory division and securities tribunal. The Regulatory Division would promote increased accountability and stability in capital markets through increased communication with the Minister of Finance and establishment of an Investor Advisory Panel to represent the interests of both large and small investors at all stages of the regulation and enforcement process. Also, similar to the recent move by the OSC to distribute public settlements to investors, the Regulatory Division would have the capacity to provide restitution directly to investors. Enforcement proceedings would be carried out before an expert securities tribunal.

Under a nation-wide mandate, a national securities regulator would have the capacity to pool enforcement resources, coordinate enforcement efforts across multiple Canadian jurisdictions, and represent Canada in negotiations with regulators in international markets.[145] Opponents of a national securities regulator argue that similar coordination can be, and is, achieved through cooperation among the provinces and territories. However, even a highly integrated regulatory framework creates a degree of duplicative costs and inefficient allocation of resources. More importantly, a lack of centralized accountability in Canadian capital markets still remains.[146] Inevitably, thirteen separate regulators will pursue different types of capital market offenses with different intensities and varying degrees of effectiveness in each jurisdiction. As the system is presently constituted, there is considerable inconsistency in the nature of cases that get pursued and the factors deemed relevant in sanctioning.[147] Consequently, it is very difficult to identify and prioritize issues of national interest.

In ruling that the federal government lacked jurisdiction to enact the proposed securities act, the Supreme Court of Canada held that capital

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143. *Id.* ¶ 116.

144. DOUGLAS M. HYNDMAN ET AL., CAN. SEC. TRANSITION OFF., TRANSITION PLAN FOR THE CANADIAN SECURITIES REGULATORY AUTHORITY 3 (July 12, 2010).

145. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 20.

146. Cory & Pilkington, *supra* note 38, at 247–48.

147. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 22.

markets in Canada developed at a local level and concluded that there was insufficient evidence to support the contention that they now operate at the national level.[148] By focusing narrowly on the federalist division of powers question, the Supreme Court did not acquire as clear an understanding of the evolution and present state of Canadian capital markets. As a result, the Court did not provide a clear path forward for the future development of Canadian capital markets.

The Court maintained that since specialized industries are geographically clustered within Canada, the securities markets for these industries will be similarly clustered along geographic lines.[149] However, although these companies are often headquartered in particular geographic markets, they frequently distribute their securities in national and international markets. Thus, the appropriate market for capital is at least nationwide. In Canada, over two-thirds of issuers are reporting in more than one jurisdiction.[150] Consequently, there is a high degree of inefficiency and duplication for both regulators and reporting issuers in Canadian capital markets.

2. Options Moving Forward

Following the Supreme Court of Canada's decision in *Reference re Securities Act*,[151] public securities regulation is at a crossroads. Although the previous discussion of public regulation in Canada demonstrated that the provinces and territories have a relatively robust enforcement environment compared to the United States, the duplication and overlap in each of the jurisdictions greatly diminishes the ability of provincial and territorial regulators to develop nation-wide enforcement strategies. After the Supreme Court's decision, there are three options available to securities regulators: (1) continue with provincially regulated securities markets and encourage cooperation under the passport system, (2) introduce a national regulator to address systemic risk factors that arise at the national level, or (3) encourage the provinces to cooperate with the federal government in developing a single securities regulator.

First, although increased cooperation and integration is possible under the current model for securities regulation, inefficiencies and a lack of clear strategic direction continue to inhibit it. Under the passport system, Canadian securities regulators lack a unitary voice on the international stage. Further, it is not possible to effectively integrate securities regula-

148. Reference re Securities Act, 2011 SCC 66, ¶¶ 116–27 (Can.).
149. *Id.* ¶ 127.
150. IT'S TIME, *supra* note 68, at 5.
151. *Re Securities Act*, 2011 SCC 66, ¶ 149.

tion with macro-economic policies and the financial sector regulations made at the federal level. Thus, Canada will continue to be vulnerable to regulatory gaps, as evidenced in the regulation of ABCP during the 2007 financial crisis.

The Supreme Court indicated that a federal regulator focused on systemic risk factors is a constitutionally valid option.[152] However, it is not clear how the federal government could identify what constitutes systemic risk and develop an appropriate regulatory framework without trenching upon provincial regulatory efforts. Would this regulator focus on companies with market capitalizations above a certain threshold or regulate particular financial instruments or products? The narrow mandate of such a regulator could further exacerbate our patchwork regulatory environment wherein the federal regulator simply becomes the fourteenth actor in Canada.

Finally, the preferred option is for the federal government to continue to work towards establishing a national regulator by exploring cooperative solutions such as an opt-in national regulator. For example, the provinces could independently create an agency or the federal government could continue to build upon the foundation laid by the Canadian Securities Transition Office. Although the latter solution might be restricted to those provinces willing to cede jurisdiction to a centralized body, such a solution will provide for more effective enforcement proceedings and greater efficiency for all market participants.

III. PRIVATE ENFORCEMENT

Unlike the United States, which instituted secondary market liability in the 1930s and implemented well-established class action legislation by the 1960s,[153] Canada's private enforcement regime is a relatively recent development. In the 1970s, Canadian securities laws were amended to incorporate a private statutory right of action for misrepresentations in an issuer's prospectus. The capacity of private parties to initiate civil actions was further enhanced by the adoption of class action legislation in Ontario in 1993, and later by all other provinces.[154] This made it easier and more cost-effective for investors to bring actions against issuers and market intermediaries. In 2005, Canada's private enforcement regime took its present form, when securities laws were amended to provide statutory liability for secondary market misrepresentations. The regime

152. *Id.* ¶ 104.

153. SEC Rules and Regulations under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2009).

154. Class Proceedings Act, S.O. 1992, c. 6 (Can.).

was developed following the 1994 report of the Toronto Stock Exchange Committee on Corporate Disclosure ("Allen Committee").[155] The Allen Committee recognized that deterrence would be a primary objective, as well as compensation of aggrieved investors. Secondary market investors were thereby enabled to bring actions for non-negligent breaches of the issuer's continuous disclosure obligations.

Part III will review the literature and quantitative data on private enforcement in Canada and highlight three key observations. First, Canadian and American securities and class action laws are based on the same underlying principles and policies.[156] However, key differences emerge as a result of Canada's jurisprudential approach to class action certification and its cap on secondary market statutory liability. These differences may be responsible for the recent divergence in Canadian and American jurisprudence on global class actions.

Second, even after accounting for Canada's smaller capital markets, Canada has significantly fewer securities class actions than the United States each year. Interestingly, although initial claim values in Canada are significantly lower than those in the United States, median settlement values are similar. This statistic raises the question of what is causing such a convergence, but it is difficult to draw definitive conclusions. Before the factors responsible for these trends can be accurately evaluated, the Canadian class action environment must be allowed time to develop and yield more long term data.

Finally, there is a strong interplay between public and private enforcement in Canada. Both enforcement routes are often used simultaneously to promote stability and capacity in Canadian capital markets. The ABCP crisis in 2007 demonstrated the ability of public and private actors to work cooperatively to develop a court sanctioned restructuring and release from private liability. This enabled Canada to avoid most of the 255 new class actions initiated in the United States following the financial crisis.[157] The interplay between public and private enforcement was also evident when Canadian securities regulators sanctioned five mutual

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155. TORONTO STOCK EXCH. COMM. ON CORPORATE DISCLOSURE, FINAL REPORT: RESPONSIBLE CORPORATE DISCLOSURE: A SEARCH FOR BALANCE (1997) (Can.).

156. *See* TARA GRAY & ANDREW KITCHING, PARL. INFO. & RES. SERVICE, PRB 05-28E, REFORMING CANADIAN SECURITIES REGULATION 14 (2005), *available at* http://www.parl.gc.ca/Content/LOP/researchpublications/prb0528-e.htm.

157. JORDAN MILEV ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN CLASS ACTION LITIGATION: 2011 YEAR-END REVIEW 2 (Dec. 14, 2011), *available at* http://www.nera.com/nera-files/PUB_Trends_Year-End_1211_final.pdf; BRADLEY HEYS & MARK BERENBLUT, NERA ECON. CONSULTING, TRENDS IN CANADIAN SECURITIES CLASS ACTIONS: 2011 UPDATE 2 (2012), *available at* http://www.nera.com/nera-files/PUB_Recent_Trends_Canada_01.12.pdf.

funds for not having adequate safeguards in place to prevent market timing and the subsequent use of a private class action by investors to claim residual damages not captured in the public settlement.[158]

A. Statutory Framework & Jurisprudence

1. Secondary Market Liability

Primary market statutory civil liability was incorporated into provincial securities legislation far earlier than secondary market statutory liability in Canada. As noted earlier, the United States has imposed statutory liability on secondary market transactions since the 1930s, which allows considerable analysis of the effectiveness of the United States' secondary enforcement regime.[159] In particular, observers are critical of the tendency for secondary market actions to result in pocket shifting from the corporation or its insurers to its shareholders.[160] Thus, Canadian legislation and jurisprudence has the opportunity to consider the American experience in developing its own private enforcement system.

In 2005, following decades of debate, part XXIII.1 of the Ontario Securities Act was introduced to provide statutory liability for secondary market disclosures.[161] The change modernized Canadian securities legislation by providing investors with a strict liability, statutory right of action when an issuer breaches their continuous disclosure obligations.[162] The reforms greatly simplify the secondary market liability framework, make secondary market liability more attainable than under the common law remedies of negligent misrepresentation and fraud, and provide a common legal issue for investors to rely upon in seeking certification in a class action.

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158. Fischer v. IG Inv. Mgmt. Ltd., 2012 ONCA 47 (Can.).

159. *See, e.g.*, Ann Morales Olazábal, *Defining Recklessness: A Doctrinal Approach to Deterrence of Secondary Market Securities Fraud*, 2010 WIS. L. REV. 1415, 1415; Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 237 (2007).

160. *See* Adam C. Pritchard & Janis P. Sarra, *Securities Class Actions Move North: A Doctrinal and Empirical Analysis of Securities Class Actions in Canada*, 47 ALTA. L. REV. 881, 882 (2009).

161. R.S.O. 1990, c. S-5,§ 23.1 (Can.); *see* 3 PHILIP ANISMAN ET AL., PROPOSALS FOR A SECURITIES MARKET LAW FOR CANADA (Philip Anisman ed., 1979) (Volume 3 presents "papers prepared by the consultants to the Securities Market Study to provide an analytical and policy background for the development of the [proposals] as set out in the preceding two volumes." The studying and resulting proposals were meant "to facilitate the formulation by the [g]overnment of Canada of its policy on the regulation of the Canadian securities market.").

162. R.S.O. 1990, c. S-5, § 138.4(4) (Can.).

2. Standing, the Burden of Proof, and Statutory & Common Law Actions

Similar to the United States, Canada provides a right of action to any person or company who transacts in an issuer's securities where a misrepresentation is made in a document or statement.[163] The right of action extends from the time the misrepresentation is made until the time the statement is corrected.[164] Misrepresentations or omissions that give rise to liability can occur in any document released by the responsible issuer or in any public oral statement released by a person with actual or ostensible authority to speak on behalf of the responsible issuer. Persons deemed to have influence by virtue of their relationship to the issuer may also be liable for their conduct or misrepresentations. Civil actions may be brought against the reporting issuer and its directors, officers, and experts for their contributions to the disclosure, as well as control persons and other individuals deemed to have influence in the corporation.[165] Thus, in the Canadian context, the group of potential defendants is confined to persons who enter into a special relationship with the issuer rather than including any individual who makes a misstatement or commits a manipulative act.

To determine the appropriate burden for imposing liability for misrepresentation or omissions, Canadian securities legislation distinguishes between core and non-core documents. The distinction is based on whether the material is a constitutive part of the issuer's continuous disclosure obligations as opposed to other, non-core compulsory filings with securities regulators.[166] Issuers are subject to strict liability for any misrepresentations or omissions of material facts in their core documents. For non-core documents, the plaintiff's burden of proof is higher and requires that at the time the document or statement was issued, the defendant knew of the misrepresentation, deliberately avoided acquiring knowledge of the misrepresentation, or was guilty of gross misconduct in connection with the document or oral statement.[167] Thus, Canada's strict liability standard for core documents imposes greater liability on defendants than in the United States, where plaintiffs are generally required to demonstrate recklessness.[168]

Although the Ontario Securities Act gives plaintiffs a statutory right of action for misrepresentations or omissions, the common law torts of neg-

163. *Id.* § 138.3 (Can.).

164. *Id.* § 138.3(1)–(3) (Can.); Securities Act of 1933, 15 U.S.C. § 77q (2006); 17 C.F.R. § 240.10b-5 (2012).

165. R.S.O. 1990, c. S-5, § 138.3(1)–(3) (Can.).

166. *Id.* § 138.1.

167. *Id.* § 138.4(1).

168. Pritchard & Sarra, *supra* note 160, at 893.

ligent misrepresentation and fraud remain available to investors in both the primary and secondary markets.[169] These common law remedies are preferable where the plaintiffs seek damages in excess of the statutory cap on secondary market liability or where the three-year limitation period under the Ontario Securities Act has elapsed.[170] Thus, it is common for plaintiffs to plead both a statutory claim under the Ontario Securities Act and a common law claim of negligent or fraudulent misrepresentation.

In pleading a common law cause of action, plaintiffs are required to demonstrate their reliance on the misrepresentation. Following the Supreme Court of Canada's decision in *Queen v. Cognos*,[171] courts have vacillated on the proper approach to proving detrimental reliance in the context of class actions. In *McCann v. CP Ships*, the court refused to require every class member to show reliance in order for the claim to proceed as a class action.[172] This approach was subsequently affirmed in *Silver v. Imax*,[173] where the court allowed questions of reliance to be considered at trial. However, the *Imax* and *McCann* decisions were challenged in *Dobbie v. Arctic Glacier Income Fund*, where the Court found that in certain circumstances the question of individual reliance may overwhelm the common issue and render the negligent misrepresentation claim inappropriate for a class action proceeding.[174] Without an appellate court's decision clarifying the proper approach to detrimental reliance in a securities class action, this area of the law remains uncertain.

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169. R.S.O. 1990, c. S-5, §§ 130(10), 138.13.

170. *Id.* § 138.1 (Statutory Cap on Liability); *id.* § 138 (180 days from knowledge of misrepresentation or omission, or a three-year limitation period for primary market statutory liability); *id.* § 138.14 (six months from knowledge of misrepresentation or omission, or a three-year limitation from when the transaction giving rise to the cause of action occurred). The *Limitations Act*, § 15(2) provides for a fifteen year absolute limitation period and § 4 provides for a two-year limitation period from when the cause of action was discovered. Limitations Act, S.O. 2002, c. 24, §§ 4, 15(2). But see also, provisions which toll the limitation period in class actions legislation, for example, section 28(1) of the Class Proceedings Act. S.O. 1992, c. 6, § 28(1) (Can.).

171. Queen v. Cognos Inc., [1993] 1 S.C.R. 87 (Can.).

172. McCann v. CP Ships Ltd., [2009] O.J. No. 5182, ¶ 59 (Can. Ont. Sup. Ct. J.) (QL).

173. Silver v. Imax Corp., [2009] O.J. No. 5585, ¶ 40 (Can. Ont. Sup. Ct. J.) (QL).

174. Dobbie v. Arctic Glacier Income Fund, 2011 ONSC 25, ¶ 227 (Can. Ont. Sup. Ct.).

3. Limits on Secondary Market Statutory Liability

The limit on secondary market statutory liability is a defining feature of Canada's securities regime. In Ontario, potential damages against issuers are capped at the greater of $1 million or 5% of issuer's market capitalization. Influential persons within the corporation or officers or directors of the issuer are liable up to the greater of $25,000 or 50% of their aggregate compensation from the issuer. Experts are liable for the greater of $1 million or the revenue earned from the issuer and its affiliates in the twelve months prior. Finally persons making oral public statements are liable for the greater of $25,000 or 50% of their aggregate compensation from the issuer.[175] Given these relatively low caps, the prospect of a high settlement under the Ontario Securities Act's secondary market statutory liability provisions is greatly diminished unless the plaintiff brings suit against a large issuer or is able to successfully advance a common law claim for negligent or fraudulent misrepresentation. Consequently, if it is indeed the case that private enforcement disproportionately targets large issuers, public regulators might consider work to restore balance by examining how they might best tailor their enforcement activities to fill this gap and ensure comprehensive market discipline.

4. The Class Actions Regime

This section discusses the development of Ontario's class action regime since its inception in 1993. Compared to the United States, the Canadian class action regime places the greatest procedural hurdle before the action commences, rather than assessing the claim during the pleadings process. Consequently, Canada has taken a relatively reserved approach to securities class actions, and has yet to develop a class action bar as large and highly specialized as that found in the United States.

Securities legislation provides investors with a broad right to bring civil actions against an issuer. However, the high cost of litigation relative to the quantum of damages often make these actions impractical for retail investors. The introduction of class action legislation helps to overcome these barriers and makes securities litigation financially viable for a far wider class of investors.[176] Thus, any discussion of the effectiveness of Canada's private securities enforcement regime must also consider the efficacy of the class action system.

Ontario's 1993 Class Proceedings Act was modeled on Rule 23 of the United States Rules of Civil Procedure. However, the 1982 Law Reform

175. R.S.O. 1990, c. S-5, § 138.1.

176. Pritchard & Sarra, *supra* note 160, at 882.

Commission of Ontario generated much of the policy used for interpreting the provisions of the Class Proceedings Act. These guiding principles are (1) the promotion of judicial economy and efficiency, (2) enhanced access to private litigation, and (3) the modification and deterrence of the wrongdoer's behavior.[177] Some argue that these principles render Canadian legislation "*more liberal* in facilitating class actions than its American counterpart,"[178] and the principles may also present a challenge to finding an effective balance between public and private securities enforcement. This contention is examined in greater detail in the discussion of the *Fischer v. IG Investment Management* class action certification, where a class of investors sought private redress for losses accruing from market timing in Canadian mutual funds, following a finding of public liability and an order that damages be paid back to the injured investors.[179]

In addition to requiring plaintiffs to obtain leave from the court to bring a secondary market statutory liability claim, they must also seek certification under the Class Proceedings Act. "The certification motion is intended to screen claims . . . at least in part to protect the defendant from being unjustifiably embroiled in complex and costly litigation."[180] Canada and the United States have adopted similar approaches to certify classes by requiring individuals to have a common question of law or fact, and ensuring that the class action represents the preferable procedure.[181] A significant difference between the two regimes, however, is that in Canada, the class proceedings framework requires prospective class counsel to produce a plan and workable method for structuring the proceedings.[182] As a result, the certification process can be highly litigious and competing firms challenge each other's capacity to effectively manage the action.[183] Consequently, protracted contests for carriage of the class action can add significant delays to the early stages of the securities class action process in Canada. When carriage of the class action is not contested, the court will grant leave where it is satisfied the action is brought in good faith and there is a reasonable possibility of success.[184] Although the Court in *Silver v. Imax* appears to have established a low

177. Gary D. Watson, *Class Actions: The Canadian Experience*, 11 DUKE J. COMP. & INT'L L. 269, 269–71 (2001).

178. *Id.* at 272.

179. Fischer v. IG Inv. Mgmt. Ltd., 2012 ONCA 47, ¶ 18 (Can.).

180. Robertson v. Thomson Corp., [1999] O.R. 3d 389, ¶ 4 (Can. Ont. Gen. Div.).

181. Class Proceedings Act, S.O. 1992, c. 6, § 5(1) (Can.); FED. R. CIV. P. 23.

182. *Fischer*, 2012 ONCA 47.

183. *See, e.g.*, Smith v. Sino Forest Corp., 2012 ONSC 24 (Can.).

184. R.S.O. 1990, c. S-5, § 138.8(1).

standard of "more than a *de minimis* possibility of success at trial" for obtaining leave,[185] the good faith requirement becomes relevant where sanctions are pursued by both public and private agents.

In contrast, U.S. reforms focus on reducing "abusive litigation," by enacting legislation such as the Private Securities Litigation Reform Act of 1995.[186] These amendments created procedural safeguards to filter out frivolous and abusive litigation at the pleading process,[187] rather than examining the substance of a claim during the certification process. Similarly, the Securities Litigation Uniform Standards Act of 1998 extended the Private Securities Litigation Reform Act's provisions from federal court securities fraud suits to include state court securities fraud suits.[188] As a result, American law and jurisprudence has evolved in a manner conducive to large and numerous securities class actions.

Comparison of class action legislation in Canada and the United States reveals that, on one hand, the legislators have adopted similar approaches to certification. As evident in the data on private enforcement (below), however, Canada has fewer securities class actions than the United States, even after appropriate deflators are taken into account. From a legislative perspective, this may be attributed to Canada's emphasis on certification, which creates a barrier to entry before the class action can get under way and in some sense provides an incentive to litigate outside of Canada. In contrast, the U.S. focus on "abusive litigation" moves delays into the pleadings stage,[189] enabling U.S. courts to establish the class more expeditiously.

Unlike the United States, which has provided for class actions and secondary market liability since the 1930s, Canada's legislation is quite young. As a result, Canada has not yet developed a large and highly specialized class action bar. Historically, Canada has not culturally recognized class actions as a fundamental element of Canada's civil procedure regime, but that is changing. However, in recent years, Canada has experienced greater specialization and competition within the plaintiff's class action bar. This maturation is particularly evident in the recent contest for carriage of the *Sino Forest* class action.[190] In their motion, four applicants vied for the right to lead this international class action which

185. Silver v. Imax Corp., [2009] O.J. No. 5585, ¶ 324 (Can. Ont. Sup. Ct. J.) (QL).

186. JAMES M BARTOS, UNITED STATES SECURITIES LAW: A PRACTICAL GUIDE 265 (3d ed. 2006).

187. *Id.*

188. *Id.*

189. Pritchard & Sarra, *supra* note 160, at 913.

190. Smith v. Sino Forest Corp., 2012 ONSC 24, ¶ 1 (Can.).

claimed damages of $6.5 billion.[191] In reaching his decision, Justice Perell of the Ontario Superior Court noted that all firms involved likely had the capacity and expertise to manage a class action of this magnitude.[192] Eventually Justice Perell decided that the action proposed by two firms jointly should prevail because of the arm's-length relationship between the representative plaintiff and the defendant, the broader class definition, and their cautious pleadings.[193] The ability of four leading class action firms to contest carriage of the *Sino Forest* action evidences the growth of the Canadian class action bar and its increasing capacity to manage multiple large class actions simultaneously, while maintaining high settlement values.

B. An Overview of the Most Recent Empirical Data on Securities Class Action Litigation in Canada

Review of the empirical data on securities class action litigation highlights several distinct features in Canada's private enforcement regime. In particular, since the introduction of secondary market statutory liability in 2005, the number of new filings and ongoing cases has steadily increased.[194] However, the numbers of class action settlements in Canada continue to be far fewer than the United States, averaging approximately one-fifth the number of claims per issuer from 2008–2011.[195] Interestingly, median settlement values in Canada tend to be roughly comparable to those in the United States averaging between $9 and $11 million per action—notwithstanding the fact that Canada's market capitalization is approximately one-tenth than that of the United States.[196]

Given that over 88% of the TSX and TSX-Venture's market capitalization is held by the 200 largest issuers and over 40% of listed companies there have market capitalization below $10 million,[197] statutory liability

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191. Statement of Claim ¶ 2(f), Trs. Labourer's Pension Fund Cent. & E. Can. v. Sino Forest Corp., 2012 ONSC 1924 (No. CV-11-431153-00CP), *available at* http://www.kmlaw.ca/site_documents/111100_SOC_6jan12.pdf.

192. *Sino Forest*, 2012 ONSC ¶ 234 (Can.). Motions for certification were made by Rochon Genova LLP, Kim Orr Barrister P.C., and jointly by Siskinds LLP and Koskie Minskie LLP. *Id.* ¶ 4. Carriage was ultimately awarded to Siskinds LLP and Koskie Minskie LLP. *Id.* ¶ 7.

193. *Id.* ¶¶ 277, 293, 308.

194. HEYS & BERENBLUT, *supra* note 157, at 4.

195. Pritchard & Sarra, *supra* note 160, at 881.

196. Nicholls, *supra* note 7, at 134, 149.

197. *Id.* at 133–34. These 40% of issuers with a market capitalization of less than $10 million will have a maximum secondary market statutory liability of $1 million, pursuant to Ontario Securities Act § 138.1. From 2008-2011, the smallest class action settlement was $1.3 million in *Henault v. Bear Lake Gold Ltd.*, 2010 ONSC 4474 (Can.), which

in the secondary market regime may impose a limit on the ability of private enforcement to ensure comprehensive market discipline. Consequently, the high median settlement values in Canadian securities litigation relative to U.S. settlements suggests that litigation has focused on larger issuers who have the market capitalization to pay multi-million dollar settlements.

Year	**Number of Claims Filed**[198]	**Number Secondary Market Statutory Liability Claims Filed**[199]	**Total Number of Claims Outstanding**[200]	**Number of Claims Filed in the U.S.**[201]
2008	12	8	26	245
2009	9	6	28	218
2010	10	8	33	241
2011	15	9	45	232

Table 4: Secondary Market Liability Claims, 2008–2011

1. 2008.

Buoyed by a sharp increase in the number of secondary market statutory liability claims, twelve new class actions were filed in 2008, representing a 240% increase from 2007. The steady growth in secondary market statutory liability claims and as a percentage of the total securities litigation in Canada demonstrates the suitability of the secondary market for class actions and the limited incentives for litigation in the primary market, when investors retain a statutory right of rescission.[202] However, despite the increase in the number of new claims, growth in the total number of ongoing class actions remained relatively modest—increasing from twenty-two active cases at the end of 2007 to twenty-six by the end of 2008.[203]

The United States also experienced a dramatic increase in class actions between 2007 and 2008, increasing from 198 to 245.[204] This increase was largely driven by the 102 new class actions claiming damages after the

settled for 6.5% of its initial claim value. This indicates that there were no settlements against the smallest 40% of issuers in Canada over this period.

198. HEYS & BERENBLUT, *supra* note 157, at 2.
199. *Id.*
200. *Id.* at 11.
201. *Id.* at 16.
202. R.S.O. 1990, c. S-5, § 105.
203. HEYS & BERENBLUT, *supra* note 157, at 3.
204. *Id.* at 3.

2007 credit crisis.[205] By contrast, proactive intervention by provincial securities regulators and private institutions during the ABCP crisis in 2007 enabled Canada to avoid much of this litigation. Because of the court-supervised restructuring of the ABCP market and release from private liability only three class actions related to the credit crisis were filed in Canada.[206]

2. 2009

Following the dramatic growth in the number of securities class actions in 2008, there was a moderate decrease of nine new securities class actions filed in 2009.[207] This cooling is likely due to the more conservative investment climate following the recession and lack of readily attainable financing to support shareholder activism. Moreover, the lingering effects of the credit crisis made it difficult for prospective litigants to effectively pursue private actions. Although the conduct leading to the credit crisis provided prospective litigants with many viable causes of action, the defendants they sought to recover from may have lacked adequate resources to pay large settlements because of the effects of the crisis.

Despite the slight cooling in securities class actions in 2009, the number of new filings and ongoing actions remained above pre-recession levels. Moreover, median settlement values and the ratio of initial claim value to settlement value, or claim-to-settlement value, remained consistent with previous years, which were $9.1 million and 15.3%, respectively. By contrast, the United States experienced a marked decrease in both the number of class action filings and settlement values in 2009.[208] Although the smaller number of class action settlements in Canada limits the robustness of any conclusions, the steady increase in the number of ongoing securities class actions and constancy in claim-to-settlement ratios demonstrates the development of an increasingly capable class actions bar in Canada.[209] These values indicate that Canadian firms are selective in the cases they pursue and have the skills necessary to obtain

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205. MILEV ET AL., *supra* note 157, at 2.

206. A detailed discussion of Canada's management of the ABCP Crisis takes place *infra* Part III.C.

207. HEYS & BERENBLUT, *supra* note 157, at 2.

208. MILEV ET AL., *supra* note 157, at 17.

209. *See, e.g.*, Monsanto v. TVI Pacific Inc., 2009 ONSC 43191 (Can.); Pysznyj v. Orsu Metals Corp., 2010 ONSC 1151 (Can.); Ainslie v Afexa Life Sciences Inc., 2010 ONSC 4294 (Can.); McCann v. CP Ships Ltd., [2009] O.J. No. 5182 (Can. Ont. S.C.J.); Yee v. Aurelian Resources Inc., [2009] 007 ABQB 68 (Can.); O'Neil v. SunOpta Inc., [2010] O.J. No. 5251, 2010 ONSC 2735 (Can. Ont. S.C.J.).

consistent outcomes, especially when compared to the wide discrepancy in settlement values and claim-to-settlement ratios in the United States.[210]

3. 2010

The number of securities class actions continued to increase steadily in 2010 with ten new filings, eight of which involved secondary market statutory liability claims.[211] Overall, the number of active securities class action claims increased from twenty-eight to thirty-three. This continued growth in the number of secondary market statutory liability filings was likely fostered by the relatively liberal approach to certification adopted by the Ontario Superior Court in *Silver v Imax* in 2009,[212] and the growing familiarity and experience with the secondary market statutory liability regime.

The settlement of $28.5 million in *Elliott v. NovaGold*[213] represented Canada's largest securities class action settlement to date. However, this large settlement value was offset by a record low settlement of $1.3 million in *Henault v. Bear Lake Gold*.[214] As a result, the average annual settlement value of $13.5 million was slightly higher.[215] Record settlements in the United States, where the median settlement value was $11 million and the mean average was $42 million, likely contributed to the increase seen in Canada.[216] Although settlement values in Canada were, on average, higher than in previous years, the wider range indicates that securities class actions in Canada are expanding. Law firms are becoming increasingly entrepreneurial by searching for potential class actions with claims worth a variety of values.

4. 2011

In 2011, the number of securities class actions in Canada reached a record high. Fifteen new claims were brought and a total of forty-five ac-

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210. MILEV ET AL., *supra* note 157, at 19–23.

211. HEYS & BERENBLUT, *supra* note 157, at 2.

212. Silver v. Imax Corp., [2009] O.J. No. 5585 (Can. Ont. Sup. Ct. J.) (QL).

213. Judgment at ¶ 1(f), Elliott v. NovaGold Resources Inc. (Can. Ont. Sup. Ct. J.) (Aug. 4, 2010) [hereinafter NovaGold Judgment].

214. Henault v. Bear Lake Gold Ltd., 2010 ONSC 4474, ¶ 18 (Can.).

215. *See* NovaGold Judgment, ¶ 1(f) (Can. Ont. Sup. Ct. J.) (2010); *Henault*, 2010 ONSC 4474, ¶ 18; West Coast Soft Wear Ltd. v. 1000128 Alberta Ltd. [2010] O.J. Nos. 5247, 5248 ¶ 45 (Can. Ont. S.C.J.); Metzler Inv. v. Gildan Activewear, 2011 ONSC 1146, ¶ 6 (Can.). The median value was $10 million, and averaged 12.6% of the original claim value.

216. MILEV ET AL., *supra* note 157, at 18.

tive claims continued with initial claim values totaling $24.5 billion.[217] This dramatic increase was driven in part by the large number of new claims initiated against foreign issuers. The 450% growth in the number of securities class actions over the past decade highlights the rapid development of Canada's private enforcement regime and demonstrates a strong trend towards continued growth in the coming years.[218]

However, there was also a significant decrease in the number of class action settlements in 2011, with only two cases settling, compared to five in 2010.[219] Settlement values in these two cases continued to reflect a trend towards a broader range of settlement values, with Norbourg Asset Management settling with investors for $55 million and Redline Communications Group for $3.6 million, with an average claim-to-settlement ratio of 17.5%.[220] Given the number of ongoing high-value claims, it is anticipated that this broader range of settlement values will become a permanent fixture of Canada's class actions environment over the coming years.

An emerging dynamic in Canadian and American securities class actions is the high number of claims against Chinese companies. This was most pronounced in the United States where the number of filings against Chinese-based issuers jumped from ten in 2010 to thirty-nine in 2011.[221] Although attention for the increase in the number of claims in Canada against Chinese issuers was muted by the smaller market, the three new Canadian claims against Sino Forest, Cathy Forest Products, and Zungi Haxi Corporation have garnered significant publicity in both Canada and the United States. These claims are raising concerns about the capacity of public and private regulators to secure judgments against these issuers.[222] The OSC has responded to these concerns by initiating a targeted review of foreign issuers to ensure that existing disclosure requirements provide investors with sufficient information.[223] Further, the review is examining whether auditors, underwriters, and other market intermediaries supporting the issuer's distribution are providing an effective check on the issuer's regulatory compliance.[224]

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217. HEYS & BERENBLUT, *supra* note 157, at 3.
218. *Id.* at 3.
219. *Id.* at 11–12.
220. *Id.* at 10.
221. *Id.* at 4.
222. *Id.*
223. Press Release, O.S.C., OSC Commences Emerging Market Issuers Regulatory Review (July 5, 2011), *available at* http://www.osc.gov.on.ca/en/NewsEvents_nr_20110705_osc-reg-review.htm.
224. *Id.*; *see also* R.S.O. 1990 c. S-5, §§ 37.3, 57.

5. Observations

The steady growth in securities class actions, in particular secondary market statutory liability claims, demonstrates the robust nature of Canada's private enforcement regime. High average settlement values as a percentage of the initial claim values supports the proposition that there is a strong balance between proactive public enforcement and, where necessary, private actions, to provide an effective mechanism for investors to recover a portion of their losses. However, the number of securities class action filings in Canada continues to be far fewer than the number of filings in the United States, even when accounting for deflators, such as population.[225]

Over the past three years, the range of settlement values in Canadian class actions has grown progressively wider as new record settlements are reached. Given the United States Supreme Court's decision in *Morrison v. National Australia Bank*,[226] it is likely that the trend in large class actions favoring Canadian firms will continue. Thus, it is anticipated that the Canadian securities class action bar will remain under pressure to expand in coming years to meet this growing demand.

C. An Analysis of the Balance between Public and Private Enforcement

As Canada's securities regulatory regime continues to develop, the need for balance between public and private enforcement becomes increasingly critical. Unlike LLSV theories of securities enforcement,[227] which emphasize the role of private enforcement as the most effective mechanism for balancing investor protection and economic growth,[228] I see a system which balances public and private enforcement as most effective. The greatest value in such a system is that it allows public and private enforcement to work together to an ultimate common objective.[229] It is not that either enforcement arm is inherently superior, rather the balance and the use of effective regulatory incentives can ensure that both public and private enforcement work together effectively to provide comprehensive investor protection and efficient capital markets.[230]

Recently, Canada experienced three critical securities enforcement events, which have shaped the present regulatory environment and pro-

225. HEYS & BERENBLUT, *supra* note 157, at 3, 16.

226. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2869 (2010).

227. LLSV refers broadly to the works of Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny.

228. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1141–45 (1998).

229. Puri, *Legal Origins*, *supra* note 49, at 1671.

230. Jackson & Roe, *supra* note 1, at 208.

vided a strong foundation for future reforms. First, Canada's ABCP crisis in 2007 demonstrated the potential for public and private actors to cooperate in fashioning an appropriate remedy. However, the largely private nature of settlement negotiations and agreements leaves significant questions unanswered with respect to accountability and whether the agreement was truly in the best interests of investors. Second, the public and private response to market timing in Canadian mutual funds between 1999 and 2003 emphasized the similar, but jurisdictionally separate objectives of public and private enforcement regimes. Finally, the *Abdula v. Canadian Solar—Certification* [231] decision, recently affirmed by the Ontario Court of Appeal, demonstrates the nature of the challenges for Canadian securities regulation, as the nation becomes increasingly involved in global class actions.

The interplay between public and private enforcement raises questions about the proper balance between the deterrence and compensatory objectives of market regulation. Since the OSC appears to be taking a more proactive role in sanctioning violations and seeking compensation for harmed investors, regulators must be careful to ensure that public enforcement does not rob private litigants of their day in court. Public and private enforcement should not be viewed as mutually exclusive avenues for redress.[232]

Remedies provided by the OSC should not be regarded as complete substitutes for private settlements. But, if investors were to receive standing to participate in proceedings before the OSC and were provided sufficient compensation through a court-sanctioned restitution or compensation process, it is conceivable that their right to a private claim should be extinguished. This, of course, is subject to the implementation of appropriate legislation.

1. Canada's Asset Backed Commercial Paper Crisis in 2007

The lack of class actions resulting from the Canadian credit crisis was primarily due to the response of private institutions, which took quick action to freeze the ABCP market. At the start of the 2007 financial crisis, the Canadian ABCP market was composed of approximately $32 billion in non-bank sponsored notes and $85 billion in bank sponsored notes.[233] Prior to the crisis, regulators had adopted a hands-off approach to ABCP regulation. Since issuers were not required to provide a long-

231. Abdula v. Canadian Solar, 2011 ONSC 5105, *leave to appeal granted* 2012 ONCA 211 (Can.).

232. *See* PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 8.

233. Chant, *supra* note 62, at 4.

form prospectus detailing the content and assets underlying the ABCP, they were able to market all ABCP products as homogeneous, low-risk investment products. When the credit crisis arrived, investors began to question the quality of the assets guaranteeing these products and, as a result, the turnover of maturing notes ground to a halt. Prompt intervention by private financial institutions prevented widespread defaults in the non-bank sponsored markets and ensured that the expectations of investors were protected.

Following the market freeze, the Pan-Canadian Investor Committee agreed to a court approved restructuring of the ABCP market. The restructuring included a full release from private liability with the exception of claims for fraud and provided a full return on the investments of investors with less than $1 million in the ABCP market.[234] As a result, the Canadian market avoided the dramatic increase in class actions seen in the United States. Therefore, comparisons of the number of class actions in the United States and Canada following the 2008 financial crisis may not provide a complete basis for analyzing the effectiveness of Canada's private enforcement regime.

In sharp contrast to the Canadian experience, 255 new securities class actions were filed in the United States in 2008, with the credit crisis driving these numbers to a ten-year high.[235] One hundred and ten of these cases were a direct result of the credit crisis and approximately half of the new filings were against defendants in the financial sector.[236] The types of cases brought were similar to those in Canada, with approximately 25% related to accounting, over 40% related to product and operational defects, and the remainder divided among company-specific earnings guidance, merger integration issues, customer and vendor issues, and other industry-related issues.[237]

The credit crisis generated an interesting dilemma for plaintiffs, since their losses were incredibly large, but the pockets from which they attempted to recover these losses were incredibly small due to the crisis.[238] The disparity between the number of cases brought in Canada and the United States as a result of the credit crisis was significantly affected by Canada's resolution of the ABCP issue. Thus, the balance between public and private enforcement in Canada may have helped increase short-

234. *Metcalfe & Mansfield*, 2008 CanLII 23497, ¶ 39 (Can. Ont. Sup. Ct. J.).

235. STEPHANIE PLANCICH & SVETLANA STARYKH, NERA ECON. CONSULTING, 2008 TRENDS IN SECURITIES CLASS ACTIONS 1 (Dec. 2008), *available at* http://www.nera.com/extImage/PUB_Recent_Trends_Report_1208.pdf.

236. *Id.* at 1.

237. *Id.* at 6.

238. *Id.* at 17.

term investor confidence and provide greater certainty than would have been possible under a post facto, private enforcement system.

Although issuers were released from private liability, public discipline was still enforced through sanctions by provincial securities regulators. Most notably, fines were levied against the investment firm Coventree Inc. and two of its executives for misrepresentations prior to the ABCP crisis. Also, private settlements were entered wherein seven Canadian banks agreed to pay $139 million in fines including $75 million from National Bank and $22 million from the Canadian Imperial Bank of Commerce.[239] Thus, the Canadian approach may favor proactive, public regulation as a first line of defense and private enforcement as a secondary layer of protection.

2. The Public and Private Response to Market Timing in Canadian Mutual Funds

Public and private enforcement both serve important roles in Ontario's securities enforcement regime. As a public regulator, the OSC has broad public interest jurisdiction to impose market discipline and, where appropriate, seek leave from the court to direct compensation to investors.[240] A number of private civil remedies are also available to investors to ensure they receive adequate compensation and a right to manage their own claims. Since public and private enforcement work towards the common goal of ensuring comprehensive market discipline, their enforcement activities may overlap and raise issues of certainty and finality for the parties involved. The Ontario Court of Appeal's recent decision in *Fischer* underscores the need for these two regimes to work cooperatively.[241] Further, a good balance between both systems ensures more effective use of scarce enforcement resources.[242]

In 2003, the OSC commenced an investigation into late trading and market timing in 105 Canadian mutual funds and ordered these funds to provide the OSC with an overview of the policies and procedures that they were using to combat market timing and late trading. Market timing occurs when investors take advantage of the "stale prices" of foreign securities used to calculate the Net Asset Value ("NAV") of an international mutual fund. A fund's NAV value is calculated daily at 4:00 pm EST, using the closing market values of all the fund's holdings. Because

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239. Order, *In re* Coventree Inc., Geoffrey Cornish & Dean Tai, OSC PROC. (Nov. 8, 2011).

240. *See* R.S.O. 1990, c. S-5, §§ 127, 128.

241. *See* Fischer v. IG Inv. Mgmt. Ltd., 2012 ONCA 47 (Can.).

242. PURI, ENFORCEMENT EFFECTIVENESS, *supra* note 35, at 16; *see, e.g.*, *OSC Staff Notice 11-719*, *supra* note 82, at 8410.

European and Asian markets close at 6:00 pm and fourteen hours prior to North American markets, the closing prices of these securities do not reflect developments in the North American market and may be undervalued. Market timers exploit upward trends in the North American market by recognizing that foreign equities in the fund are likely to gain when the market opens the next day, and as a result the NAV value of the fund will undervalue these foreign securities. In order to capitalize on this position, market timers make a short-term investment in the fund and then sell their investment once the foreign market appreciation is factored into the NAV and realize the arbitrage profit. Although not illegal, market timing reduces the profitability of the fund for long term investors and forces managers to hold large sums of money out of the market to pay for daily churn in the fund.

When investigating five mutual fund companies[243] the OSC maintained that the failure of these funds to implement adequate safeguards against market timing constituted a breach of the manager's fiduciary duty to the fund.[244] By 2005, the OSC had settled or rendered decisions against all five mutual funds, who agreed to pay a total $205.6 million to their investors.[245] Significantly, these settlements were deemed to be "without prejudice" to the parties in "any civil or other proceedings which may be brought by any other person or agency."[246]

In 2009, a class of investors applied to certify a class action against these five funds for residual damages not accounted for in the OSC's settlement. The motions judge refused their application, maintaining that a class action was not the preferable procedure since the policy objectives of compensation, judicial economy, access to justice, and behavior modification had been satisfied by the OSC settlement.[247] This decision was subsequently overturned by the Divisional Court, which held that

243. The five funds include CI Mutual Funds, AIC Limited, Franklin Templeton Investments, IG Investment Management Ltd, and AGF Funds Inc. *Fischer*, 2012 ONCA 47, ¶ 1 n.1.

244. Settlement Agreement, *In re* Sec. Act R.S.O. 1990, c.S.5, as amended & AGF Funds Inc., OSC PROC. (Dec. 12, 2004); *In re* Sec. Act R.S.O. 1990, c.S.5, as amended & CI Mutual Funds Inc., OSC PROC. (Dec. 16, 2004); Settlement Agreement, *In re* Sec. Act R.S.O. 1990, c.S.5, as amended & Franklin Templeton Investments Inc., OSC PROC. (Dec. 28, 2005); Settlement Agreement, *In re* Sec. Act R.S.O. 1990, c.S.5, as amended & I.G. Investment Management Ltd., OSC PROC. (Dec. 16, 2004); Settlement Agreement, *In re* Sec. Act R.S.O. 1990, c.S.5, as amended & AIC Ltd., OSC PROC. (Dec. 16, 2004).

245. *See, e.g.*, *supra* note 244.

246. *Fischer*, 2012 ONCA 47, ¶ 17.

247. *Id.* ¶ 80.

since investors were claiming monetary damages beyond those provided by the OSC, their claim could not have been fully satisfied.[248]

Chief Justice Winkler of the Ontario Court of Appeals upheld the Divisional Court's ruling and found that the OSC serves a public regulatory function, which is distinct from the private remedial goals of the proposed class action.[249] Chief Justice Winkler ruled that the OSC "lacked the jurisdiction under its enabling provision of s. 127(1) of the *Securities Act* to decide the liability and damages issues raised in the private law action."[250] Consequently, decisions of the OSC are not capable of extinguishing a private party's right of action.

The Ontario Court of Appeal's decision in *Fischer* is significant because it affirms the interrelationship between public and private enforcement in Canada and recognizes the purposes they serve. Although it is still premature to assess the full impact of this decision, the precedent it establishes provides greater certainty for prospective securities class actions where public enforcement activities have taken place. This distinction between public and private liability may ultimately expand the scope of compensation available to investors seeking redress for secondary market statutory liability since sanctions levied by the OSC are not prejudicial to the investor's private right of action and the cap on private, secondary market civil liability under §138.1 of the Ontario Securities Act. However, in order for the OSC to assume this role legitimately, the legislature would need to amend their enabling legislation.

3. Global Class Actions

In an increasingly integrated global economy, securities litigation frequently spans multiple jurisdictions. This is especially pronounced in Canadian markets, given the high percentage of companies cross-listed on domestic and foreign exchanges. A major challenge for regulators and courts is determining the proper role of international private enforcement and whether an active securities litigation system encourages a more effective regulatory environment.[251] Ontario courts appear willing to assume jurisdiction in cross-border proceedings without requiring the majority of investors to be Canadian residents. This approach stands in stark contrast to the U.S. Supreme Court's decision in *Morrison*, where for-

248. Fischer v IG Inv. Mgmt. Ltd., 2011 ONSC 292, ¶¶ 235–65 (Can.).

249. *Fischer*, 2012 ONSC 47, ¶ 10.

250. *Id.* ¶ 80.

251. *See generally* La Porta, *supra* note 1 (discussing the various systems of protection for investors in legal systems all over the world); Jackson & Roe, *supra* note 1 (concluding that public enforcement is overall as important as private enforcement in explaining financial market outcomes around the world).

eign plaintiffs were denied jurisdiction to sue American defendants when the securities were purchased on foreign exchanges.[252] The divergent jurisprudence in Canada and the United States may significantly impact the development of Canada's class action system as foreign investors begin to regard Canada as a hospitable jurisdiction for global securities class actions.

Generally, where there is a real and substantial connection between the individual claim and the jurisdiction in which the claim is being brought, a Canadian court will exercise its inherent jurisdiction to certify national and global class actions.[253] However, two recent decisions in Ontario conflict on whether foreign investors who purchased their securities abroad should be certified as members of an Ontario class action. In *McKenna v. Gammon Gold*, the court refused to include investors who purchased securities outside of Canada in the class.[254] In a more recent certification decision in *Silver v. Imax*, the court defined the class to include both Canadian and U.S. investors who purchased their shares on the TSX and NASDAQ.[255] The court accepted that since Imax was an Ontario based company, trading on the TSX, Ontario was the appropriate jurisdiction, even though only 10–15% of the investors were Canadian residents.[256]

Another example of Canadian courts' willingness to assume jurisdiction in global class actions was in *Mondor v. Fisherman*, where Canadian investors brought a class action against YBM for secondary market losses.[257] Since YBM's headquarters were located in Pennsylvania, a class action was also filed by American shareholders in the U.S. District Court for the Eastern District of Pennsylvania.[258] It was agreed by the judges in both jurisdictions, however, that Canada had a greater interest than the United States in the subject matter since YBM was incorporated in Canada.[259] These cases demonstrate a general willingness by Canadian

252. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2869 (2010).

253. *See, e.g.*, Van Breda v. Village Resorts Ltd., 2012 SCC 17 (Can.); Baxter v. Canada (Att'y Gen.), [2005] O.J. No. 2165, ¶ 12 (Can. Ont. Sup. Ct. J.) (QL); Nantais v. Telectronics Proprietary (Can.) Ltd., [1995] O.J. No. 2592, ¶ 98 (Can. Ont. Gen. Div.) (QL); Carom v. Bre-X Minerals Ltd., [1999] O.J. No. 1662, ¶¶ 281–86 (Can. Ont. Sup. Ct. J.) (QL); Wilson v. Servier Can. Inc., [2000] O.J. No. 3392, ¶ 28 (Can. Ont. Sup. Ct. J.) (QL).

254. McKenna v. Gammon Gold Inc., 2010 ONSC 1591, ¶ 116 (Can.).

255. Silver v. Imax Corp., [2009] O.J. No. 5585, ¶ 6 (Can. Ont. Sup. Ct. J.) (QL).

256. *Id.* ¶¶ 109–30.

257. Mondor v. Fisherman, [2002] O.J. No. 1855, ¶ 1 (Can. Ont. Sup. Ct. J.) (QL).

258. Paraschos v. YBM Magnex Int'l Inc., 130 F. Supp. 2d 642, 642 (E.D. Pa. 2000).

259. *Mondor*, [2002] O.J. No. 1855, ¶¶ 11–12.

courts to assume jurisdiction for international class actions where a connection to Canada has been established.

The opportunity for Canadian courts to hear global class actions may be accentuated by the U.S. Supreme Court's decision in *Morrison*,[260] where Justice Scalia held that there is no cause of action for a foreign plaintiff to sue foreign and American defendants for misconduct in connection with securities traded on foreign exchanges.[261] Since the United States appears to be adopting a more restrictive approach to international class action certification, *Morrison* may steer litigation to the jurisdiction where the company is incorporated or listed. This may, in turn, force the Canadian class action bar to develop increased autonomy and capacity.

Another indication of the willingness of Canadian courts to assume jurisdiction in international class actions was seen in the certification decision in *Abdula v. Canadian Solar*.[262] In approving the certification, the Ontario Superior Court held that Canada had jurisdiction because Canadian Solar is a company incorporated in Canada who sold securities to Canadian investors, notwithstanding that Canadian Solar's principal place of business is China, their securities are listed exclusively on the NASDAQ, and all regulatory filings and disclosures were made to the SEC.[263] In his decision, Justice Taylor relied heavily upon the Ontario Superior Court's decision in *Silver v. Imax* to support his liberal approach to certifying this action.[264] Since Canadian Solar's sole links to Canada's jurisdiction are its place of incorporation and investors, this decision appears to push the limits of the precedent from *Imax* and *Mondor*. Thus, the Ontario Court of Appeal's recent decision in *Canadian Solar* is very important to the evolution of Canada's global class action regime. The Court of Appeal's affirmation of Justice Taylor's decision, clearly signals Canada's willingness to allow actions against foreign issuers if a real and substantial connection to Canada is established, and may cause plaintiffs to regard Canada as a viable alternative to the United States following its decision in *Morrison*.

4. Private Enforcement Conclusions

The introduction of secondary market statutory liability and class action legislation created an opportunity for investors to pursue far more claims than would have been possible under the common law. Still, secu-

260. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2888 (2010).

261. *Id.*

262. Abdula v. Canadian Solar, 2011 ONSC 5105, *leave to appeal granted* 2012 ONCA 211 (Can.).

263. *Id.*

264. Silver v. Imax Corp., [2009] O.J. Nos. 5573, 5585 (Can. Ont. Sup. Ct. J.) (QL).

rities class action litigation in Canada occurs far less frequently than in the United States. This appears to be the result of multiple factors. First, Canadian capital markets are approximately one-tenth the size of American markets. Second, secondary market statutory liability has been part of the U.S. securities landscape for over eighty years, whereas it has existed in Canada for only seven years and is still developing sufficient jurisprudence to guide its implementation. Also, elements of the Canadian regime may limit the number of cases pursued under the secondary market civil liability provision. The limits on statutory liability and the double leave requirement for certifying a secondary market statutory liability class action serve as procedural gatekeepers for private enforcement. Consequently, the frequency and range of defendants appearing in private securities actions appears to be limited. [265]

CONCLUSION

Securities enforcement in Canada has significant room for further development and harmonization between the public and private enforcement regimes. Overall, the future of securities regulation in Canada depends on the ability of legislators, courts, and regulators to strike an appropriate balance between public and private mechanisms. Despite the suggestion that investors should be allowed to seek redress through the civil liability system, a robust public regulatory system is essential for deterrence and compensation.

Review of Canada's public enforcement regime suggests that Canadian regulators are traditionally more reserved than their American counterparts. This difference appears to be due to the differing philosophical approaches to enforcement. Similarly, private enforcement in Canada also appears to be less active than in the United States. As a result, any reforms aimed at improving securities enforcement in Canada must not proceed with a view that one enforcement regime is dominant in Canada. Strengthening the capacity of one regime without due regard for the other may significantly limit the ability of the overall securities regime to achieve optimal deterrence and compensation.

Recent initiatives by the OSC to return the proceeds of public settlements to investors and the courts' willingness to grant broad standing to global securities class actions may demonstrate an effort to align the interests and objectives of public and private enforcement. Overall, these appear to be positive developments, and so long as they are properly managed, they will complement the recent growth in private enforcement

265. Mary Condon, *Rethinking Enforcement and Litigation in Ontario Securities Regulation*, 32 QUEEN'S L.J. 1, 43 (2006).

since the introduction of secondary market statutory liability in 2005. The number of private securities class actions has been increasing steadily and damages have remained comparatively high as a percentage of initial claim value. This demonstrates the strength of the plaintiff's bar in Canada. However, the number of claims filed in Canada continues to be far fewer than the United States (even after accounting for appropriate deflators), indicating that there continues to be significant room for further development.

Further development is also necessary for public and private enforcement regimes in Canada. The number of private actions initiated by investors continues to be far lower than the United States. Given the statutory cap on secondary market statutory damages, we must question whether private enforcement is capable of providing market discipline against smaller issuers. After the Supreme Court of Canada's recent reference decision on the constitutionality of a national securities regulator, public enforcement will continue to be challenged by a lack of coordinated, centralized enforcement and duplication of resources in each of the provinces and territories.

ACCESS TO JUSTICE OR JUSTICE NOT ACCESSED: IS THERE A CASE FOR PUBLIC FUNDING OF DERIVATIVE CLAIMS?

Arad Reisberg[*]

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* Reader in Corporate and Financial Law and Vice-Dean for Research, Faculty of Laws, University College London; Director, UCL Centre for Commercial Law. I am grateful to Professors Dan Prentice and John Lowry for their comments on an earlier draft of this Paper. This Paper benefitted from comments at the international symposium "Globalization of the United States Litigation Model," held on October 21, 2011 by the Dennis J. Block Center for the Study of International Business Law at Brooklyn Law School. The usual disclaimers apply.

INTRODUCTION

This Paper examines whether there is a case, in appropriate circumstances, to provide public funding for derivative claims.[1] Claims are expensive, and their cost "is a major obstacle in the path of a minor-

1. In this paper the terms "derivative claim(s)" and "derivative action(s)" are used interchangeably. Similarly, "firm," "company," and "corporation" are used interchangeably to refer to a noncharitable limited liability incorporated company.

ity shareholder bringing a derivative action on behalf of the company."[2] For example, there is nothing in the relatively new derivative claims procedure in Part 11 of the UK Companies Act 2006 that will convince a rational shareholder he is better off litigating the case on behalf of the company rather than selling his shares.[3] It is unnecessary to repeat my argument from 2004[4] and subsequent times[5] that costs and fees rules need to be reevaluated if any real change is to occur.[6] Indeed,

> the treatment of fees has a direct impact on the frequency [of claims]. The more advantageous the fee rule is to the prospective plaintiff, the greater the employment of litigation. This [is] significant for policy analysis as it assists in the creation of rules that permit judicial determination of questions deemed important to societal interests. An understanding of the economic effect of fees on the decision to commence litigation allows the development of rules to encourage those actions, which advance policy objectives. Underlying this analysis is the question whether an action should be promoted or deterred. The determination of this question is a matter for legislation and judicial innovation.[7]

The purpose of this Paper is to highlight and analyze an interesting recent development, whereby public funding may be provided in specific cases to fund derivative claims. An amendment made to the Israeli Companies Law of 1999[8] in May 2011 ("Amendment 16") permits the Israeli Securities Authority ("ISA") to fund derivative claims in cases where it

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2. Arad Reisberg, *Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation*, 4 J. CORP. L. STUD. 345, 345 (2004) [hereinafter Reisberg, *Funding Derivative Actions*].

3. *See* Arad Reisberg, *Derivative Claims under the Companies Act 2006: Much Ado About Nothing?*, *in* RATIONALITY IN COMPANY LAW: ESSAYS IN HONOUR OF DD PRENTICE 17, 29, 51 (John Armour & Jennifer Payne eds., 2009) [hereinafter Reisberg, *Derivative Claims*].

4. *See generally* Reisberg, *Funding Derivative Actions*, *supra* note 2.

5. *See generally* Arad Reisberg, *Derivative Actions and the Funding Problem: The Way Forward*, 2006 J. BUS. L. 445 [hereinafter Reisberg, *The Funding Problem*]; *see also* ARAD REISBERG, DERIVATIVE ACTIONS AND CORPORATE GOVERNANCE: THEORY AND OPERATION 222–73 (2007) [hereinafter REISBERG, THEORY AND OPERATION].

6. Reisberg, *Derivative Claims*, *supra* note 3, at 366. As stated above, this is the author's thesis that runs throughout his works.

7. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 346 (citing STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 492 (2004)); John D. Wilson, *Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder's Derivative Action*, 5 WINDSOR Y.B. ACCESS TO JUST. 142, 171 (1985).

8. Companies Law, 5759–1999, 44 LSI 119 (1999) (Isr.) [hereinafter Companies Law], *available at* http://www.isa.gov.il/Download/IsaFile_958.pdf.

is convinced there is a public interest.[9] This has the potential to be an important development for several reasons. First, it extends the discussion on how to address the funding problem in derivative action procedures beyond the common solutions (i.e. those involving various fee arrangements such as costs orders, rewarding the plaintiff, or contingency fees) and its "usual suspects" (i.e. plaintiff shareholders or attorneys) to an entirely novel domain—that of a public regulator—and public funding for these private actions. Second, and directly related to the previous point, providing public funding for private actions cuts across the traditional public/private dichotomy. It shows that the choice lies not solely between private and public enforcement, but also between a private enforcement aided by a public body (i.e. privately initiated and pursued litigation which is publicly funded). Finally, the Israeli solution may offer a new strategy to address a major concern in the literature on the theory of litigation, namely, the basic problem that private incentives to litigate may diverge from what is socially desirable and that strategies may be employed to tackle this.[10]

In this Paper, I will discuss the problem of funding of derivative actions in a different taxonomy. Despite the various fee mechanisms and fee-favoring rules available under Israeli law before the introduction of Amendment 16, the fact that parties would still not pursue these claims demonstrates the underproduction of positive externalities. Thus if we are to motivate private actions by aggrieved parties, access to funding must be considered. Put simply, the policy underlying Amendment 16 reveals a new truth: where lawsuits would produce collateral social benefits, individuals are given financial support by a public body to litigate their claims. The new mechanism of a public body internalizing the cost (ISA), and thus enabling the lawsuits to be brought, helps produce these social benefits.

The Paper is structured as follows. Section A will briefly explicate the economics of derivative claim litigation. Section B will then outline the derivative action procedure under Israeli Companies Law of 1999, looking in particular at the various costs and fees arrangements under its regime. It will also briefly look at the time, cost, and number of procedures usually expected to resolve a commercial dispute through the Israeli courts. Section C will examine the details of Amendment 16, from which derivative actions may be underwritten through public funds. It will also look into the rationales behind the law. Subsequently, this Paper will in-

9. *Id.* § 209(a).

10. SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW, *supra* note 7, at 492–93.

quire into the advantages (both theoretical and practical) of public funding of such claims as well as highlight the shortcomings of such an approach. As part of this consideration, class actions currently funded by ISA will be analyzed. Finally, the implications of the preceding discussion will be examined and assessed in Section D with a view toward determining whether public funding provides a way forward for the funding problem, and whether it could be extended to other jurisdictions.

A. THE ECONOMICS OF DERIVATIVE CLAIM LITIGATION

Derivative actions enable "shareholders, usually minority shareholders, . . . to enforce the company's rights where directors have breached their duties (since in these circumstances it is unlikely that the directors, who usually act on behalf of the company, will want to take action)."[11] The prosecuting shareholder is normally named as the plaintiff and the company named as nominal defendant,[12] though this conceals the true nature of the parties.

> In reality the company is the true plaintiff in interest, and in all but exceptional cases any damages or other relief obtained flow directly to the company and not to the nominal plaintiff. This fact has a significant impact on the nominal plaintiff's decision to commence litigation, as his interest in the outcome will generally be quite diffuse and remote.[13]

In financial terms, a shareholder lacks any direct remedy that would make the action worthwhile for him or her. Despite success, "any damages recovered accrue to the company"[14] and the shareholder will therefore receive only a pro rata share of the gains of a successful action.[15] Under English law, the shareholder may have to pay not only the expenses of his or her litigation, but also the legal expenses of the defen-

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11. REISBERG, THEORY AND OPERATION, *supra* note 5, at 1.

12. *See, e.g.*, Taylor v. Nat'l Union of Mineworkers, [1985] B.C.L.C. 237 at 246 (Eng.). The case is thus res judicata, i.e. the matter cannot be raised again, either in the same court or in a different court.

13. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 347.

14. Ian Ramsay, *Corporate Governance, Shareholder Litigation and the Prospects For Statutory Derivative Action*, 15 U. S. WALES L.J. 149, 163 (1992).

15. *Id.* Then only indirectly and to the extent that the proceedings cause the value of his own share to rise sufficiently, so that he might be willing to sue in order to sell his shares later at increased prices. This result, nonetheless, is far from certain as a successful action may reduce share values. Also, "shareholders who own small stakes in the company have little incentive to bring a derivative action because the benefit of the suit accrues to shareholders according to the *size* of their holding, *not* their efforts in bringing the action." REISBERG, THEORY AND OPERATION, *supra* note 5, at 257–69 (emphasis in original).

dant if the action is unsuccessful.[16] A prospective plaintiff, being aware that the company and other shareholders will "free-ride" on his or her efforts, is likely inclined to forgo suit in anticipation of other plaintiffs.[17] Ultimately, even if shareholder litigation results in intangible deterrence benefits, there is little reason for individual shareholders to sue. Consequently, if all shareholders share this same view, "then no one is likely to step forward even in situations where litigation would increase total share value."[18] As I have explained,

> An imbalance therefore arises in derivative litigation, as the fees faced by the nominal plaintiff will, in most cases, outweigh the potential benefit accruing to him. This consequent deterrence to derivative actions is common to both the English and American fee rules. [As a result,] [r]ational plaintiffs [will] therefore . . . rarely initiate derivative actions. Empirically, however, this is not the case in the United States. The fact that the action is employed in the United States is due to adjustments in the usual cost rules, the most significant of which are the "common fund", the "substantial benefit" doctrines and the recognition of contingency fee arrangements.[19]

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16. Owing to the English "loser-pays" rule that costs follow the event. In the United States this is, of course, different. *See infra* notes 19–20 and accompanying text.

17. Brian R. Cheffins, *Reforming the Derivative Action: The Canadian Experience and British Prospects*, 2 COMPANY FIN. & INSOLVENCY L. REV. 227, 257 (1997).

18. *Id.* at 257–58.

19. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 347–48. The pattern of derivative litigation can be explained in large measure by the incentive structure which exists for lawyers in the United States. *Id.* at 348 n.13. *See, e.g.*, Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J.L. ECON. & ORG. 55, 85 (1991); Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 366–67 (2001); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1157 (1990); Deborah DeMott, *Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions*, 11 SYDNEY L. REV. 259, 273 (1987). These themes and sources are explored in Reisberg, *Funding Derivative Actions*, *supra* note 2, at 348, 348 n.13. For further information on the common fund doctrine, see *id.* at 349 n.20.

> According to the doctrine, when a fund is recovered which benefits a class of persons beyond the nominal plaintiff, the legal fees expended in recovery are treated as a first charge against the fund. The theory of the doctrine is based on unjust enrichment and demands that all beneficiaries contribute pro rata to the expense of recovery. In the early application of the doctrine a monetary fund had to be recovered or saved. The shortcomings of the restrictive application became obvious when injunctive or declaratory relief was sought as there was no fund to charge. This deficiency was cured by judicial innovation, which extended the doctrine to situations where a substantial, although not monetary,

> As a result of the well-built fee structure in the [United States], it is common to see attorneys functioning more like "entrepreneurs" who conduct litigation almost entirely on their own, with virtually no monitoring by the shareholders whose names are used only as the key to the courtroom door. . . . The contingency fees arrangement and the lodestar method are perhaps the two most important mechanisms that affect not only who pays the attorneys' fees and how these fees are calculated, but also how the plaintiffs' attorneys conduct the derivative action litigation. Not surprisingly, win or lose, derivative actions appear to be fairly common in the [United States.] [20]

English law's dearth of similar doctrines to derivative actions may explain their underutilization.[21] Indeed, "the traditional way in which most

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> benefit was obtained, justifying an award of attorneys' fees against the benefiting entity.

Id. (citing Sprague v. Ticonic Nat'l Bank, 307 U.S. 161, 169 (1939); Lang Thai, *How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand*, 30 AUSTL. BUS. L. REV. 118, 123 n.48 (2002) (citing P.A. Batista, *Counsel Fees in Derivative Litigation: End of the Golden Harvest?*, 11 SEC. REG. L.J. 153 (1983); Carol G. Hammett, *Attorney's Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Reexamined*, 60 CAL. L. REV. 164, 164–65 (1972); AM. L. INST. [A.L.I.], PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 cmts. a & c (Proposed Final Draft 1992) [hereinafter PRINCIPLES OF CORP. GOVERNANCE]). For further information on the substantial benefit doctrine, see Reisberg, *Funding Derivative Actions*, *supra* note 2, at 350.

> Based on these approaches, there are two methods for calculating attorneys' fees in derivative actions. The first method is the percentage scale, which is applicable when the case generates a common fund for the company—the attorney will then be paid in the range of 20–30% of the common fund, depending on the prior agreement. Stated differently, a percentage scale will be used to calculate attorneys' fees if derivative action results in a tangible monetary relief. In a case where derivative litigation results in an intangible or therapeutic relief only, the courts will apply the alternative method, known as the "lodestar method", to allow attorneys to be paid for their work. The lodestar method is applicable if the derivative action results in a substantial benefit to the company, whether by judgment or settlement.

Id. (internal citations omitted).

20. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 350 (internal citations omitted); *see* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation*, 54 U. CHI. L. REV. 877, 885 (1987); Jonathan Macey & Geoffrey P. Miller, *The Plaintiff's Attorney Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3 (1991).

21. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 348. Of course this is not the whole picture. There are other reasons, including standing and policy issues. *See id.* at 354–64.

Commonwealth jurisdictions address the obstacle of funding in a derivative action is by recognizing that the plaintiff should be indemnified for costs incurred in the proceeding, usually by allowing the court discretion on this matter.[22] A major obstacle to derivative action is eliminated by compensating the shareholder's costs. In fact, "the possibility of awarding a cost indemnity order is a 'significant incentive' to use the derivative action."[23] However, as I have explained elsewhere, these arguments are flawed and "ignore the realities of derivative action litigation."[24] Careful inspection of the operation of indemnity costs orders reveals significant failings in the operation of these orders.[25] Thus, "it is a less than adequate response to the formidable funding problem inherent in derivative actions."[26] The common law position on costs of derivative claims has not changed.[27] It follows that the practicalities of financing share-

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> In addition, in the UK, market forces can be quite potent. It is widely acknowledged that the UK has a more robust and less regulated takeover market than the [United States], while the [United States] is more permissive towards derivative litigation. Miller argues that these differences can be viewed as reflecting alternative approaches to controlling "agency costs." Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast between the United States and England*, 1998 COLUM. BUS. L. REV. 51, 52. Arguably, the differences also stem largely from the political influence of the organized bar. Because the English system until recently did not recognize any form of contingency fees, there is little support from the organized bar to push for liberalization in the rules governing derivative litigation. Thus incumbent managers, who are generally hostile to derivative litigation, exercise a great deal of control over the scope of the remedy. The recognition of contingency fees and the "common fund" doctrine . . . permitting attorney compensation out of the amounts generated for the benefit of the corporation have created a strong interest group within the organized bar that favours a relatively liberal scope for the remedy. Because the organized bar is usually quite influential in the design of corporate rules, it has been able to ensure a relatively wide-ranging derivative remedy despite the remedy's unpopularity among corporate managers. *Id.*; *see also*, John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 1–3 (1999).

Id. at 348 n.14 (adjusted for proper Bluebook form).

22. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 351.

23. *Id.* at 352 (citing D.D. Prentice, Wallersteiner v. Moir*: The Demise of the Rule in* Foss v Harbottle*?*, 40 CONV. & PROP. LAW. 51, 59 (1976)); LAW COMM'N, SHAREHOLDER REMEDIES (CONSULTATION), 1996, EWLC 142, ¶ 18.1 (U.K.) [hereinafter SHAREHOLDER REMEDIES CONSULTATION].

24. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 352.

25. *Id.*; *see* REISBERG, THEORY AND OPERATION, *supra* note 5.

26. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 365.

27. Advance indemnities, along the lines of those supported in *Wallersteiner v. Moir*, [1975] Q.B. 373 (U.K.) and Civil Procedure Rules [CPR], 1998, S.I. 1998/3132, r.

holder litigation remains a major obstacle in the new procedure under Part 11 of the U.K. Companies Act 2006.[28]

B. THE PROCEDURE UNDER ISRAELI LAW: VARIOUS FINANCIAL INCENTIVES TO ENCOURAGE DERIVATIVE ACTIONS

1. Background

Under the Israeli Companies Law of 1999 ("Companies Law"), derivative action is defined as "an action brought by a plaintiff on behalf of a company for a wrong done to the company."[29] There are no express sections under the Companies Law as to the causes of action for which the derivative action is to be available. However, a prospective plaintiff has to seek leave to bring the action beyond the preliminary stages[30] and the statute sets out the conditions that the court must determine are satisfied before leave can be given.[31]

> The Israeli derivative action is a descendant of the common law derivative action. [The derivative action mechanism was developed by the judiciary, which followed and expanded the English doctrine on the matter.] Over the years, Israeli courts have generally shown a willingness to grant a shareholder standing where justice requires it, but unlike English courts, they have also shown an inclination to effectively "brush aside" the procedural barriers of *Foss v. Harbottle* where they stand in the way of justice being served. This attitude has continued in recent cases, with the most obvious point of contrast lying in the courts' willingness to embrace the "interests of justice" as an exception to *Foss v. Harbottle* in its own right. This tendency culminated with the replacement of the existing derivative action procedure with a new one on a statutory footing as part of the third chapter of the Israeli Companies Law of 1999 that came into effect in February 2000.[32]

19.9(7) (U.K.), where the company may reimburse the shareholder for bringing the action if the court grants leave to continue, will be difficult to obtain as the statutory reforms fail to induce the courts to rethink their cautious position here.

28. Companies Act, 2006, c. 46, § 263(2)(a) (U.K.) [hereinafter Companies Act 2006]; *see also* Reisberg, *Derivative Claims*, *supra* note 3; Arad Reisberg, *Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action*, 6 EUR. COMPANY & FIN. L. REV. 219, 239 (2009).

29. Companies Law § 1.

30. Arad Reisberg, *Promoting the Use of Derivative Action*, 24 COMPANY LAW. 250, 250 (2003) [hereinafter Reisberg, *Derivative Action*]; Companies Law § 194 (A).

31. Reisberg, *Derivative Action*, *supra* note 30, at 250; Companies Law § 198.

32. Reisberg, *Derivative Action*, *supra* note 30, at 250 (citing Foss v. Harbottle, (1843) 67 Eng. Rep. 189, 2 Hare 461 (U.K.); Neve-Yam of Arsuf Beach Hotels Ltd. v.

One fundamental objective seems to underline the majority of sections in the statutory derivative action: encouraging or promoting the use of derivative actions.[33] The sections are designed "to turn the derivative action into a beneficial tool in enforcing corporate accountability. The derivative action is made more widely accessible for prospective plaintiffs by mitigating the effect of distorted litigation incentives"[34] and by limiting the financial liability plaintiffs face when initiating a derivative action. These include levying low court fees for derivative actions, granting the courts the right to award special dispensation to the filing shareholder (i.e. the possibility of rewarding the plaintiff), and transferring the costs onto the company once the claim is approved as a derivative action by the court.[35] Let us look at these more closely.

2. Distributing the Burden of Court Fees[36]

In spite of the tendency of Israeli courts to encourage the use of derivative actions, "[o]ne of the major obstacles still in the way of bringing derivative actions is that under Israeli law the plaintiff must carry the burden of the costs of proceeding, between the stage where he is granted permission to bring the action and its final conclusion in judgment."[37] Israeli courts have upheld this view, finding that the plaintiff must meet the burden of court fees.[38]

Cohen, 30 PD 517, 528–29 [1976] (Isr.); Gil v. Discount Bank Le-Israel Ltd., PM(2) 294 [1988] (Isr.)). The doctrine of *Foss v. Harbottle* was well stated by Lord Davey in *Burland v. Earle* (more clearly than in *Foss* itself) where he said:

> It is an elementary principle of the law relating to joint stock companies that the Court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so. Again it is clear law that in order to redress a wrong done to the company, or to recover money or damages alleged to be due to the company, the action should prima facie be brought by the company itself.

Burland v. Earle, [1902] A.C. 83 (P.C.) (U.K.).

33. Reisberg, *Derivative Action*, *supra* note 30, at 250; IRIT HAVIV-SEGAL, CORPORATE LAW IN ISRAEL, AFTER THE NEW COMPANIES ACT 605 (1999) (Isr.).

34. Reisberg, *Derivative Action*, *supra* note 30, at 250.

35. *See id.* (for a fuller account). The fact that the costs of derivative actions are to be met by the company, and are not linked to the success of the case, provides more certainty to prospective plaintiffs.

36. Court fees are levy paid directly to court upon bringing any action before Israeli courts. They are set in regulations and their rate is reviewed regularly.

37. Reisberg, *Derivative Action*, *supra* note 30, at 251; HAVIV-SEGAL, *supra* note 33, at 606.

38. Y.A.Z Investments v. Zelinger, Tak-Al, 97(2) PD 550 (Civil Appeal Request 1470/97) (Isr.).

The Companies Law tackles this head on. Section 199(1) states that when the court has granted leave to bring a derivative action, the court may give instructions as to the manner and dates of payment of court fees—including the division of payment between the plaintiff and the company. Arguably, this may serve to alleviate some of the plaintiffs' pressures (provided, of course, the court follows the spirit of this provision). In addition, and as an exception under the Israeli legal system, court fees do no need to be paid at the same time as the application to leave is submitted. Another positive measure towards potential plaintiffs is that when leave is not granted by the court to bring a derivative action or leave is granted with changes and the plaintiff has withdrawn his case, no court fees will be paid as well. Not to be deterred by high litigation costs, plaintiffs have nothing to lose or pay from their own pockets for bearing the risk of bringing the action.[39]

3. Covering for Plaintiff's Expenses during the Legal Proceedings

The arrangements under Sections 199(1) and 199(2) provide the court discretion to relieve the burden of expenses even at this early stage of proceeding. Under Section 199(2), when the court has granted leave to bring a derivative action, the court can already "order the company to pay the plaintiff such sums as it may prescribe to cover the plaintiff's costs or to deposit a security for such payment."[40] The court has discretion to distinguish between cases brought because the company is improperly prevented from averting or remedying a self-interested board's wrong or by majority shareholders acting improperly, and frivolous cases that are brought by vexatious litigants.[41] Indeed, Section 200 provides that once the court has reached a decision on the derivative action, it may, amongst other options, order the plaintiff to pay the company's expenses—part or all—according to the circumstances. Therefore, in cases where the court has shifted the burden of costs onto the company at an early stage of proceedings, it may still decide to return that burden to the plaintiff if it feels there was no justification for bringing the action retrospectively.[42]

In order to encourage derivative actions, a number of modifications were made in the context of the Companies Law. Only a part of the court fee (not the full fee) is paid at the time that a derivative action is filed. "Regulations stipulate that when a petition for the approval of a deriva-

39. Reisberg, *Derivative Action*, *supra* note 30, at 251–52.
40. Companies Law § 199(2).
41. HAVIV-SEGAL, *supra* note 33, at 606.
42. *Id.* at 607.

tive action is filed, the petitioner will pay a petition fee of NIS 2000."[43] The rest of the fee will be paid only if the petition is granted, and then by the company itself. As ISA helpfully explains, "this removes an obstacle that had blocked shareholders in the past—shareholders who refrained from filing derivative actions because of the high court fee that they were required to pay upon filing the petition."[44]

4. Costs of Derivative Actions Are to Be Met by the Company and Are Not Linked to the Success of the Case

4.1 General

Section 200 provides that "where the court has adjudicated on a derivative action, it may require the company to pay the plaintiff's costs and it may require the plaintiff to pay costs incurred by the company, in whole or in part, taking into account the judgment and the other circumstances of the case."[45]

It is clear then, that the court's discretion to order the company to meet the costs of proceedings is not limited to situations where the action was successful, and the court may order the company to meet the costs of proceeding when appropriate, even if the case eventually failed. Essentially, this recognizes the fact that the proceedings are those of the company. In this context, perhaps a better inquiry is whether the decision to bring the action was justified in the first place, not whether it was ultimately successful.[46] Nevertheless, the words of the Act ("taking into account the judgment and other relevant circumstances")[47] do suggest that there is still some importance placed on the success of the case.[48] An-

43. ISRAEL SEC. AUTH. [ISA], ISRAEL SELF ASSESSMENT ACCORDING TO METHODOLOGY FOR ASSESSING THE IMPLEMENTATION OF THE OECD PRINCIPLES ON CORPORATE GOVERNANCE AS PART OF PROCESS OF ACCESSION TO THE OECD 22 (Dec. 2008) [hereinafter ISA, SELF ASSESSMENT], *available at* http://www.isa.gov.il/Download/IsaFile_4544.pdf. At exchange rates as of September 30, 2011, this is roughly around $540.

44. *Id.* at 22.

45. Companies Law § 200.

46. HAVIV-SEGAL, *supra* note 33, at 607.

47. Companies Law § 200.

48. Compare the test formulated by Lord Denning in *Wallersteiner v. Moir* that even if the action fails,

> assuming that the minority shareholder had reasonable ground for bringing the action—that it was a reasonable and prudent course to take in the interests of the company—he should not himself be liable to pay the costs of the other side, but the company itself should be liable, because he was acting for it and not for himself.

other possible test to determine whether the plaintiff should be entitled to be indemnified by the company against all costs and expenses reasonably incurred by him in the course of the proceedings is "whether an independent board of directors would have decided to bring the action."[49]

There is no doubt that Section 200 is potentially one of the most important sections for prospective plaintiffs, as it mitigates the effect of distorted litigation incentives. With regard to a derivative claim as well, Section 201 of the Companies Law provides that in the event of a favorable ruling in the claim, the court may order the payment of compensation to the plaintiff for the effort invested in filing the petition and proving it.[50] Section 200 also provides that when a court has awarded expenses in favor of the defendant, the company will pay the expenses that have been so awarded, unless the court rules, for special reasons which shall be recorded, that the expenses are to be paid by the plaintiff.

4.2 Addressing the Issue of Attorney's Fees Specifically

Section 200 deals with costs[51] generally, but there is little guidance to the court with regard to attorney's fees. However, a recent amendment to the Companies Law, namely Section 200A, has expressively dealt with this issue. Amendment No. 3 to the Companies Law provides that the fees of the plaintiff's attorney in a derivative action will be set by the court and paid by the company unless the court decides for special reasons that the plaintiff should pay its attorney's fees.[52]

It should be noted that the Section uses the words "will be set by the court," which imply that this is a mandatory obligation. Interestingly, the official explanation to the Amendment provides great insight into the reasoning behind the terms. According to the document, the arrangements are similar to those in the United States and are geared toward encouraging potential plaintiffs to use the tool of the derivative action.[53] Essentially, it is submitted—this aligns with the fact that the proceedings are brought on behalf of the company. More importantly, although Section 200 provides that once the court has reached a judgment on the derivative action the court may order the company to meet the plaintiff's

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Wallersteiner v. Moir, [1975] Q.B. 373 (U.K.).

49. *Id.*

50. Companies Law § 201.

51. In English law the term "costs" includes lawyer's fees, whereas in Israel the term refers to the required disbursements in bringing action, i.e. filing fees. It is useful then, in order to avoid confusion, to use the term "fees" when discussing the payment due to lawyers.

52. *See* Companies Law § 44 (amend. 3), 2005.

53. *See* Companies Bill (amend.), 2002, at 646 & § 34 (explanatory notes) (Isr.).

costs, this may not be enough, as in many cases the costs granted are not sufficient (so that it may not cover, in actual terms, for all the attorney's fees).[54] Likewise, leaving the issue of attorney's fees unarranged may deter potential plaintiffs from bringing derivative actions for fear that they will have to meet the burden of attorney's fees themselves. Undetermined payment may also deter potential attorneys from taking on the representation for fear that the fee agreements between themselves and the plaintiff will not be respected by the company.[55] The lack of plaintiff-favoring fee rules in derivative actions generally limits the use of such actions, for the potential gain to the nominal shareholder plaintiff will almost always be outweighed by the potential liability for legal fees, with the result that the expected value of litigation will normally be negative. If a procedure could be devised to compensate a shareholder by ordering the company to pay the attorney his fees, then a formidable deterrent to the commencing of derivative action would be removed. The effect of Section 200 may reduce the personal risk faced by potential plaintiffs. Again, in terms of policy objective, this underlines the fact that derivative actions efficiently enforce corporate duties and obligations, and such actions would not be pursued by rational plaintiffs absent adequate fee incentives.[56] However, as I have explained elsewhere, this only reduces, rather than eliminates, the deterrent effect of fees in litigation.[57] Under Section 200, the plaintiff must prevail for the court to order the company to pay the attorney his fees.[58] If the action is unsuccessful, the plaintiff still remains liable for lawyer's fees. This may be mitigated if the court uses its discretion and orders the company to meet the costs of proceedings in case the action was unsuccessful.

5. The Possibility of Rewarding the Plaintiff

Section 201 provides that "where the court rules in favor of the company, it may order the payment of a reward to the plaintiff taking into account, *inter alia*, the benefit derived by the company from filing the claim and from winning it."[59] The court therefore has the discretion to increase the share of the plaintiff in the proceeds of the successful action beyond his indirect recovery (to the extent that recovery has any actual impact on the value of his shares because of the success of the case).

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54. *Id.*

55. *Id.*

56. Compare the U.S. decision in *Schechtman v. Wolfson*, 244 F.2d 537, 539 (2d Cir. 1957).

57. *See* Reisberg, *Funding Derivative Actions*, *supra* note 2, at 351.

58. Compare with the English indemnity costs orders, see *supra* Section B.4.

59. Companies Law § 201.

This has been described as a "major revolution" as it reflects the policy of the new Act to encourage shareholders and directors to inform the court of management irregularities by means of derivative actions.[60] In large companies, where the average holdings of shareholders is rather small, meeting the costs of bringing the action by the company may not be enough to encourage potential plaintiffs to initiate derivative action. In these types of companies an additional incentive, such as receiving part of the proceeds of a successful action, may be needed. The absence of such a direct reward prior to the Companies Law of 1999 has been offered as a possible explanation of the small number of derivative actions brought in Israel in the past.[61]

Essentially, the Section deals directly with a fundamental obstacle inherent in derivative litigation. An indemnity order in favor of the plaintiff out of company funds is usually ordered once a derivative action is brought. It presupposes that a shareholder would want to bring the action on behalf of the company. However, it fails to promote or give any incentive for a shareholder to commence litigation in the first place.[62]

> First, there is the expense of litigation and the prospect that the shareholder may have to pay the legal expenses of the defendant if the action is unsuccessful. . . . Second, even if the litigation is successful, any damages recovered accrue to the company . . . and not just to the shareholder bringing the action. Because the plaintiff shareholder will therefore receive only a pro rata share of the gains of a successful action (and then only indirectly and only to the extent the proceedings cause the value of his own share to rise) the fact that other shareholders will "free-ride" on the plaintiff shareholder's action creates a disincentive to commence litigation.[63]

This sort of free-riding effect has a strong incentive for any prospective plaintiff to leave it to someone else to sue. However, "if all shareholders share the same view, no one is likely to step forward even in situations where litigation would increase total share value."[64] Section 201 tackles this issue by making it possible for the court to award successful plaintiffs with partial proceeds of a successful action beyond their indirect recovery. In effect then, the plaintiff can benefit directly in monetary terms, which in turn may make the remedy more worthwhile in the eyes

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60. HAVIV-SEGAL, *supra* note 33, at 609.

61. Y. GROSS, ON THE NEW COMPANIES ACT, 1999, at 224 (2000) (Isr.). *But see infra* Section D.2.2.3.1.

62. On the difference between removing a deterrent and providing an incentive see REISBERG, THEORY AND OPERATION, *supra* note 5, at 232–34.

63. Ramsay, *supra* note 14, at 163.

64. Cheffins, *supra* note 17.

of prospective plaintiffs. It has been suggested that the policy considerations guiding the court in determining the extent of the reward should include the severity and the extent of the abuse or infringement. The more severe the abuse or infringement, the higher the personal reward for the plaintiff should be.[65]

6. Resolving a Commercial Dispute through the Israeli Courts

Finally, and before we turn to examine the new Amendment in the following Section, it is perhaps worth putting the Israeli system in a wider context in terms of the quantifiable cost, time, and procedures usually expected to resolve a commercial dispute (such as through a derivative action) through the Israeli courts. As can be seen below under Figure 1, the Israeli system does not compare favorably with the OECD average. According to Enforcing Contracts[66] published by the *World Bank*,[67] there are 35 procedures in an average commercial trial (compared with 31 at the OECD), it lasts on average 890 days (just more than 500 days at the OECD), and it costs 25.3% of the claim to resolve a commercial dispute through the Israeli courts (19% at the OECD).

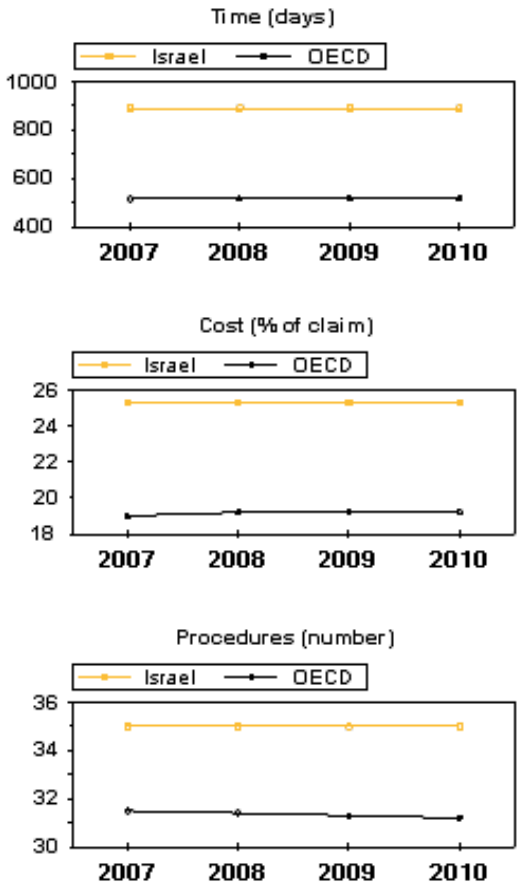
(*See graphs on next page.*)

65. HAVIV-SEGAL, *supra* note 33, at 608.

66. This is a slightly misleading title which measures three things: (1) number of procedures to enforce a contract, i.e. any interaction between the parties in a commercial dispute or between them and the judge or court officer, steps to file the case, steps for trial and judgment, as well asd steps to enforce the judgment; (2) time required to complete procedures (calendar days), i.e. time to file and serve the case, time for trial and obtaining judgment and time to enforce the judgment; and (3) cost required to complete procedures i.e. average attorney fees, court costs, including expert fees and enforcement costs. *See Doing Business: Enforcing Contracts in Israel*, WORLD BANK (2011), www.doingbusiness.org/data/exploreeconomies/Israel/enforcing-contracts [hereinafter *Doing Business Report*].

67. *Id.*

Figure 1: Enforcing Contracts Subindicators in Israel [68] 2007–2010



68. *Id.*

C. PUBLIC FUNDING OF DERIVATIVE CLAIMS UNDER ISRAELI LAW

1. Background: The Possibility of ISA Funding for Derivative Actions

ISA[69] announced in 2005 that it would, in principle, be prepared to provide funding for derivative actions in cases it believes are "of general importance to the public."[70] In line with this approach, Amendment 16 to the Companies Law was introduced in May 2011.[71] In theory, the amendment was designed to encourage derivative actions by limiting the financial liability plaintiffs face when initiating such an action. A new Section 205 has been inserted into the Companies Law, which states as follows:

> (a) Any plaintiff, who wishes to bring a derivative action in the name of a public company or a private company, and who meets the criteria under section 171(a), is allowed to request the Israel Securities Authority to bear his costs.
>
> (b) If the Israel Securities Authority is convinced there is a public interest in bringing the case and there is a reasonable prospect the court would grant leave for the action to continue as a derivative action, the Authority may bear the plaintiff's costs, on such sums and conditions as it thinks fit; the Authority's decisions according to this section cannot be used as an evidence and it is not possible to submit them before the court.
>
> (c) If the court decided in favour of the company, the court may in its judgment provide for the company to reimburse the Israel Securities Authority for its expenses.[72]

Section 205A makes it clear then that in order for funding to be carried out by ISA, ISA needs to be convinced that two cumulative conditions

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69. The Israel Securities Authority ("ISA") is an independent regulatory body, established under the Securities Law of 1968, whose members are appointed by the Minister of Finance. Its mandate is to protect the interests of the investing public. ISA has a wide range of responsibilities and powers. *ISA in a Nutshell*, ISA, http://www.isa.gov.il/Default.aspx?Site=english (last visited May 8, 2012) (for a view of the areas and issues ISA is in charge of). ISA is the Israeli equivalent of the SEC. *See infra* notes 164–73 and accompanying text.

70. *See* GLOBES, ISRAEL BUSINESS CONFERENCE 2005 REPORT: ANALYSIS SECTION (Dec. 3–5, 2005) (Isr.).

71. First, in Companies Law of 1999 Draft Bill (amend. no. 12) (Corporate Governance Efficiency) (Mar. 10, 2010), which subsequently became Companies Act (amend. no. 16), 2011 (effective May 2011) (Isr.).

72. Companies Law § 205(a)–(c).

are met: (1) there is a public interest in bringing the case[73] and (2) there is a reasonable prospect the court would grant leave for the action to continue as a derivative action. The rationale for this Section is explained in the following terms:

> [T]he cost of funding the lawsuit may deter derivative actions from being brought, and so, in order to incentivise the plaintiff, it is proposed to introduce a similar arrangement which exists for class actions (under section 209 of the Companies Law).[74]

Interestingly, the Explanatory Notes to Amendment 16 add two important points.[75] First, the plaintiff in derivative actions, in addition to benefiting himself (and like the position in class actions cases), benefits all other shareholders who are similarly positioned. Secondly, this Amendment "would strengthen enforcement in the financial markets."[76]

At first blush, this appears like a positive step forward in terms of effective corporate governance. If funding can be provided (by whatever source, even public), then this should be welcomed on the basis that it addresses the incentives problem inherent in derivative action litigation. Indeed, this amendment should be seen in its wider context—it was one of three amendments relating to derivative actions introduced as part of Amendment 16 under which the Israeli legislature sought, yet again,[77] to encourage and stimulate the use of derivative actions.[78] Nonetheless, the

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73. On the public character of derivative claims see REISBERG, THEORY AND OPERATION, *supra* note 5, at 68–71.

74. Companies Act, (amend. no. 16), § 19 (explanatory notes) 2011.

75. *Id.*

76. *Id.* In an earlier draft of this Amendment it was stated that the derivative claim has a central role in enforcing the company's right, including enforcing directors' duties. It was expected the funding would be given for the application at the leave stage including covering expert and legal opinions as well as any costs that are likely to be incurred in case the court should refuse leave. *See* Companies Law, (amend. no. 10) para. 12 (May 2008) (Isr.).

77. Recall that, as we saw in Section C above, there were previously a number of amendments brought forward *after* the Companies Law of 1999 came into force in 2000 as the volume of derivative action litigation was perceived to be low.

78. The two additional reforms in favor of the plaintiff are as follows: first, under Section 194 the plaintiff is no longer required to make a demand first on the board before filing the suit, if the board (or most of the individuals comprising the board) have a personal interest in the lawsuit or are subject to the lawsuit or a disclosure to the board may damage the relief sought by the plaintiff. The applicant filing a derivative action can skip over this hurdle and submit the claim directly to court. Secondly, under Section 198A, an applicant filing a derivative action may now ask the court to order the company to reveal documents relating to the leave to proceed of the derivative claim. Such a request would be approved if the court is persuaded that the applicant has provided an initial evidentiary basis for the claim. It appears that this addition is introduced on the basis that this is not a

ramifications of new Section 205A require further thought. There are at least two discrete issues present. First, the details of the Section itself need to be examined. As part of this inquiry, one must look more closely at the rationales offered by the new amendment, namely, will the new rule indeed benefit all other shareholders who are similarly positioned, and would it strengthen enforcement in the financial markets. Secondly, one may wonder whether it is indeed necessarily the case that the plaintiff in derivative actions is in exactly the same position as in class actions cases. Indeed, as will be seen below, this is questionable.

2. An Analysis of the Details of Section 205A

This Section will first deal with the practicalities of the Section itself. Recall that ISA needs to be convinced that two conditions are met: (1) that there is a public interest in bringing the case; and (2) that there is a reasonable prospect the court would grant leave for the action to continue as a derivative action. Let us first deal with the latter.

2.1 There is a Reasonable Prospect That the Court Would Grant Leave for the Action to Continue as a Derivative Action

The second condition for deciding whether a derivative action should be allowed to proceed is spelled out in a similar fashion to other various derivative action legislations.[79] There is nothing novel about this. Indeed, it is reasonably clear what this will entail.[80] To take a recent example from the U.K., *Iesini v. Westrip Holdings Ltd*[81] usefully noted some of the factors which a director, acting in accordance with Section 172 of the U.K. Companies Act 2006 (which is what the court is directed to consider) would take into account in reaching his or her decision whether to allow a derivative claim to proceed:

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personal action, and as such, the shareholder plaintiff may not be in possession of all the material he needs in order to be able to establish an exhaustive and substantive claim. On the problem of access to information and discovery in derivative actions, see REISBERG, THEORY AND OPERATION, *supra* note 5, at 85–87, 216–19 ("In derivative action litigation there is an added concern. Information asymmetries accompany managerial misconduct: directors know the frequency and amount of harm caused by their misconduct, whereas shareholders do not.").

79. *See, e.g.*, New Zealand Companies Act 1993, § 165(1)(b) (N.Z.) ("the likelihood of the proceeding succeeding"); *see also* Companies Act 2006, c. 46, § 263(2)(a) (U.K.) ("Permission (or leave) must be refused if the court is satisfied—(a) that a person acting in accordance with Section 172 (duty to promote the success of the company) would not seek to continue the claim.").

80. Companies Law § 263(2)(a) (referencing exemption and indemnification decision by directors).

81. Ienesi v. Westrip Holdings Ltd., [2009] EWHC (Ch) 2526 (Eng.).

> They include: the size of the claim; the strength of the claim; the cost of the proceedings; the company's ability to fund the proceedings; the ability of the potential defendants to satisfy a judgment; the impact on the company if it lost the claim and had to pay not only its own costs but the defendant's as well; any disruption to the company's activities while the claim is pursued; whether the prosecution of the claim would damage the company in other ways (e.g. by losing the services of a valuable employee or alienating a key supplier or customer) and so on. The weighing of all these considerations is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case.[82]

So far, so good. But the crucial question here is altogether different—whereas judicial oversight in deciding such factors is commonplace (i.e. in virtually all jurisdictions in which the derivative action has been put on a statutory footing the court is entrusted with this task),[83] and noncontroversial, it is ISA which is asked to conduct this assessment (in all likelihood *before* applying to the court) in addition to the court. Leaving aside the issue of duplication (discussed below), the question is how well can ISA perform the specific task of *evaluating* the potential success of litigation? Are ISA's officials qualified to conduct such a task? Whereas ISA has some experience and expertise in evaluating the potential success of litigation in the area of class action,[84] it is by no means on the scale or comes as "natural" as for the court. Courts have a lengthy history of determining cases involving breaches of duty and have developed considerable expertise and knowledge in this area.[85] "[T]o the extent that the determination hinges on an appraisal of the *merits* of the litigation, it has been suggested that the court's perspective and expertise are superior to the boards."[86] There is no reason why an independent expert may not, in appropriate cases, be allowed to investigate and advise ISA on the action[87] (naturally this requires allocating further financial resources too),

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82. *Ienesi*, EWHC (Ch) at [85].

83. Jurisdictions including: Canada, Australia, New Zealand, Singapore, and South Africa, to name a few.

84. *See infra* C.3.

85. *See* REISBERG, THEORY AND OPERATION, *supra* note 5, at 232–41.

86. Ramsay, *supra* note 14, at 173–74; *see* John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 282–83 (1981).

87. The South African legislature provides, in the limited context of the statutory derivative action, a first step for the appointment by the court of a *curator ad litem*, whose role is to investigate the shareholder's complaint and advise the court whether the litigation should be allowed to proceed. Companies Act 61 of 1973 § 266 (S. Afr.). The curator is given unrestricted access to the company's books and records. Likewise in

which in turn may provide ISA with arguably better and more neutral information than either a resolution in a shareholders' meeting or the views of an allegedly biased board. Nonetheless, and although ISA's expertise can gradually develop over time, there is an inescapable problem here. Whereas the court's role in assessing this question is unquestionably unbiased (in the sense that it is not party to the litigation), ISA's position here is more akin to that of a party to the litigation rather than an independent adjudicator.[88] Once it decides to support a case by giving it a "stamp of approval" in the form of financial support, it is inevitably a party to the litigation regardless of the fact that ISA's decision to support the case cannot be used as evidence and it is not possible to submit it before the court.

2.2. Is There a Public Interest in Bringing the Case?

The Paper now turns to the first condition under Section 205A in order for funding to be carried out by ISA, namely, that there is a public interest in bringing the case. The discussion about this element needs to be broken down into a number of avenues of inquiry. These are explored in detail next.

2.2.1 Litigation is a Public Good

The argument that derivative actions solve a collective action problem rests on the premise that, very much like the class action mechanism,[89] the device enables the creation of a good that would not otherwise be produced, namely, a lawsuit. In other words, litigation can be conceptualized as a public good as "its pursuit produces positive externalities, and litigants in group-like situations therefore have incentives to free ride."[90] But Rubenstein rightly asks:

Section 247(A) of the Australian Corporations Law, the court, on application by a shareholder "acting in good faith and for a proper purpose," is authorized to order that the applicant be allowed to inspect the company's records, not personally, but through a lawyer or registered company auditor acting on his behalf, on such terms as the court thinks fit. *Corporations Act 2001* (Cth) s 247(A) (Austl.).

88. Indeed, recall that Section 209 provides that if the court decided in favor of the company, the court may in its judgment provide for the company to reimburse ISA for its expenses. Companies Law § 209(c). This is very similar to the arrangement under Section 200, *supra* Section B.4, under which the court may order the company to meet the plaintiff's costs. Companies Law § 200.

89. William B. Rubenstein, *Why Enable Litigation?: A Positive Externalities Theory of the Small Claims Class Action*, 74 UMKC L. REV. 709, 709 n.5 (2006).

90. *See id.* at 720–28.

> [w]hat are the positive externalities that flow from individual litigation? Most generally, as Judge Posner explains, litigation "establishes rules of conduct designed to shape future conduct, not only the present disputants' but also other people's." These "rules of conduct" constitute goods with the attributes of public goods: the rules of conduct are not diminished when used and no individual can be excluded from using them. More specifically, the positive externalities of individual lawsuits can be grouped into four sets of effects: 1) decree effects; 2) settlement effects; 3) threat effects; and 4) institutional effects.[91]

First, one must look at decree effects. This is based on the assumption that the legal principle developed in a particular case will generate more certainty in shaping social behavior and, at the same time, lower the need for future adjudication regarding the decided matter.[92] It follows that a potential social benefit from derivative action litigation is solely supplementary to its role as a governance mechanism: legal rules are public goods.[93] In theory then, litigation can reduce legal uncertainty.

As Kamar explains, the absence of clear legal rules is costly.[94] First, it leads to variance in valuations of the legal standard and therefore to divergences of behavior from what is perceived to be the social optimum.[95] This may result in corporate fiduciaries overestimating the legal constraints and forgoing efficient transactions, while other fiduciaries may undervalue the very same restrictions and carry out inefficient transactions. Second, legal indeterminacy produces liability risk that risk-averse fiduciaries are in a somewhat poor position to bear. This is because exposing corporate fiduciaries to this risk results in their services being more costly and less productive to shareholders. [96]

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91. *Id.* at 723 (citations omitted) (quoting RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 530–31 (6th ed. 2003) (discussing social benefits of litigation beyond dispute resolution); *see also* Kenneth E. Scott, *Two Models of the Civil Process*, 27 STAN. L. REV. 937, 938 (1975) (describing a "behavior modification model" of litigation in which "[n]ot the resolution of the immediate dispute but its effect on the future conduct of others is the heart of the matter").

92. *Id.*; *see also* HAZEL GENN, JUDGING CIVIL JUSTICE 74 (2010) ("an elaborated, granular body of rules in a common law system offers guidance on how to ascertain legal risk").

93. *See* Romano, *supra* note 19; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34–35 (1991).

94. Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887, 888–89 (1999).

95. *Id.*

96. *Id.*

The decree effects have a number of positive externalities. First, there is a general legal effect: if future litigation does arise, the decree from the initial case will serve as *stare decisis*, hence making resolution of later cases more efficient. Second, the decree in the initial case could also be used to preclude relitigation of factual matters in future cases among the same or similarly situated litigants. Finally, the decree may necessitate a party to stop a practice affecting a wider group of individuals (that is in spite of the fact that the initial case was prosecuted by only one of them). In short, a particular a lawsuit that generates a judicial decision has therefore produced noteworthy social benefits in terms of forming conduct, lessening litigation costs, and conserving judicial resources.[97]

Second, individual lawsuits resulting in settlements,[98] may nevertheless produce analogous positive externalities as "settlement effects." "If one litigant successfully challenges a policy that affects many persons, a defendant may agree to change its behavior as to the entire class."[99] For example, in *Fletcher v. A.J. Industries, Inc.*,[100] a derivative action had been settled by certain agreements regarding the future conduct of corporate affairs, and the court held that the settlement had resulted in a substantial benefit to the corporation and therefore that the plaintiff was entitled to an award of attorneys' fees despite the fact that no fund was produced.[101]

It should be highlighted that even if a defendant does not subscribe as a formal matter to alter its general policy as a result of the initial case, it may nevertheless do so informally lest it be faced with repeated lawsuits. This may be the case if a group of plaintiffs is closely related to one another or share legal counsel—in such a case, information about the initial settlement can easily be spread among similarly situated parties, who can then use it to their benefit. And vice versa: shared information about a weak settlement may dissuade litigation. In the same way, settlements by some defendants within the same industry could boost other defendant/competitors to opt for settling

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97. Rubenstein, *supra* note 89, at 723–24. This is one of the primary reasons that Professor Fiss opposes settlement. *See* Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1085 (1984). Indeed, it is not necessarily true that an unsatisfactory settlement is better than the best trial. "Trials reduce disputes and it is profound mistake to view a trial as a failure of the civil justice system." Patrick E. Higginbotham, *So Why Do We Call Them Trial Courts?*, 55 SMU L. REV. 1405, 1421 (2002); *see also* GENN, *supra* note 92, at 74.

98. After all, the vast majority of civil cases are settled. *See, e.g.*, GENN, *supra* note 92, at 21.

99. Rubenstein, *supra* note 89, at 724.

100. Fletcher v. A.J. Indus., Inc., 266 Cal. App. 2d 313, 72 Cal. Rptr. 146 (1968).

101. *Id.*

their case. In short, settlements, as well as judicial decrees, produce three major positive externalities: they alter behavior beyond the initial parties, diminish future litigation costs with settlement range determinations, and maintain judicial resources.[102]

In the context of derivative actions, there is yet another strength in the settlement process that enables the derivative action to confer a public good. As seen earlier, because of his small stake in the company, the protesting shareholder has very little incentive to reflect on the gravity of the action on the company.[103] Therefore, derivative actions generate a risk of strategic behavior by minority shareholders. They open the "possibility for 'gold-digging' claims,"[104] meaning that the plaintiff shareholder and defendants pursue their own advantages while likely ignoring those interests of the company. To reduce the possibility of such claims, for example, under English law, an order for an indemnity in respect to costs awarded to a shareholder also requires court approval for any offer of settlement of the action.[105] "This procedure is analogous to that in the United States[106] and Israeli[107] systems for class and derivative actions, which does not otherwise exist in the procedure under English law."[108] Control of settlements by the courts therefore produces a public good by guarding against abuse.[109]

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102. Rubenstein, *supra* note 89, at 724.

> Unlike traditional litigation, remarkably few of the [derivative] suits in my study ended with monetary payments. Instead, these suits more commonly ended with corporations agreeing to reform their own corporate governance practices, from the number of independent directors on their boards to the method by which they compensate their top executives. These settlements reflect the rise of a new type of shareholder activism, one that has gone undocumented in the legal literature.

Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1749 (2010).

103. Wilson, *supra* note 7, at 179–80.

104. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 354.

105. CPR 19.9(3) (U.K.).

106. Rule 23.1(c) of the Federal Rules of Civil Procedure provides that "[a] derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval." FED. R. CIV. P. 23(1)(c).

107. Section 202 provides that "A plaintiff shall not withdraw a derivative action, and shall not enter into an arrangement or settlement with the defendant, other than with the consent of the court; the application for such consent specify all details of the arrangement or settlement, including any payment offered to the plaintiff." Companies Law § 202.

108. Reisberg, *Funding Derivative Actions*, *supra* note 2, at 354.

109. *See* REISBERG, THEORY AND OPERATION, *supra* note 5, at 68–69.

Third, "the very threat of individual litigation, absent settlement or decree, may also produce positive social benefits"[110] in the form of enhanced deterrence.[111] The argument for a deterrence rationale relies on a likely unknowable variable: gains to shareholders resulting from future deterred misconduct.[112] Although these gains cannot be quantified reliably, it is easy to understate them. This is partly because a successful derivative action likely spurs a positive externality: deterrence of misconduct in other companies.[113] As a result, even if the deterrent benefits to the company in whose name the action is brought do not exceed the company's direct and indirect litigation costs, its shareholders still may benefit.[114] In addition, arguably, a credible threat of an action, "particularly one that can get beyond a motion to dismiss,"[115] has an important consequence. "The desire to avoid litigation . . . provides a lever for influencing the conduct of senior management and the board."[116] Likewise, when the deterrence query is fixated upon a threatened mischief to shareholders themselves, there is then a basis to allow some recovery out of prophylactic concerns in order to reiterate that directors possess an ultimate responsibility to the shareholders.[117]

Finally, and similar to the case in class actions put forward by Rubenstein,[118] the institutional upshot of the derivative action device is the growth of a private group of law enforcers. By enabling litigation,

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110. Rubenstein, *supra* note 89, at 724.

111. *See also id.* at 59–66 (for a discussion of the role of deterrence in derivative actions).

112. John C. Coffee, Jr., *New Myths and Old Realties: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407, 1428 (1993) [hereinafter Coffee, *New Myths and Old Realties*].

113. In this respect, Shavell explains that the social benefits of litigation could exceed the private benefits in some instances. An illustration would be where the action generates some beneficial deterrent effects that cause others to desist from a course of conduct that would impose externalities on society. Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333, 334 (1982).

114. For example, a study in the United States has shown that the "impact of decisions in derivative cases like *Caremark*, *Disney*, and *Oracle* goes well beyond the outcome of the cases themselves. These decisions changed the rules for future legal practice by forcing companies to accept better conduct and procedures." Robert Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1749 (2004).

115. Robert H. Mundheim, *Commentary: The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 55, 57 (1999).

116. *Id.* In other words, education of the board and senior management may well be an ancillary benefit when assessing the impact of these actions.

117. *See* REISBERG, THEORY AND OPERATION, *supra* note 5, at 184–87.

118. *Id.*

the derivative action has the structural effect of sharing law enforcement among public agencies and private enforcers and of reallocating a substantial amount of that enforcement to the private sector. The latter may be classified as a significant value if private enforcement is, as often argued, more efficient than public enforcement. Even if private enforcement produces its own difficulties (e.g. the agency costs that derivative actions generate), "the sheer diversity of enforcers should generate more innovations than a monopolistic government enforcer would produce. These *structural effects* are not the immediate purpose of any particular piece of derivative action litigation, yet they are critical externalities of class suits."[119]

2.2.2 The Public Character of Derivative Claims

The second question that arises asks why is it assumed in Amendment 16 that there would even be "a public interest" in bringing a derivative action? After all, in the corporate setting, a derivative action can be perceived as being just another commercial dispute as it usually addresses purely private injuries. For example, it is not uncommon for an English court to characterize its objective as simply doing justice to those harmed by the director's misconduct, i.e. it is concerned with a resolution of a private dispute (likely compensation).[120]

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119. Rubenstein, *supra* note 89, at 724–25 (citation omitted). For a recent exploration of this see Lars Klöhn, *Private Versus Public Enforcement of Laws—A Law & Economics Perspective* 13–14 (Ludwig-Maximilians-Universität Munich Working Paper, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1730308. Public enforcement resources may also be inadequate. On the general problem of public law enforcement see A. Mitchell Polinsky & Steven Shavell, *The Theory of Public Enforcement of Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 406–07 (A. Mitchell Polinksy & Steven Shavell eds., 2006). Standard policy analysis in corporate law strongly favors the private side. It is usually thought that "private enforcement benefits from the sharp prod of financial incentives, while public enforcers are civil servants working within burdensome administrative contexts." W.W. Bratton & M.L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 163 (2011). "Effective public and private enforcement reinforces self discipline as the real threat of legal action compels companies to tighten their governance processes to ensure conduct consistent with the law." MALAY. SEC. COMM'N, *Chapter 6: Public and Private Enforcement*, CORPORATE GOVERNANCE BLUEPRINT 65 (2011) [hereinafter MALAY. SEC. COMM'N REPORT], *available at* http://www.sc.com.my/eng/html/cg/cg2011/pdf/cg_blueprint2011.pdf. Given a limited public apparatus, it follows that any private enforcement is better than none. Bratton & Wachter, *supra*, at 70.

120. The latter objective is well illustrated in the reasoning of *Nurcombe v. Nurcombe* [1985] 1 W.L.R. 370, 378 (Lord Browne-Wilkinson, L.J.) (U.K.).

However, as Cox explained elsewhere,[121] "few shareholder actions entail breaches of a private contract between the plaintiffs and the [action]'s defendants."[122] Instead, most actions are based on breaches of fiduciary obligations or, more commonly, fraud. It is clear then that in most derivative actions the norm invoked has a *substantial*, if not *exclusive*, *public source and importance*.[123] Indeed, it has been argued that "[t]he right for a minority shareholder to take derivative action performs the purpose of checking majority abuse of the company and is thus *a public good* provided by regulation which otherwise would not be if left to private bargain."[124] Or as an advisory committee in Australia usefully put it, "private enforcement accomplished via shareholder litigation may be preferable to public enforcement."[125] As such, "[t]his area of law is thus more mandatory/prohibitory in nature and should not be contractu-

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121. REISBERG, THEORY AND OPERATION, *supra* note 5, at 68–69.

122. James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 11 (1999).

123. This point was usefully framed in *Zapata Corp. v. Maldonado* wherein the Court held that it "should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests." 430 A.2d 779, 789 (Del. 1981). Perhaps the best example is where a derivative action holds an entire board of experienced directors liable for breach of duty. *See* Smith v. Van Gorkom, 488 A.2d 858, 880, 893 (Del. 1985), *overruled by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009), *superseded by statute*, DEL. CODE ANN. tit. 8, § 102 (West). Arguably we all benefited from the "public good" provided by Mr. Moir's plight in *Wallersteiner v. Moir*, [1975] Q.B. 373 (U.K.). There is also ample evidence from the US to support this point. *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971) "set a standard of conduct which reverberated throughout" the mutual fund industry.

> The case held that an adviser to a mutual fund occupied a fiduciary relationship to it and could not sell that position for a profit. The profit in that situation amounted to pennies per share. But the point here is that the case set a standard of conduct for an entire industry. The same could be said of many other notable [cases]: *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955); *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971); *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), to name a few. None of those derivative actions involved large recoveries for the [companies] for whom they were brought. And certainly if you calculated the recoveries on a share by share basis, they would have been [tiny]. But they were of immeasurable importance to the integrity of corporate governance by setting standards for corporate actors.

Stanley M. Gorssman, *Commentary: The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 47, 47–48 (1999).

124. Iris H. Chiu, *Contextualising Shareholders' Disputes: A Way to Reconceptualise Minority Shareholder Remedies*, 2006 J. BUS. L. 312, 337 (emphasis added).

125. COMPANIES & SEC. ADVISORY COMM., REPORT ON A STATUTORY DERIVATIVE ACTION (1993).

ally waived or modified."[126] In addition, the corporate group, rather than "private partnership," has become "the quintessential model of corporate business activity in the late twentieth century."[127] In this context, corporate activity (and in particular the exercising of directors' discretion in business decision-making) has become more of a "public" concern, which should therefore be subject to greater judicial scrutiny in order to protect individual members' rights.[128]

In theory, therefore, "derivative actions provide a *public link* to the norm by requiring resolution in court, where potentially a public voice, the court, addresses the facts of each case through the lens of the applicable norm."[129] Moreover, attracting judicial attention to the public potential of the derivative action is strongly supported by the traditional raison d'être of the derivative action.[130] Standing to bring a derivative action is conferred as otherwise a wrong to the company will go without redress.[131] Such an approach invites early consideration of the public character of derivative actions.[132] Moreover, as Coffee rightly noted,

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126. Chiu, *supra* note 124, at 338. This is because the investor protection objective, which could be pursued in a minority derivative action in court, may not be capable of being met through private bargain. It should be noted that in the United States where the contrarian approach is more widely accepted, modification of the minority derivative action by allowing derivative grievances to be arbitrated in lieu of a derivative action in court has become acceptable. *See* Jeffrey A. Sanborn, *The Rise of "Shareholder Derivative Arbitration" in the Public Corporation:* In Re Salomon Inc. Shareholders' Derivative Litigation, 31 WAKE FOREST L. REV. 337, 340 (1996); *see also* Andrew J. Sockol, *A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations*, 77 TULANE L. REV. 1095, 1111, 1114 (2003) (arguing that shareholder arbitration should become the norm for derivative actions); Frank H. Easterbrook, *Pragmatism's Role in Interpretation*, 31 HARV. J.L. & PUB. POL'Y 901, 905 (2008).

127. Stephen Bottomley, *Shareholders' Derivative Actions and Public Interest Suits: Two Versions of the Same Story?*, 15 UNIV. N.S.W. L.J. 127, 141–42 (1992).

128. *Id.* For judicial recognition (in Canada) of the public role of management, and the corresponding need for strict standards of conduct see *Canadian Aero Service Ltd. v. O'Malley*, [1973] S.C.R. 592, 610 (Can.).

129. Arad Reisberg, *Shareholders' Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions*, 6 EUR. BUS. ORG. L. REV. 227 (2005) (emphasis in original). "While the reality is that most cases settle, a flow of adjudicated cases is necessary to provide guidance on the law and, most importantly, to create credible threat of litigation if settlement is not achieved." GENN, *supra* note 92, at 21.

130. For example, the fact that a member may bring a derivative action in relation to wrongs which were done to the company before he became a member. *See generally* Seaton v. Grant, [1867] L.R. 2 Ch. App. 459 (Eng.) (which illustrates that compensation cannot be the sole rationale i.e. "true injury" is not required).

131. Smith v. Croft (No 2), [1988] Ch. 114 at 186 (Eng.).

132. *See also* Lord Wedderburn of Charlton, *The Social Responsibility of Companies*, 15 MELB. U. L. REV. 4, 24 (1985) ("[fiduciary duty] is imposed in private law, but with a

once private disputes are transported into the domain of a public courtroom, a limited public interest must be accepted as attaching to the decision procedure.[133] This public interest does not mean that every cause of action should be litigated at whatever cost to the company and its shareholders, nonetheless it does require that courts steer their business in a suitable fashion. For example, if a court is told that bribery is a profitable yet illegal method of doing business and a company demonstrates a plan to carry on with such conduct, then that court is morally compromised if it straightaway dismisses the action.[134]

2.2.3 The "Public Interest" Fallacy?

The discussion about the "public character" of derivative actions so far presupposed a resolution of the dispute in court. However, Amendment 16 additionally provides discretion for ISA to decide on matters of "public interest." In other words, the legislature intervened in this area implying two policy premises: first, that there should be more public enforcement in this area of law (or put more accurately, that public enforcement should complement private enforcement when it is in the public "interest" to do so), and second, that it is in the "public interest" that more such cases be brought (i.e. there are not enough derivative action cases brought). This, nonetheless, raises some questions that warrant attention.

2.2.3.1 Is There a Market Failure That Requires Intervention?

The general justification for government intervention most commonly used by mainstream economists, mostly rests on the view that a particular market can be enhanced because it "fails"—that is, it does not achieve "public interest" objectives. It follows that the state should intervene to regulate what would otherwise be the market outcome.[135] This seems to be the case in this discussion. In spite of the various measures introduced for the derivative action procedure since the Israeli Companies Law was introduced in 2000,[136] very few derivative action cases are initiated by private enforcers (leaving for a second the question of whether this is

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public function. It is a vehicle of a social purpose.") (emphasis in original). *See generally* J.E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW 200–36 (1993).

133. John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 817 (1983).

134. *Id.*

135. JOHN BLUNDELL & COLIN ROBINSON, REGULATION WITHOUT THE STATE . . . THE DEBATE CONTINUES 3 (2000).

136. *See supra* Section C.

true or not).[137] And so a governmental body, namely ISA, is charged with improving the situation. But, as will be seen next, there are a number of fundamental problems with this "market-failure" approach to policy-making.

a. The Infrequency of Proceedings Argument

There is an important point to be made here, which relates to the arguably low number of cases brought under Israeli law. Very much like the U.K., which despite reforms[138] has not seen an increase in the number of derivative actions,[139] there are currently few derivative actions brought in Israel by private plaintiffs. Likewise in Canada, where the statutory derivative action has been part of the law for many years, although the device hasn't been used very frequently, there have still been some influential cases. Canadian writers have therefore opined that the "statutory derivative action has failed to make a dramatic [practical] impact."[140] Focusing on the infrequency of proceedings may, nonetheless, be a misleading portrayal as "[i]t is not necessarily a flaw that there may in practice be few cases brought under the derivative action jurisdiction."[141] Arguably, this fact is actually in line with the very nature of the derivative action, as is explained next.

First and foremost, recall that a derivative action is an action that should only be brought in exceptional circumstances. The principle underlying the limitations on the derivative action, that generally the company is the proper plaintiff and that only in exceptional circumstances cases should shareholders be able to sue on its behalf, is a sound one.[142]

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137. A "worrying feature" of this policy was that it "proceeded on the basis of anecdote and the partial views of different actors within the system." GENN, *supra* note 92, at 62. This phenomena of "policy making in the dark" is, however, a common feature of civil justice reviews around the world conducted in the absence of any research or empirical data. *Id.*; *see also infra* Section C.2.2.3.1 a–c.

138. As the Company Law White Paper acknowledged it is possible but unlikely that putting derivative actions on a statutory footing will affect the low number of cases brought. DEP'T OF TRADE & INDUS., COMPANY LAW REFORM, 2005, at 275, cmt. 6454 (U.K.).

139. *See, e.g.*, Coffee, *Privatization and Corporate Governance*, *supra* note 21, at 2 (noting the sharp contrast between the UK and US in shareholder enforcement); Eilis Ferran, *Company Law Reform in the UK*, 5 SING. J. INT'L & COMP. L. 516, 541 (2001).

140. Brian R. Cheffins & Janet M. Dine, *Shareholder Remedies: Lessons from Canada*, 13 COMPANY LAW. 89, 94 (1992).

141. S. Deakin, E. Ferran & R. Nolan, *Shareholders' Rights and Remedies: An Overview*, 2 COMPANY FIN. & INSOLVENCY L. REV. 162, 164 (1997); Pearlie Koh Ming Choo, *The Statutory Derivative Action in Singapore—A Critical Examination*, 13 BOND L. REV. 64, 81 (2001).

142. *See* REISBERG, THEORY AND OPERATION, *supra* note 5, at 77–80.

No one would welcome a change in the law that opened the floodgates to corporate litigation. The real problem with the law as it presently stands is, although in theory it contains a derivative action, the rules relating to it have become so uncertain and obscure that no one can confidently predict when such an action will be allowed to proceed, if at all.[143] This last point is indeed confirmed by the view of one practitioner.[144]

Second, given the deterrence objective of the action, a positive interpretation could be that the evidence in Canada indicates that the action is indeed working. A low number of litigated actions does not necessarily indicate that the derivative action is failing to make an impact. In fact, if the courts had been swamped with derivative applications, the fear expressed by the U.K. Law Commission and others that the availability of the action has potential to expand companies' involvement in futile and disruptive litigation[145] would certainly have been vindicated. There will always be fraud and corporate malpractice. The law has not eliminated these, nor will derivative actions or any other mechanism of corporate governance. It is nevertheless likely that the derivative action, if perceived as a potent threat and if freed of its procedural handcuffs, may have an effect on those involved in corporate governance and, over the long run, may change their values and the ways in which they go about their tasks. There will be cases where such proceedings justify redressing serious corporate abuse "on the ground of necessity alone in order to prevent a wrong going without redress."[146]

Finally, the infrequency of proceedings as a likely inaccurate pointer to the effectiveness of the derivative action can also be seen from the experience with the U.K. wrongful trading actions.[147] The available evidence indicates a relatively low number of wrongful trading petitions, espe-

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143. Deakin et al., *supra* note 141, at 164–65; *see also* Reisberg, *Derivative Claims*, *supra* note 3, at 47.

144. Kosmin suggests that the average practitioner often gives up in despair and turns to alternative routes, not always successful ones, and that the Law Commission's description of the law in this area as being virtually inaccessible save to lawyers specializing in the field is being too generous. Leslie Kosmin, *Minority Shareholders' Remedies: A Practitioner Perspective*, 2 COMPANY FIN. & INSOLVENCY L. REV. 201, 212–13 (1997).

145. For a firm advocate of this view see, for example, Christopher Hale, *What's Right with the Rule in* Foss v. Harbottle*?*, 2 COMPANY FIN. & INSOLVENCY L. REV. 219, 226 (1997).

146. Smith v. Croft (No 2), [1988] Ch. 114 at 185 (Eng.).

147. Insolvency Act, 1986, c. 45, § 214 (U.K.). For a stimulating discussion on what is generally the socially optimal level of litigation given its expense and how it compares to the privately determined level of litigation see generally Steven Shavell, *The Level of Litigation: Private Versus Social Optimality*, 19 INT'L REV. L. & ECON. 99 (1999).

cially compared with disqualification proceedings.[148] There are different views about the extent to which Section 214 of the relevant Insolvency Act has been a success.[149] At the same time, although there has not been an abundance of cases in the area, there have been important ones.[150] More notably, it has been suggested that the infrequency of proceedings is probably not an accurate pointer to the effectiveness of the sections.[151] In many situations the wrongful trading sections are operating on the minds of directors who will have been warned about the dangers they face once the company becomes insolvent.[152] It can be seen then that the legislation presents an important theoretical limitation on the otherwise prevalent doctrine of limited liability. And there is no reason to assume that the same incentives could not present themselves with respect to derivative action litigation.

Returning to the Israeli context, we already mentioned that the prevailing perception in Israel seems to be that there are not enough or sufficient derivative actions cases brought by private enforcers. Not only is this based on anecdote and the partial views of different actors within the system, but, in fact, the level of investor protection (such as by means of shareholder suits) afforded by the Israeli system is relatively high by international standards, which suggests that an argument for reform that rests predominantly on the perception of low level of litigation is misguided. For example, according to the World Bank *Doing Business 2011 Report*, Israel is ranked 5 in the world (out of 183 economies) in terms of the level of protection afforded to investors (see Figure 2 below), and its strength of investor protection index is 8.3 (out of 10), which is much higher than the OECD average of 6 (see Table 1 below). These figures makes the case for reform, which rests on the infrequency of proceed-

148. *See* Rizwaan J. Mokal, *An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain*, 59 C.L.J. 335, 335–57 (2000). It is estimated that disqualification cases are now reaching a figure of 1,500 per year. *See* A. Hicks, *Wrongful Trading—Has it been a Failure?* 9 INSOLVENCY L. & PRAC. 134 (1993); Rebecca Perry & David Milman, *Transaction Avoidance Provisions in Corporate Insolvency: An Empirical Study*, 14 INSOLVENCY L. & PRAC. 280 (1998).

149. *See, e.g.*, B.G. PETTET, COMPANY LAW (2005) 36–37; *see also* Fidelis Oditah, *Wrongful Trading,* LLOYD'S MAR. COM. L.Q. 205 (1990); Mokal, *supra* note 148, at 148.

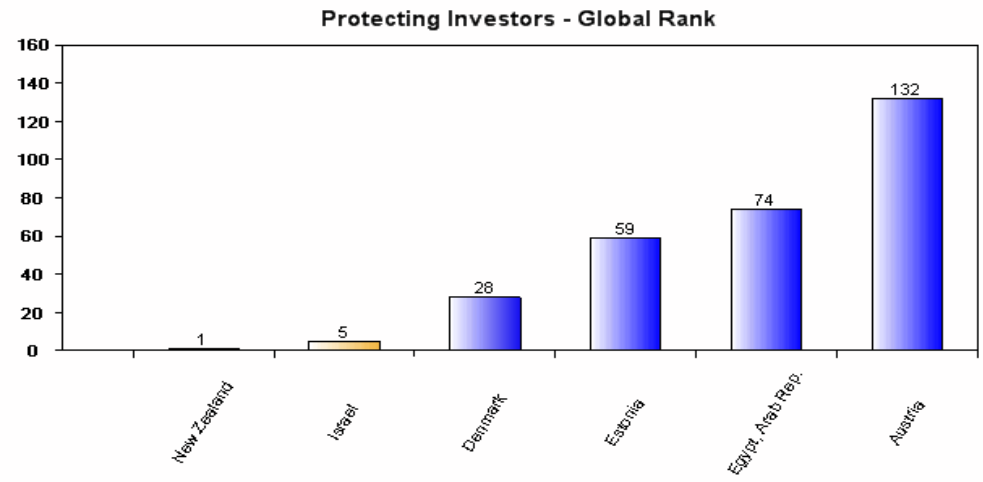
150. *See generally* Re Produce Mktg. Consortium Ltd. (No. 2), [1989] B.C.L.C. 520 (Eng.); *see also* Re Hydrodam (Corby) Ltd., [1994] 2 B.C.L.C. 180 (Eng.); Re Sherborne Associates Ltd. [1995], B.C.C. 40 (Eng.); Re Brian D Pierson (Contractors) Ltd., [2000] 1 B.C.L.C. 275 (Eng.).

151. PETTET, *supra* note 149, at 36–37.

152. *Id.*

ings, even more shaky and raises questions as to whether there was indeed a need to go that far by providing public funding.

Figure 2[153]



153. *See Doing Business Report*, *supra* note 66. This measures the strength of minority shareholder protections against misuse of corporate assets by directors for their personal gain. This methodology was developed by Simeon Djankov et al., *Debt Enforcement Around the World*, 116 J. POL. ECON. 1105 (2008). This is, of course, not the only methodology available. A number of academic works offer additional insights into investor protection. *See* Priya P. Lele & Mathias S. Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUD. 17 (2007) (proposing a shareholder protection index for five countries and code the development of the law for over three decades); John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 6 J. EMPIRICAL LEGAL STUD. 343 (2009) (using a panel data set covering a range of developed and developing countries, showing that common law systems were more protective of shareholder interests than civil-law ones in the period 1995–2005 and that civilian systems were catching up, suggesting that legal origin was not much of an obstacle to formal convergence in shareholder protection law); Simon Deakin & Mathias Siems, *Comparative Law and Finance: Past, Present, and Future Research*, 166 J. INSTITUTIONAL & THEORETICAL ECON. 120 (2010) (reporting the results of a new approach to coding which has produced longitudinal data sets on shareholder, creditor, and worker protection). There has also been some academic criticism of the above overall ranking, in particular in the literature on law and finance and amongst economists. *See, e.g.*, Claude Ménard & Betrand du Marais, *Can We Rank Legal Systems According to Their Economic Efficiency?*, 26 WASH. U. J.L. & POL'Y 55 (2008); Benito Arruñada, *Pitfalls to Avoid When Measuring Institutions: Is Doing Business Damaging Business?*, 35 J. COMP. ECON. 729 (2007).

Table 1: Israel-OECD [154]

Strength of Investor Protection Index[155]

Indicator	Israel	OECD Average
Extent of disclosure index (0-10)	7	6
Extent of director liability index (0-10)	9	5.2
Ease of shareholder suits index (0-10)	9	6.9
Strength of investor protection index (0-10)	8.3	6

b. The Unattainable Ideal

The second problem with the "market-failure" approach to policy-making in this context is that, as Blundell puts it "the market-failure approach implies perfect government—an altruistic and omniscient body, which can detect and will unswervingly pursue the "public interest." "But, of course, this disregards the self-interest of its own members or more general political considerations. The contrast between 'imperfect' markets with perfect governments is naturally deceptive as it leads to

154. Adapted from *Doing Business Report*, *supra* note 66.

155. The Protecting Investors indicators below measure three areas: transparency of transactions (Extent of Disclosure Index), which looks at who can approve related-party transactions and requirements for external and internal disclosure in case of related-party transactions. The second is liability for self-dealing (Extent of Director Liability Index), which consists of the ability of shareholders to hold the interested party and the approving body liable in case of a prejudicial related-party transaction, the available legal remedies (damages—repayment of profits, fines, imprisonment, and rescission of the transaction), and the ability of shareholders to sue directly or derivatively. The third area, shareholders' ability to sue officers and directors for misconduct (Ease of Shareholder Suits Index) looks at documents and information available during trial as well as access to internal corporate documents (directly or through a government inspector). The indexes vary between 0 and 10, with higher values indicating greater disclosure, greater liability of directors, greater powers of shareholders to challenge the transaction, and better investor protection. A simple average of the extent of disclosure, the extent of director liability and ease of shareholder suits indices then makes up the overall score (i.e. the strength of investor protection index (0-10)). *See Doing Business Report*, *supra* note 66.

demands for more government intervention than would be made if the imperfects of government were taking into consideration."[156] In short, the problem with this government intervention hypothesis is that it rests on uncertain foundations of principle and as such leads to leads to practical problems. Government advocates' frequently touted assumption that "it will on balance be beneficial and achieve that elusive concept, the 'public interest'" is flawed and illegitimate.[157]

Indeed, public regulators, such as ISA, cannot be insulated from political and interest group pressures.[158] Put simply, there may be difficulties associated with the introduction and implementation of regulatory measures (i.e. interest groups may have too large an influence on the law-making process),[159] or lack of familiarity with the marketplace. This may result with a distorted outcome: regulators may, in practice, serve the private interest of the regulated industry and, ironically, protect it from any competition, instead of the supposed goal to promote the public interest. This suggests that political pressures stipulate a background incentive that is somewhat different than the one that exists for private regulators.[160] "But worse, it is a fallacy to assume that government officials are disinterested purveyors of the public interest. They are themselves personally interested, in terms of salary and career prospects, in the outcome of the regulatory process."[161] Indeed, "there is no reason to believe that the priorities established by a corporate regulator for enforcement are necessarily the correct ones [or are identical to those of each and every company]. This dictates a role for private enforcement."[162] Finally,

> when the legal system assigns an enforcement role [(or alternatively leaves room for) private enforcers (i.e. through litigation of derivative actions)] there is less need to rely on public agencies and in turn the tendency of such public agencies . . . to determine, sometimes arbitrar-

156. BLUNDELL, *supra* note 135, at 3–4. The "public choice" approach, which criticizes the perfect government assumption, is explained in GORDON TULLOCK, THE VOTE MOTIVE (2006); *see also* WILLIAM MITCHELL, GOVERNMENT AS IT IS (1988).

157. *See, e.g.*, REGULATION: ECONOMIC THEORY AND HISTORY (Jack High ed., 1991) (critiquing the "public interest" theory).

158. BLUNDELL, *supra* note 135, at 74–75. "In Chicago, the police cars are emblazoned with the phrase 'we serve and protect,' and often that phrase can be applied to public regulators." *Id*.

159. These issues are explored in detail in BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION ch. 4 (1997).

160. Randall S. Kroszner, *The Role of Private Regulation in Maintaining Global Financial Stability*, 18 CATO J. 355, 359 (1999).

161. BLUNDELL, *supra* note 135, at 34.

162. Ramsay, *supra* note 14, at 152.

> ily or for political reasons, not to enforce rights or duties it had previously guarded[163]

is likely to be higher.

c. Limited Resources and Funding

There is a policy question that arises: should shareholders be expecting public enforcers, in this case, ISA, to pick up the bill for litigation, thereby externalizing the cost of enforcement on the taxpayers? The answer is not as straightforward as it would seem. When the Israeli legislator decided in favor of making a stronger commitment to enforcement of derivative actions by allowing ISA to fund these actions, it probably presumed that the necessary monies would be available at no extra cost to the taxpayers. In theory, this assumption is correct: ISA is funded by fees it collects from exchange transactions and related activities.[164] But that is not the real issue here. The true problem lies with the fact that ISA needs to allocate its resources to a wide-range of activities it oversees, supervises, and enforces. However, like many similar statutory securities bodies worldwide, it is only provided with a very limited budget.[165] In fact, ISA is considered to be chronically underfunded, thus foreclosing a shift to public enforcement. Indeed, limits on funding and resources of corporate regulators means that they cannot, of necessity, pursue all breaches and enforcement of the law. In this respect ISA is in a somewhat similar position to that of the SEC[166] or the U.K.'s Financial Services Authority

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163. *Id.* (citing A.L.I., PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS Part VII, 220–21 (Tentative Draft No. 1, 1982) (on why private enforcement serves a fail-safe function and ensures greater stability in the application of law.).

164. ISA is funded by annual fees payable by companies that are subject to the Securities Law and the Joint Investment Law, fees payable for applications to receive permits to publish prospectuses, private offerings, licensing fees payable by investment advisors and investment portfolio managers, and fees payable by the Tel Aviv Stock Exchange. The budget is approved by the Minister of Finance and the Finance Committee of the Knesset.

165. The Israel Securities Authority was established under the Securities Law, 1968 and its mandate is to protect the interests of the investing public. ISA has a wide range of responsibilities and powers. *See ISA in a Nutshell*, *supra* note 69.

166. As the New York Times reported on September 20, 2011:

> The near-collapse of the world financial system in the fall of 2008 and the global credit crisis that followed gave rise to widespread calls for changes in the regulatory system. A year and a half later, in July 2010, Congress passed a bill, [which later became the Dodd-Frank Act], expanding the federal government's role in the markets, reflecting a renewed mistrust of financial markets. A year after the Dodd-Frank Act was signed, necessitating the creation of thousands of job positions, the SEC has been expanding headcount.

("FSA"), and the right question, in particular in light of the recent financial crisis and what has been on the agenda in terms of reforms is as follows: has ISA got the necessary and/or adequate resources to deal with what is already on its table? ISA, like the SEC, is under huge pressures and its budget has recently been under-cut. It follows that it probably cannot, as a practical matter, allocate enough resources or time or expertise to pursue yet another regulatory role. If it does, some other area of its activities would suffer, which raises the question whether that decision would be in the "public interest".

In short, public enforcement resources are generally inadequate.[167] This means there is a constant and ongoing internal competition for resources and priorities within ISA, where some areas get to be prioritized over others.[168] In particular, it is reported that the issue of private enforcement

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Financial Regulatory Reform, N.Y. TIMES, http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/financial_regulatory_reform/index.html (last updated Sept. 20, 2011). Under the Act the SEC is responsible for implementing a series of regulatory initiatives required. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC, http://www.sec.gov/spotlight/dodd-frank.shtml (last modified May 8, 2012) (which expanded the SEC mandate including creating five new offices). The SEC 2011 study 'Organizational Study and Reform' (March 2011) provides a detailed account of these and other changes:

> According to the SEC's 2012 budget request it hopes to fill 780 positions by 30 September 2012, the end of fiscal year 2012. [Three hundred and twelve] positions would go toward strengthening core operations, like gathering market intelligence, monitoring financial disclosures of corporations and overseeing money market funds. The other 468 positions would deal with implementing new rules from the Act relating to the derivatives market, overseeing hedge funds and whistle-blowing. In addition to examiners, the agency will hire staffers with experience in derivatives, credit default swaps, collateralized debt obligations and securitized products as well as compliance officers.

BOSTON CONSULTING GRP., U.S. SECURITIES AND EXCHANGE COMMISSION ORGANIZATIONAL STUDY AND REFORM (Mar. 2011), *available at* http://www.sec.gov/news/studies/2011/967study.pdf.

167. "The maximum number of approved positions at ISA as of the end of December 2009 stood at 181, in addition to eight intern positions and ten student positions." *See* ISA, ANNUAL REPORT 2009, at 3 (May 27, 2010), *available at* http://www.isa.gov.il/Download/IsaFile_5219.pdf. The SEC, by comparison, currently has a support staff of around 3,800, made up of lawyers, accountants, economists, computer experts and administrators. U.S. SEC. & EXCH. COMM. [SEC], FY 2011 PERFORMANCE AND ACCOUNTABILITY REPORT (Nov. 15, 2011), *available at* http://www.sec.gov/about/secpar/secpar2011.pdf.

168. This issue is well-illustrated in the annual business plan published by ISA or the U.K. Financial Services Authority which outlines regulatory and strategic priorities for the regulator each year. *See generally* FIN. SERVICES AUTH., BUSINESS PLAN 2011/12

of securities laws has *not* been one of the top priorities of ISA in recent years.[169] How does this sit with the new expectation that ISA funds derivative claims in appropriate cases remains to be seen. One answer to this may be to recognize that there is no need to have many cases in order to achieve high levels of deterrence. For example, the use of a few "test cases" may be sufficient to deter potential abuse by directors who are situated similarly at other companies.[170]

2.2.4 What is the Relationship between ISA's Recommendation and the Court's Discretion?

Recall that 209A(b) states:

> Where the Israel Securities Authority is convinced that the action is in the interests of the public and that there is a reasonable prospect that the court approve it . . . the Authority may bear the plaintiff's costs, in such sum and on such conditions as it shall prescribe; *the Authority's decisions according to this section cannot be used as an evidence and it is not possible to submit them before the court.*[171]

On its face, this Section recognizes that ISA's decisions cannot be used as evidence and are inadmissible in court, which suggests that there was a fear that they would influence the court in some way. But even if the content of these decisions is now known, the fact that ISA has deliberated and concluded that public money should be spent on a case on the grounds that there is a "public interest" in the case will not escape the court. This raises panoply of interesting questions: what weight should be given to ISA's decisions? In other words, what would be the implications for a particular case's chances of succeeding that it is supported by ISA? Would this bias the court in favor of allowing the case to continue on the grounds that ISA has already made its own "judgment" that the case is of general interest/importance to the public? Furthermore, should the court accede to the committee's decision or should it review the decision as if the former never occurred? If so, at what cost? Or perhaps the court should only review the committee's decision if it is suspected to be biased? And vice versa: would the fact that ISA, for example, has decided *not* to support a case, after being approached and after investigating its merits, be used as a tactical weapon by the defendants in court to suggest that there is no "public interest" in litigating this case?

(U.K.), *available at* http://www.fsa.gov.uk/pubs/plan/pb2011_12.pdf; ISA ANNUAL REPORT 2009, *supra* note 167.

169. *See generally* ANNUAL REPORT 2009, *supra* note 167.

170. *See* REISBERG, THEORY AND OPERATION, *supra* note 5, at 59–66.

171. Companies Law § 209(A) (emphasis added).

It is noteworthy that a comparable problem arises in the context of judicial review of the merits of a decision of a committee of independent directors in the United States (known as a Special Litigation Committees) in derivative litigation:[172]

> The question is to what extent . . . should a court defer to a recommendation of [Commission]? In practice, unsurprisingly, this fundamental question has been fiercely debated in U.S. courts and proposed Model Acts with no clear resolution emerging. Secondly, if judicial review of the merits of a decision of a committee of independent directors is utilized, this may be seen as an undesirable duplication of tasks.[173]

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172. Arad Reisberg, *Theoretical Reflections on Derivative Actions in English Law: The Representative Problem*, 3 EUR. COMPANY & FIN. L. REV. 69, 69–108 (2006) [hereinafter Reisberg, *The Representative Problem*]; *see* Ramsay, *supra* note 14, at 173; Jerold Solovy, Barry Levenstam & Daniel S. Goldman, *The Role of Special Litigation Committees in Shareholder Derivative Litigation*, 25 TORT & INS. J. 864, 864–65 (1990).

173. Reisberg, *The Representative Problem*, *supra* note 172, at 89–90, 93–94; *see* Ramsay, *supra* note 14, at 173. While some courts have shown considerable deference to recommendations of SLCs (Auerbach v. Benett, 47 N.Y.2d 619, 623 (1979)), others rejected any notion of wholesale deference to the recommendation of the SLC. For example, the influential Delaware Supreme Court decision in *Zapata Corp. v. Maldonado* applied a two-stage test on whether to accept its recommendations: "First, the Court should inquire into the independence and good faith of the committee" and the grounds supporting its recommendation. 430 A.2d 779, 788–89 (Del. 1981). Second, the court applies "its own independent business judgment" to determine whether the derivative action should be dismissed. *Id.* The *Zapata* analysis has subsequently been applied by the Delaware Court of Chancery numerous times. Outside of Delaware, in many states (including California, Colorado, Georgia, Maryland, Michigan, Ohio, and Virginia) there appears to be no clear decision by the highest state court on the status of SLCs, but federal courts hearing derivative actions based on diversity jurisdiction have reached decisions construing the authority of such a committee. Although some argue that the law on derivative actions is uniform nationally in the sense that everyone has followed Delaware, Coffee believes that it is an egregious overstatement to characterize the law on SLCs as largely resolved. *See* Coffee, *New Myths and Old Realties*, *supra* note 112, at 1432–33. In *In re Oracle Corp. Derivative Litigation*, the Delaware Court of Chancery denied the motion of a SLC to dismiss derivative claims brought by Oracle stockholders. 824 A.2d 917 (Del. Ch. 2003). The SLC was established by the board of directors of the Oracle Corporation to investigate claims of insider trading and breach of the fiduciary duty of loyalty brought against Oracle directors. The court based its finding on the SLC's inability to prove the independence of its two members, and thus the committee itself, from the directors being investigated. In doing so, the court applied an independence inquiry that expanded upon the traditional "domination and control" notion of independence, to include personal and philanthropic connections with the directors, which the court concluded created an "unacceptable risk of bias." *Id.* at 947. Arguably, this represents a broadening of the inquiry of director independence by the Delaware Court of Chancery. *See* Jeremy J. Kobeski, In Re *Oracle Corporation Derivative Litigation: Has a*

The same may apply to ISA's decisions. Although there is no doubt that the court is free to decide on the case regardless of (or in spite of) ISA's position, what is clear is that the balance is shifted in favor of the plaintiff even before the case or its merits are heard. No doubt, this can be rebutted. It, nonetheless, at least puts forward the notion that there is a *prima facie* case to be looked at closely.

2.2.5 ISA's Recommendation and Decision

One last issue should be considered here. On what grounds/how will ISA decide to support a case?

Since the entry into force of Amendment 16, ISA has not yet received any formal request for funding a derivative action according to Section 205A.[174] That said, ISA officials report "an awakening in the field" and that they have been in contact with a number of lawyers who are "sniffing" around and may be interested in filing derivative actions.[175] Although it is still in its early days and ISA has not yet published a guidance document on how it would finance derivatives action or about enforcement information in general,[176] it is expected that the issue of private enforcement of securities laws in the near future be allowed more

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New Species of Director Independence Been Uncovered?, 29 DEL. J. CORP. L. 849, 850–51 (2004).

Contrast the Model Business Corporation Act (drafted by the American Bar Association's committee on Corporate Governance) which provides that a derivate action shall be dismissed by the court where a committee of independent directors has determined in its business judgment that the action is not in the best interest of the company, with that of the American Law Institute, which allows more scope for judicial review of the recommendations of SLC. *See* PRINCIPLES OF CORP. GOVERNANCE, *supra* note 19, at 725–66.

174. Data received from ISA Officials (based on direct conversations and e-mails) (2012) (on file with author).

175. *Id*. This may also receive a boost from a recent decision of the Economics Department at the District Court in Tel-Aviv-Jaffa to allow a double derivative action, although such an arrangement is not catered for in the Companies Law of 1999. *See* Jonathan Ben-Ami v. Mivtachim Holdings Ltd., TA 21785-02-11 [2011] (not yet published) (Isr.). On the importance of these type of actions see Arad Reisberg & Dan Prentice, *Multiple Derivative Actions*, 125 L.Q. REV. 209 (2009).

176. As a public body it is assumed it should provide a policy document that would help prospective litigants/lawyers assessing the chances of their respective cases being funded by ISA. Whatever the case may be, it is clear that it cannot be helpful to allow the factors which ISA will take into account in deciding whether to support a case to proliferate unnecessarily—this can prolong proceedings, create uncertainty, and result in the unprincipled development of the jurisdiction. As a public authority, it should reach its decision efficiently, speedily and with openness.

attention than before.[177] So it would be instructive to look at the experience ISA has had so far with funding class action litigation to get an idea on how it will operate in practice and how it may help shape its future policy.

Firstly, it is instructive to look more generally at how ISA perceives its own role. The Securities Law defines its role as the protection of investors' affairs.[178] It is reported that ISA interpreted this provision as defining its function as creating a fair and functioning capital market. In line with this, ISA representatives promote enforcement's role in encouraging investors' marketplace trust.[179] They conceive economic legislation, including corporate law legislation, "as an ordering instrument that enables the economy to work, rather than as an independent justice mechanism in its own right."[180] Moreover, unlike its U.S. counterpart, "ISA views the highly concentrated ownership structure of Israeli companies as the unique and main problem of the Israeli capital market. Accordingly, it justifies stricter rules as a means to protect minority shareholders against control holders."[181]

Looking more closely at the issue of enforcement, a policy document issued by ISA in April 2003 on its website[182] provides details of its enforcement policy at the time and its intent to ask for amendments in the Companies Law which would allow it to enforce the Companies Law sections more forcibly.[183] The document is quite telling as it reveals some of the seeds that led to Amendment 16 as well as the policy issues and thinking behind it and more generally the Companies Law.[184] In the document, ISA explains that the Companies Law eliminated numerous criminal sections that were previously part of the Companies Ordinance[185] and instead established new enforcement arrangements.[186] The

177. Based on direct conversations and e-mails with ISA Officials (2012) (on file with author).

178. *See* Securities Law, 5728-1968, 22 LSI 266, ch. 2 (1968) (Isr.).

179. Yael T. Ben-Zion, *The Political Dynamics of Corporate Legislation: Lessons from Israel*, 11 FORDHAM J. CORP. & FIN. L. 187, 243 (2006).

180. *Id.*

181. *Id.*

182. *SEC Initiates a Change to Empower it to Enforce the Companies Act*, ISA (Apr. 7, 2003), http://www.isa.gov.il/Default.aspx?Site=MAIN&ID=8,175,854 [hereinafter *SEC Initiates a Change*].

183. *Id.*

184. For an interesting examination of the political history that accompanied the enactment of the Companies Law of 1999 see Ben-Zion, *supra* note 179.

185. The Companies Ordinance, later replaced by the Companies Law, had been largely based on the English Act of 1929 but underwent reform several times.

186. *SEC Initiates a Change*, *supra* note 182.

basic concept that underlines the Companies Law on this subject is the idea that the most effective enforcement mechanism is the market mechanism.[187] In principle, the Companies Law avoided criminal sanctions, because its architects sought to move towards civil enforcement. The Companies Law also gave priority to ensuring the operation of market mechanisms as well as providing incentives for private enforcers. Importantly, ISA noted, ISA has *not* been granted administrative punishment powers or the ability to take civil proceedings, criminal sanctions, or quasi-criminal sanctions directly against companies that violate and/or breach the Companies Law.[188] In reality, however, ISA noted, there are repeated violations of the sections of the Companies Law, without any real possibility of enforcement. The chances that a shareholder would decide to initiate a derivative action or a class action for failing to appoint an internal auditor are very slim, because, at least in public companies, such actions are filed only when shareholders themselves have suffered direct financial loss.[189] It is difficult to prove a causal connection between a failure to appoint an internal auditor and direct financial loss and therefore the probability of filing a derivative action in these circumstances are virtually nil. According to the ISA document, other examples of violations that would not trigger shareholders' enforcement include the appointment of a director who was previously convicted of an offense which disqualifies him from serving as a director and convening a general meeting without providing the minimum notice as required by law.[190]

3. What Can Be Learned from the Class Action Experience in Israel?

3.1 Are Derivative Actions the Same as Class Actions?

Recall that the rationale for Section 205A makes it clear that the new amendment establishes a similar arrangement with exists for class actions (under Section 209 of the Companies Law)[191] and that the plaintiff in derivative actions, in addition to benefiting himself (and like the position in class actions cases) benefits all other shareholders who are similarly positioned.[192] But one may wonder whether it is necessarily the case

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.* Curiously, these are precisely the instances that should trigger a derivative action. *See* Foss v. Harbottle, (1843) 67 Eng. Rep. 189, 2 Hare 461.

191. Companies Act (amend. no. 16), § 19 (explanatory notes) 2011 (Isr.).

192. In an earlier draft of the amendment it was stated that the derivative claim has a central role in enforcing the company's right, including enforcing directors' duties. It is

that the plaintiff in derivative actions is in exactly the same position as in class actions cases. While class actions and derivative actions share certain similarities, such as the fact that they usually involve multiple plaintiffs, and they both appear in the same part of the Israeli Companies Law,[193] the purposes and procedures of the two suits are very different. Class actions consolidate multiple plaintiffs' claims into a singular suit. This can be contrasted with shareholder derivative actions, which enable shareholders to seek relief for the company's injuries. This distinction can be confusing, as shareholders often pursue class action remedies for direct injuries suffered. A derivative action is utilized when a company itself is injured and first opts not to sue, but the shareholders suffer indirectly and seek action later.[194] Thus, the moniker "derivative" action is due to shareholders pursuing a claim for the corporation's instead of his own name.[195] All shareholders in a derivative action therefore benefit if a company recovers.

3.2 Funding of General Class Action Claims under Israeli Law

We now turn to examine if there is anything that can be learnt from the class action procedure and experience under Israeli law that may help assess the prospects of success of Section 205A.

The Class Action Act 2006 (the "Class Action Act"), defines a class action as:

> An action that is conducted on behalf of a group of people, who have not authorised the representative plaintiff for this purpose, and which raises material questions of fact or law which are common to all the members of the class.[196]

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expected the funding would be given for the application at the leave stage including covering expert and legal opinions as well as any costs that are likely to be incurred in case the court should refuse leave. Companies Law of 1999 (amend. no. 10), para. 12 (May 2008).

193. Or to take a U.S. example: under the 2010 California Corporations Code, both class actions and derivative actions are found in Chapter 11. CAL. CORP. CODE § 11 (2010).

194. Erika Johansen, *Class Action vs. Derivative Shareholder Lawsuits*, EHOW.COM, http://www.ehow.com/about_6505005_class-vs_-derivative-shareholder-lawsuits.html (last visited May 8, 2012).

195. *What is a shareholder derivative action?*, CORPORATE LAW LEGAL RES., http://resources.lawinfo.com/en/Legal-FAQs/corporate/Federal/what-is-a-shareholder-derivative-action.html (last visited May 8, 2012). Interestingly, that an action is truly a derivative action, rather than one brought by the minority shareholder in his own right, was a late recognition in English law. Wallersteiner v. Moir, [1975] Q.B. 373 (U.K.).

196. Class Action Act, 5766-2006, 35 LSI 298, § 2 (2006) (Isr.) [hereinafter Class Action Act].

As Plato-Shinar reports, the Class Action Act was enacted "in order to encourage the filing of appropriate class actions and to remove procedural impediments. The Law perceives the class action not as a procedural arrangement of the filing of claims, but, first and foremost, as a tool for promoting public–social interests."[197] It follows that the Law's perception is that

> the consideration and the advancement of the public interest should be at the heart of the court's discretion throughout all the stages of the proceeding. At the same time, the Law attempts to contend with the risk of the exploitation of the class action in order to make private profit, without achieving benefit for the public. The Law takes into consideration the interests of the defendants as well, and tries to balance between them and those of the public.[198]

The Israeli class action is, very much like the class action mechanism in the United States—the device serves not only the private interest of the injured parties, but also, the social-public interest. It is chiefly geared towards situations when a large company injures a group of people in such a manner that each individual suffers small damage that would not justify the filing of a claim by the individual himself. That said, all of the unique persons' damages amass into an extensive amount, thus the class action device groups the often small interests of all the injured parties, which are often unpractical to pursue, and generates an incentive to pursue a claim. The class action is thus vitally instrumental in enforcing individual rights. Resultantly, the class action's accumulated whole is often large and therefore deterrent. Class actions are instrumental in underenforced areas, and often when administrative supervision is fragmented.[199] ISA itself has stated that with respect to potential compensation to be paid to the plaintiff, it is usually the case that

> if the court rules in favor of all or part of the class with regard to all or part of a class action claim, it shall order the payment of compensation to the class action plaintiff, taking into consideration the following factors, unless it finds, for special reasons which shall be recorded, that

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197. Ruth Plato-Shinar, *Israel: The New Law on Class Actions*, 2007 J. BUS. L. 527, 540.

198. *Id.*

199. *Id.* at 527, 527 n.3; *see, e.g.*, Civil (TA) 1957/03 Ar-On Investments Ltd v The First Int'l Bank of Israel, PM 8560(1) (2006). "In that case, the bank charged some 15,000 customers with interest higher than that agreed. Only by virtue of class action proceedings the Supervisor of Banks intervened and the customers were ultimately compensated." Class Action Bill (No. 232), 5765–2005, HH 234 (Isr.); Application for Civil Appeal 4556/94 Tatzat v. Zilbershatz, 49(5) PD 774, 783–85 [1994] (Isr.); CA 2967/95 Magen Vekeshet Ltd. 527 [2007] (Isr.) (on file with the author).

> such payment is not justified under the circumstances of the case: the effort invested by the class action plaintiff and the risk he took upon himself when submitting the class action and in conducting it; the benefit brought to the members of the class from the conduct of the action; . . . the degree of importance to the general public of the class action.[200]

> The court may, for special reasons which shall be recorded, order the payment of compensation to an applicant or class action plaintiff even if the class action claim was not approved, or even if there was no ruling in favor of the class in the class action claim, whichever is relevant.[201]

One of the most important innovations in the Class Action Act is the establishment of a Foundation for Financing Class Actions, under the auspices of the Ministry of Justice.[202] The foundation's objective is to assist plaintiffs in the financing of class actions, which are of public and social importance.[203] The foundation's budget is determined in the Annual Budget Law, in a special plan that is included in the budget of the Ministry of Justice. The Minister of Justice is responsible for determining the criteria for granting financing to the various representatives. In any event, assistance from the foundation will not be given in order to finance class actions in the field of securities, because in these cases, financing is given by ISA.[204] This is considered next.

3.3 Funding Class Actions in the Field of Securities by ISA

According to ISA's own report:

> [t]he ISA regards class action lawsuits as an inextricable component of enforcement in the capital market. . . . The Director of Enforcement of ISA is charged with the supervision and coordination of all ISA enforcement activities, as well as trade control and class actions . . . . With regard to class actions, the Enforcement Department of ISA is charged with formulating recommendations to ISA Plenum as to applications to finance such [claims] and private expenditures relating thereto; monitoring claim proceedings and deciding whether to involve the State Attorney in cases that have ramifications on the efficacy of

200. Class Action Act, § 22(a)–(b).

201. ISA, SELF ASSESSMENT, *supra* note 43; *see also id.* § 229(c).

202. Plato-Shinar, *supra* note 197.

203. Class Action Act, § 27.

204. Companies Law § 209; Joint Investments in Trusts Law, 5754-1994, SH No. 5754 p. 308, § 41 (Isr.).

the class action mechanism and on the public's trust in the capital market.[205]

Table 2 below gives an idea about the level of activity at ISA on these issues.

Table 2: Cases forwarded to the Department of Investigations at ISA between 2005–2009, by type of violation[206]

Type of Violation	**2005**	**2006**	**2007**	**2008**	**2009**	**Total**
Securities fraud	7	5	1	2	4	19
Use of inside information	2	4	3	2	6	17
Misrepresentation (in prospectuses, financial statements, or immediate reports)	6	2	2	5	4	19
Non-filing and delinquent filing	-	1	11	1	-	3
Unlicensed portfolio management or investment advice	-	2	-	-	-	2
Judicial inquiries	2	5	8	7	9	31
Violations by employees of stock exchange members and prohibited acts by a licensed investment portfolio manager	-	1	1	-	-	2
Disciplinary violations	-	-	1	-	-	1

205. ANNUAL REPORT 2009, *supra* note 167, at 5.

The ISA Plenum deals, through the ISA's committees, with granting applications for permission to publish prospectuses; granting exemptions and extensions; stock exchange issues; issues relating to the ISA's finances and budget; the independence of auditors of companies subject to the Securities Law; issues relating to the licensing of investment advisors, investment marketers, and investment portfolio managers; issues relating to the imposition of civil fines on mutual fund managers, as well as other issues, as needed. The ISA Plenum usually convenes once a month. There are currently eight members of the ISA sitting at the ISA Plenum including the ISA's Chairman.

Id. at 2.

206. *Id.* at 129.

Violations under the Joint Investment in Trust Law	1	-	1	-	1	3
Violations under the Penal Law: Bribery, theft, obtaining by fraud	-	-	-	-	2	2
Total	**18**	**20**	**18**	**17**	**26**	**99**

Focusing back on class actions, recall that according to Section 209 of the Companies Law, "a plaintiff seeking to sue in a representative action deriving from a connection to a security of a public company may request ISA to bear his costs."[207] "Where the Securities Authority is convinced that the action is in the interests of the public and that there is a reasonable chance that the court will approve it as a representative action, the Authority may bear the plaintiff's costs, in such sum and on such conditions as it shall prescribe."[208] As mentioned above, the outcome of the case determines the costs in Israel, which means that a plaintiff's success garners court costs. In effect, these costs are designed to reflect the actual costs incurred by the plaintiff, but in practice often fail to cover the true time and effort expended in pursuit of litigation. Conversely, if the plaintiff loses his claim, he is liable for court costs. In case of a class action ISA may provide financial assistance and "in practice assumes approximately 80% of the costs in the failed class actions it chooses to assist. There is no set formula for calculating court costs. More often than not, the assigned costs do not cover actual expenditures."[209]

It is reported that

> [B]etween the years 2000, when the Companies Law came into force, and 2002, ISA has participated in subsidizing seven class action suits. . . . [B]etween 2000 and September 2002, the number of class action suits that were reported to ISA was fifteen, out of which eight passed the primary stage of approval as a class action by the court.[210]

During 2008 two applications for funding class action law claims were submitted to ISA. In one case, the applicant withdrew the application

207. Companies Law § 209(a).

208. *Id.* § 209(b).

209. ISA, SELF ASSESSMENT, *supra* note 43, at 159.

210. Ben-Zion, *supra* note 179, at 308–09; *see e.g.*, ISA, ANNUAL REPORT 2000 (2000), *available at* http://www.isa.gov.il/Download/ISAFile_163.pdf; ISA, ANNUAL REPORT 2001 (2001), *available at* http://www.isa.gov.il/Download/ISAFile_162.pdf; ISA, ANNUAL REPORT 2002 (2002), *available at* http://www.isa.gov.il/Download/ISAFile_161.pdf.

after ISA staff had decided against financing it, and in the other case, ISA staff agreed to fund the case. Six applications for funding class action lawsuits were received during 2009. At the time that ISA 2010 Annual Report was published these lawsuits were still pending review.[211] One financing application from the previous reporting year was withdrawn by the plaintiff after ISA decided against financing the suit.[212] It is clear then that ISA's financial support for a case is a crucial factor in its chances to be litigated at all.

A pair of important class action lawsuits completed during 2009. Both were supported by ISA.[213] One of these cases illustrates that ISA's decision to fund it was the right one under the theory of "public interest."[214] The case involved a class action against Reichert Industries Ltd.[215] On June 7, 2007, the Supreme Court ruled on the appeal filed by the class action plaintiff and the appeal filed by Mr. Dan Reichert against the District Court's ruling. The Supreme Court Ruling outlined principles defining the term "controlling shareholder" for accountability purposes. Arguably it is a "public good" to have a clear "normative [adjudication] and for the court to make [statements] sufficiently clear that business can abide by these rules and avoid legal risk."[216] The Supreme Court agreed

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211. Because of lack of data it was not possible to verify how long it usually takes ISA to review and decide on such cases and whether this time is too excessive. According to ISA, ISA Plenum (recall that the Enforcement Department of ISA is charged with formulating recommendations to ISA Plenum as to applications to finance such claims) usually convenes once a month and in 2009, ISA Plenum held eight meetings and the committee for imposing fines as per class action suits held three meetings. *See* ANNUAL REPORT 2009, *supra* note 167, at 2.

212. ANNUAL REPORT 2009, *supra* note 167.

213. In the first, Case 1498/04, a class action was brought against M.P.A. Mediterranean Assets and Investments Ltd. and Mishor Hahof Construction and Assets Ltd.

> The claim stated that the consideration awarded in return for the company's shares, as part of a forced purchase offer made by way of a full purchase offer to shareholders, was less than their fair value. After the proceedings in this case were suspended for a period of three years, at the end of 2007 the parties signed a settlement agreement. According to the agreement, which was approved by the Court in April 2008, NIS 0.20 per share were added for each share held by the shareholders on January 13, 2004 (date of the full purchase offer).

ISA, ANNUAL REPORT 2008, 134 (May 3, 2009), http://www.isa.gov.il/Download/IsaFile_4543.pdf.

214. *See supra* Section 2.2.2.

215. ANNUAL REPORT 2008, *supra* note 213, at 134–35.

216. GENN, *supra* note 92, at 74; *see also supra* Section 2.2.2. and in particular cases mentioned *supra* note 123.

that Mr. Reichert was one of the Company's "controlling shareholders" and thus held him liable for plaintiff's damages.[217]

4. Why Not Go All the Way?

Finally, it is worth asking why instead of simply funding derivative actions in cases that are in the public interest, should ISA not litigate these cases itself once it received a request to do so. Indeed, "there are times where regulators may be compelled to step in the shoes of private individuals seeking recourse through the court systems."[218] This may arise, for example, when there is "no economic incentive for private parties to proceed with action; limited access to information to support action by private parties; or when actionable conduct may have impact on wider public interest and market confidence."[219] Put simply: if the rationale is public interest and market confidence then why should ISA not litigate these cases itself, not just lend financial support to them? In order to assist ISA, there is no reason, for instance, why an independent expert may not, in appropriate cases, be allowed to investigate and advise ISA on the action[220] (naturally this requires allocating further financial resources too). After all,

> much serious misconduct by directors [such as bribery and insider dealing] is often inherently unlikely to be detected by shareholders acting alone. [Derivative actions] involving these forms of wrongdoing often piggyback on criminal governmental or internal corporate investigation. Indeed, the surge of derivative action litigation in Japan has been partly explained by such piggybacking on government[] enforcement.[221]

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217. ANNUAL REPORT 2008, *supra* note 213, at 134. The Supreme Court Ruling "presented various methods for calculating damages due in a class action suit, and determined that, in this case, the appropriate method is the 'out of pocket' method, which is based on the damages principles prescribed under tort law—restoration of the status quo ante." *Id.*

218. MALAY. SEC. COMM'N REPORT, *supra* note 119, at 65.

219. *Id.*

220. As the case in South African and Australian legislation. *See supra* note 87. As Gelter points out, continental European laws have a mechanism that is intended to alleviate the information asymmetry with respect to corporate wrongdoing, namely the minority right to have the court appoint a special auditor. The required percentage to trigger such an appointment varies between jurisdictions. *See* Martin Gelter, *Why do Shareholder Derivative Suits Remain Rare in Continental Europe?*, 37 BROOK. J. INT'L L. 843 (2012).

221. Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests*, 82 GEO. L.J. 1764, 1763–64 (1993–1994). In Japan, "information disclosure is not terribly abundant; shareholder rights to view corporate records are predicated on the holder having at least 3% of the shares; cause must be shown to appoint an

In the U.K., the Financial Services and Markets Act 2000 grants the FSA "powers to take proceedings in the civil and criminal courts to deal with misconduct relating to regulated activities."[222] The FSA "can issue civil proceedings in the High Court against firms and individuals, including those who are not members of the regulated community."[223] There are several civil actions that the FSA can pursue.[224] The main actions include "asking the High Court to grant injunctions" (for example to prevent a person from conducting regulated activities without authorisation or prevent a person from committing market abuse),[225] "ordering the payment of restitution, and granting insolvency orders."[226] "In Hong Kong, the power to assist aggrieved individuals has been further widened to allow the Hong Kong Securities and Futures Commission ("HKSFC") to petition the court for a remedy where the affairs of a listed company are being conducted in a manner, which is oppressive or unfairly prejudicial to the interest of its shareholders."[227] The same arrangement exists under U.K. law.[228] In a recent Hong-Kong case, the court ordered a company to recover the losses attributable to an alleged misconduct from its directors (for breach of fiduciary duties and conduct unfairly prejudicial to the interest of the shareholders by entering into transactions which

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outside inspector; and pretrial discovery is nonexistent." West, *supra* note 19; *see* REISBERG, THEORY AND OPERATION, *supra* note 5, at 190 (discussing the case involving Allied Irish Banks Plc). Additional factors, mainly in the form of financial incentives, are discussed in REISBERG, THEORY AND OPERATION, *supra* note 5, at 222–73.

222. *Enforcement in the Civil and Criminal Courts*, FIN. SERVICES AUTH. (Apr. 4, 2010), http://www.fsa.gov.uk/Pages/doing/regulated/law/focus/courts.shtml; *see* Financial Services and Markets, 2000, c.8, § 8(1) (Eng.).

223. *Enforcement in the Civil and Criminal Courts*, *supra* note 222.

224. *Id.*

225. In "May 2011 the FSA had, for the first time, obtained a final injunction restraining an individual from committing market abuse." *FSA Bans and Fines Self Employed Trader £700,000 for Market Abuse*, FED. SEC. ADMIN. (June 14, 2011), http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/053.shtml.

226. *See Enforcement in the Civil and Criminal Courts*, *supra* note 222.

227. *Id.*; *see* Securities and Futures Ordinance, (2003) Cap. 571, § 214 (H.K.).

228. According to the Companies Act 2006

> if it appears to the Secretary of State that . . .(a) the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members, (b) or an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial, he may apply to the court by petition for an order under this Part.

Companies Act 2006 § 995. This power under this Section has rarely, if ever, been used.

resulted in significant losses).[229] Interestingly, it was the HKSFC itself which petitioned the court for an order compelling the company to sue its directors.

As was noted recently, "the Hong Kong case illustrates the instances where regulators may be compelled to initiate action on behalf of shareholders to reinforce public confidence in the market."[230]

Although these powers can help reinforce seal-dealing, naturally, they do not come without some drawback. "Firstly there is concern over regulators running the risk of intervening in the affairs of the company and secondly, such actions by regulators may result in shareholders becoming over reliant on regulators to take action on their behalf thus exacerbating the reluctance to institute private action."[231] Then there are also the usual problems of limited resources and funding available to regulators[232] and the political and interest groups pressures[233] that would stand in the way.[234] Indeed, these concerns have caused some jurisdictions to emphasize "the need to promote private enforcement actions by shareholders [instead] and has also caused some common law countries to consider facilitating shareholders class action . . . .in order to overcome these constraints and to provide greater recourse to remedy for wrongdoings."[235]

CONCLUSION

It would be easy to dismiss Amendment 16—whereby public funding may be provided to fund derivative claims when ISA is convinced there is a public interest—as strictly a private Israeli affair. After all, it was introduced to complement the current funding mechanisms available under Israeli law, to deal with an allegedly (but unfounded) suboptimal enforcement levels, and to fit within Israeli companies' highly concentrated ownership structure and the Israeli capital market. But this Author believes such dismissal would be a mistake. Dismissal overlooks three ma-

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229. Sec. & Futures Comm'n v. Cheung Keng Ching [2010], H.C.M.O. 1869/2008 (Mar. 18, 2010) (Legal Reference System) (H.K.).

230. MALAY. SEC. COMM'N REPORT, *supra* note 119, at 66.

231. *Id.*

232. *See supra* Section 2.2.3.1 c.

233. *See supra* Section 2.2.3.1 b.

234. There is also the problem that ISA, or any other regulatory body for that matter, relies on the cases brought to it (i.e. it is passive in terms of which areas/topics are referred to it) and hence, its ability to promote areas which it deems vital to market integrity is rather limited.

235. MALAY. SEC. COMM'N REPORT, *supra* note 119, at 64–65. The Malaysian Securities Commission "recommends the establishment of a working group to study the feasibility of litigation funding by third party to assist investors in instituting private enforcement actions." *Id.* at 67.

jor benefits. First, the adoption of Amendment 16 in Israel, if successful, opens up an entirely novel domain for policy makers to address the funding problem in derivative action litigation, namely that of a public regulator and public funding for these private actions. Secondly, the formulation of the solution, combining a private enforcement aided by a public body (i.e. privately initiated and pursued litigation which are publicly funded), indicates that the response may lie in a more practical and pragmatic way forward which cuts across the traditional public/private dichotomy. Finally, the Israeli solution may offer a fresh strategy to be employed in order to create proper incentives to litigate and thus addresses a major concern in the literature on the theory of litigation, namely, the basic problem that the private incentives to litigate may diverge from what is socially desirable .

This Paper addressed derivative action funding problems in a different taxonomy. The fact that despite various fee mechanisms and fee-favoring rules available under the Israeli law, parties still would *not* pursue these claims exemplifies the underproduction of positive externalities. If funding is more forthcoming it is more likely that private actions would be pursued by aggrieved parties. Put simply, the policy underlying Amendment 16 reveals a new truth: when individuals are given financial support by a public body to litigate their claims, it is likely in recognition that these lawsuits would produce collateral social benefits. The new mechanism helps produce these benefits by internalizing a cost to a public body (ISA) that consequently enables the lawsuits to be brought.

Admittedly, these are still early days and time will tell whether this scheme under Israeli law can, or should, be followed elsewhere. Indeed, as was seen above, it is an imperfect and flawed mechanism and there are numerous difficulties that need to be addressed and overcome if this is to be implemented successfully and make any impact in practice. But so are most other mechanisms of funding, each subject to a unique benefits and costs analysis. The addition of this analysis to the scholarly literature serves several functions. Among these functions is the illumination of how a derivative action is more like other types of class action cases than generally presumed, private and public enforcement can play a complementary roles to each other, and, under this analysis, relatively unimportant the compensatory aspects of the derivative action case are compared to its other social functions. This last point is particularly important because the externality story of the derivative actions case sets the groundwork for a more general understanding of the common feature of these suits that could, in turn, facilitate private litigation as an important control tool.

THE U.S. SECURITIES FRAUD CLASS ACTION: AN UNLIKELY EXPORT TO THE EUROPEAN UNION

Manning Gilbert Warren III *

INTRODUCTION

This Article addresses the issue of whether the securities litigation model in the United States, centered on the notorious securities fraud class action, has been or should be exported throughout the world in order to provide defrauded investors greater access to justice. Specifically, the focus of this Article is whether the U.S. securities class action has spread or is likely to spread to the individual member states of the European Union ("EU"), or, alternatively, whether it may evolve into a supranational remedy through EU legislation. Although the EU has achieved an astounding degree of harmonization in the securities laws of its member states,[1] it has not yet advanced any individual or collective private remedies for violations of those securities laws. Moreover, while a number of the EU's member states have adopted collective redress procedures in other areas, none have advanced a U.S.-style class action private remedy for securities fraud.

The failure by the EU and its various member states to enact U.S.-style class action and other collective private remedies for investors in securities may be readily explained by the differences in both the structure and demographics of European securities markets. 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.[2] Consequently, there has hardly

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* H. Edward Harter, Chair of Commercial Law, Brandeis School of Law, University of Louisville. The author would like to thank Lawrence A. Sucharow, Labaton Sucharow LLP, his colleague on the securities litigation panel of Brooklyn Law School's Globalization of the U.S. Litigation Model Symposium, for his thoughtful review and comments. The author gratefully acknowledges the assistance provided by his research assistant, Taylor Gerlach, and by his administrative assistant, Janet G. Sullivan, in the final preparation of this Article.

1. *See generally* MANNING GILBERT WARREN III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, *in* EUROPEAN SECURITIES REGULATION 23 (2003).

2. Unlike stock ownership levels in the United States, Elina Laakso's summary of data gathered by the SHARE project for the year of 2006 to 2007 shows the percentage of Europeans directly investing in European stock markets to be quite low. *See* Elina Laakso, Stock Market Participation and Household Characteristics in Europe 32 (Aug. 9, 2010) (unpublished master's thesis) (on file with the Aalto University School of Economics); Brian K. Bucks, Arthur B. Kennickell, Traci L. Mach & Kevin B. Moore, *Changes*

been a populist hue and cry for more effective private remedies for securities fraud, and much less for broad-based collective redress procedures. Indeed, it is at least questionable whether there is any necessity for development of an EU-wide securities class action or stronger collective remedies among the member states. Nevertheless, the EU's European Commission recently invigorated the class action debate in Europe by initiating a public consultation process to discuss generally the utility of class actions and other forms of collective redress, both at the EU and member state regulatory levels.[3] In doing so, the Commission made it clear that the U.S. class action remedy is the model of what not to do.[4]

This Article will first focus on the U.S. class action remedy as a wounded horse, hardly the robust steed the U.S. would offer as a breed to emulate in Europe. Domestically, the class action has been endlessly politically derided since the early 1990s, and, although still on four legs, has faced considerable hostility in legislative and judicial fora.[5] After these observations, the author will briefly examine the significant barriers to entry, as well as the general hostility, that the class action confronts in the European legal culture, despite a few recent and significant inroads. While U.S. class actions have been facilitated both by principles common to the U.S. litigation system and specific to the class action, EU

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in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances, 95 FED. RES. BULL. A1 (2009) [hereinafter Bucks et al., *Changes in U.S. Family Finances*]. In only four countries did stock ownership by individuals exceed 25% (52% in Sweden, 47% Denmark, 31% Switzerland (approximately), and 29% Belgium (approximately)). Laakso, *supra.* While most countries had rates of ownership around 10%, stock ownership among households was the lowest in Italy, Greece, Spain, the Czech Republic, and Poland (7%, 6%, 6%, 4%, and 1%, respectively). *Id.* On the contrary, for the same year, 51.1% of U.S. households owned stocks directly or through investment funds. Bucks et al., *Changes in U.S. Family Finances*, *supra*, at A1, A27. Furthermore, a 2008 FESE report shines light on the largely institutional makeup of European exchanges and share-ownership structures, with institutions (private financial and non-financial enterprises and companies) accounting for more than triple the 14% of the total market value of listed shares owned by individuals. FED'N OF EUR. SEC. EXCH. [FESE], ECON. & STATISTICS COMM. [ESC], SHARE OWNERSHIP STRUCTURE IN EUROPE 11 (2008), *available at*
http://www.bourse.lu/contenu/docs/commun/societe/Actualites/2008/FESE_SHARE_OWNERSHIP_SURVEY_2007.pdf. Consequently, the lacking participation of individuals in the European share ownership structure suggests that a private remedy such as the securities class action might not even be truly needed.

3. *See generally Commission Staff Working Document*, *Public Consultation: Towards a Coherent European Approach to Collective Redress*, SEC (2011) 173 final (Feb. 4, 2011) [hereinafter *Towards a Coherent European Approach*], *available at* http://ec.europa.eu/justice/news/consulting_public/0054/sec_2011_173_en.pdf.

4. *Id.*; *see infra* notes 150–54 and accompanying text.

5. *See generally infra* notes 12–23.

collective redress schemes have been debilitated by negative corollary principles. These principles are common both to the litigation systems of the member states and specific to their various collective redress procedures. Following this discussion, the Article will briefly review the European Commission's consultation process addressing the larger issue of collective redress in the European Union. Finally, this article will conclude that aside from episodic grand results for entrepreneurial U.S. plaintiff lawyers pursuing collective relief in the Netherlands, the U.S.-style securities fraud class action is unlikely to become a viable mechanism for providing European access to justice for defrauded investors. Neither an EU level directive for broad horizontal application nor a more limited secular application to securities fraud claims appears likely at the present time or in the foreseeable future. The EU member states simply have no zeal to partner private and public enforcement of their securities laws; the private Attorney General concept remains largely unique to American jurisprudence.[6] Consequently, European investors should look to stronger and more vigorous public enforcement at the member state level through government funded and administered collective redress schemes for victims of securities fraud.

II. THE U.S. SECURITIES CLASS ACTION: BLOODY BUT UNBOWED

The U.S. securities fraud class action model has long been criticized as a failed remedy, a form of legal blackmail enabling plaintiffs' lawyers to obtain large settlements from corporate defendants based on non-meritorious claims.[7] The purported primary beneficiary, at least in terms of monetary compensation, has been plaintiffs' counsel,[8] which recovers a contingency fee ranging from roughly ten to thirty percent of the total class recovery.[9] Although qualitative corporate governance reforms are often cosmetically tacked on to settlements in order to secure court approval, class action securities litigation has been accused of being a lawyer-driven, entrepreneurial business that results in payouts not from "a securities fairy," but from the movement of corporate funds "from investors' right pocket to investors' left pocket—and paying lawyers a lot for

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6. *See* Ilana T. Buschkin, Note, *The Viability of Class Action Lawsuits in a Globalized Economy—Permitting Foreign Claimants to be Members of Class Action Lawsuits in the U.S. Federal Courts*, 90 CORNELL L. REV. 1563, 1566 n.11 (2005).

7. *See generally* Arthur A. Miller, Comment, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem,"* 92 HARV. L. REV. 664 (1979).

8. *See* Samuel Issacharoff & Geoffrey Miller, Essay, *Will Aggregate Litigation Come to Europe?*, 62 VAND. L. REV. 179, 186 (2009).

9. *See, e.g.*, *id.*

moving that money around."[10] As another prominent scholar has noted, "shareholders are suing shareholders," and as a result, "diversified shareholders wind up making pocket-shifting wealth transfers to themselves."[11] The debate over the policies served or disserved by securities class actions continues to rage, but both legislature and judicial developments evidence significant victories for the detractors.

The viability of the securities class action has been considerably reduced by both judicial and legislative determinations during the past twenty-five years. In the late 1980s, the Supreme Court effectively corralled the vast bulk of securities litigation against dishonest broker-dealers into industry-dominated arbitration proceedings.[12] This decision reversed its own thirty-five year old holding that pre-dispute arbitration agreements were violative of the anti-waiver provisions of the federal securities laws.[13] Then, in 2012, the Court effectively eliminated class action arbitration claims by upholding the enforceability of class action waivers in arbitration agreements.[14] For those claims that may be given their day in court, the Supreme Court has imposed challenging "loss causation" requirements[15] and has eliminated private aiding and abetting claims.[16] Meanwhile, Congress in the 1990s effected a deregulatory tsu-

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10. Joseph Grundfest & Nicholas Varchaver, *Winona*, *Martha & the Securities Fairy*, FORTUNE (Aug. 11, 2003), http://money.cnn.com/magazines/fortune/fortune_archive/2003/08/11/346800/index.htm.

11. John C. Coffee, Jr., *Capital Market Competitiveness and Securities Litigation*, N.Y. L.J., Nov. 16, 2006, at 5.

12. Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 226, 232–35 (1987); Rodriguez de Quijas v. Shearson/Am. Exp., Inc., 490 U.S. 477, 479–84 (1989).

13. Wilko v. Swan, 346 U.S. 427, 438 (1953) *overruled by Rodriguez de Quijas*, 490 U.S. 477 (1989).

14. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1746–52 (2011). The Court's decision in *Concepcion* was presaged by its decision less than a year earlier in *Stolt-Nielsen S.A. v. AnimalFeeds International Corp*., holding that in the absence of affirmative indicia in the agreement, a party cannot be forced to arbitrate against a putative class. Stolt–Nielsen S.A. v. AnimalFeeds Int'l Corp., 130 S. Ct. 1758, 1773–76 (2010). *See generally* Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631 (2005).

15. Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 343–46 (2005) (interpreting securities law statutes to demand that plaintiffs prove proximate causation and economic loss).

16. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008) (securities fraud plaintiffs may not sue "aiders and abettors" of fraud under a § 10(b) claim unless the aiders and abettors own conduct separately satisfies the elements of a § 10(b) claim); *see also* Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011) (barring primary violation claims against an investment adviser who prepared misleading prospectuses for the mutual fund it controlled).

nami through a trilogy of statutory enactments largely designed to impede plaintiffs' attorneys in their pursuit of both federal and state remedies for investors injured by securities law violations.[17] Securities class actions were a primary target. Among the impediments imposed were heightened pleading requirements,[18] discovery stays, restrictions on damages, and lead plaintiff and class counsel limitations.[19] When plaintiffs' class action counsel migrated to state courts, Congress slammed that door shut with the passage of preemptive legislation requiring removal of those actions to federal courts.[20] Congress next enacted the Class Action Fairness Act[21] to delimit plaintiff counsels' choice of forum by expanding federal diversity jurisdiction, mandating notices to federal and state authorities, and limiting attorney fee awards in class action coupon settlements.[22] Subsequently, and to the glee of the defense bar, the captains of the securities class action industry, Melvyn Weiss and Bill Lerach, were indicted and sent to prison for unlawful undisclosed payments to nominal plaintiffs in class actions that they filed over the years on behalf of investors.[23]

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17. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.) (enacted to limit frivolous securities lawsuits by changing procedural standards; this included heightening of pleading standards, limiting the scope of pre-trial discovery and placing fee limitations on class attorneys); National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.) (preemptive overhaul of states' securities acts to provide one uniform statutory act for companies and regulators to follow); Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. § 77p (2006) [hereinafter SLUSA] (enacted to limit the amount of securities lawsuits being brought in state courts due to plaintiffs inability to meet the heightened pleading requirements of the Reform Act). For a general discussion of these statutes and especial criticism of SLUSA, see Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60-SUM LAW & CONTEMP. PROBS. 169, 169–84 (1997).

18. Tellabs, Inc. v. Makor Issues & Rights Ltd., 551 U.S. 308, 323–24 (2007) (holding that under the Reform Act's exacting pleading requirements, a plaintiff must plead facts rendering an inference of scienter at least as likely as any plausible opposing inference).

19. Private Securities Litigation Reform Act of 1995, 109 Stat. at 737.

20. SLUSA § 77p .

21. Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4 (2005) (codified in scattered sections of 28 U.S.C.).

22. *See generally* Howard M. Erichson, *CAFA's Impact on Class Action Lawyers*, 156 U. PA. L. REV. 1593 (2008).

23. *See* Molly Selvin, *Two-year sentence for Lerach*, L.A. TIMES (Feb. 12, 2008), http://www.latimes.com/business/la-fi-lerach12feb12,0,3591784.story; Edvard Patterson, *Weiss Sentenced to 2½ years for Kickback Scheme*, BLOOMBERG (June 2, 2008, 4:38 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aGqfpC4ZjoAw.

The Supreme Court recently delivered another devastating blow to plaintiffs' securities counsel filing class actions in U.S. courts against foreign companies. Reaffirming a presumption against the extraterritorial application of U.S. securities laws, the Court, in *Morrison v. National Australia Bank Ltd*.,[24] held that the antifraud provisions applied only to domestic securities transactions and to transactions in securities listed on domestic exchanges in the United States.[25] Justice Scalia effectively eradicated any fear that U.S. courts would continue as the "Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[26]

Although the portent of securities class actions still strikes fear in the hearts of executives of publicly-held companies, the likelihood of successful securities class actions against their companies is substantially less.[27] The number of securities class action settlements approved in

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24. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2878 (2010). Two European countries filed amicus briefs in support of denying U.S. court jurisdiction over f-cubed claims: the United Kingdom and France. See Michael P. Murtagh, *The Rule 23(b)(3) Superiority Requirement and Transnational Class Actions: Excluding Foreign Class Members in Favor of European Remedies*, 34 HASTINGS INT'L COMP. L. REV. 1, 42 (2011) stating that the premise for the briefs was a belief that jurisdiction would allow "U.S. courts [to] interfere with the policy choice they [foreign nations] have made in regulating securities."

25. *Morrison*, 130 S. Ct. at 2878–82. Following the Court's decision in *Morrison*, the U.S. Congress in its Dodd-Frank Wall Street Reform and Consumer Protection Act mandated that the U.S. Securities and Exchange Commission ("SEC") conduct a study regarding whether private rights of action under the federal securities laws should be applied extraterritorially to cover transnational securities fraud. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 929Y (2010). The SEC has commenced the study and has solicited public comments. *See* Study on Extraterritorial Private Rights of Action, No. 34-63174, 75 Fed. Reg. 66,822, 66,822 (Oct. 25, 2010).

26. *Morrison*, 130 S. Ct. at 2878. One recent article has discussed whether Canada may be entitled to that distinction. *See* Tanya Monestier, *Is Canada the New "Shangri La" of Global Securities Class Actions*?, 32 NW. J. INT'L L. & BUS. 3 (forthcoming 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1929090. The author noted that "just as Ontario courts are opening their doors to global securities class actions, American courts seem to be closing theirs." *Id.* at 2–3.

27. Modern class actions require the plaintiff class to meet many prerequisites before the case may advance to the merits. Federal Rule of Civil Procedure 23(a) states four prerequisites that all classes must satisfy in order to receive class certification: (1) the class must be so numerous that joinder of the parties is impracticable (numerosity); (2) questions of law or fact common to the class must exist (commonality); (3) claims and defenses of the representative parties are typical of the claims or defenses of the class (typicality); and (4) the representative parties must fairly and adequately protect the interests of the class (adequate representation). FED. R. CIV. P. 23(a). Only once the judge determines that the class has satisfied all four prerequisites, can the class certification

2010 was the lowest in over ten years.[28] Last year's mid-term results demonstrate continuing weakness in the securities fraud class action business.[29] Professor Joseph Grundfest, Director of the Stanford Law School Securities Class Action Clearinghouse, recently concluded:

> There appears to be a sea change in the structure of the class action securities fraud litigation business. The traditional claims that U.S.-based companies have been cooking their books or hyping their stocks are in sharp decline. . . . If one focuses exclusively on traditional fraud claims against U.S.-based companies, then 2011 may well be on track to be the quietest litigation year since Congress passed the Private Securities Litigation Reform Act of 1995.[30]

Notwithstanding the decline and despite serious abuses, the securities class action in the United States has enjoyed considerable success both as a deterrent to large-scale corporate securities fraud and as a source of compensatory recovery for investors.[31] However, its success has devel-

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analysis proceed to the other requirements set out in Rule 23. *See* Georgine v. Amchem Prods., Inc., 83 F.3d 610, 624 (3d Cir. 1996), *aff'd sub nom.* Amchem Prods., Inc. v. Windsor, 521 U.S. 591 (1997). Once the requirements of Rule 23(a) have been satisfied, the class will be certified if it further satisfies any of the three types of class actions listed in Rule 23(b). *See id.* at 625. If the court finds that the class fulfills the Rule 23(b)(3) requirement that questions of law or fact common to the class predominate over solely individual claims, Rule 23(c)(2) allows absent class members to "opt-out" (exclude themselves from the class action). *See* Martin H. Redish & Andrianna D. Kastanek, *Settlement Class Actions, the Case-or-Controversy Requirement, and the Nature of the Adjudicatory Process*, 73 U. CHI. L. REV. 545, 603 (2006); *see also* FED. R. CIV. P. 23(c)(2)(B)(v). Should class members choose to exercise their right to opt-out of the class, the individual will not be bound by any settlement agreed to by the class and defendants. *See* Redish & Kastanek, *supra*. However, if a class member fails to opt-out, they will be bound by any settlement agreement reached between the class and defendants. *See id.* Thus, class members who do not affirmatively opt-out forgo the ability to bring a future action based on individual claims that the class has already collectively settled. *See generally id.*

28. STAN. LAW SCH. SEC. CLASS ACTION CLEARINGHOUSE & CORNERSTONE RES., SECURITIES CLASS ACTION FILINGS: 2010 YEAR IN REVIEW 14 (2011), *available at* http://securities.stanford.edu/clearinghouse_research/2010_YIR/Cornerstone_Research_Filings_2010_YIR.pdf.

29. *Securities Class Action Filings Decrease Moderately in First Half of 2011*, CORNERSTONE RES. (July 26, 2011), http://www.cornerstone.com/securities-filings-mid-year-2011/.

30. *Id.*

31. At a recent informational program, *Governance Reforms Through Securities Class Actions*, sponsored by Institutional Shareholder Services, Inc., experts stated that institutional investors view class action litigation as an effective means to achieve corporate reform. Che Odom, *Securities Class Actions an Effective Way to Spur Governance Reforms, Experts Say*, 26 CORP. COUNS. WEEKLY (BNA) 329 (Nov. 2, 2011), *available at*

oped in a uniquely adversarial legal system in a uniquely litigious culture. The primary features facilitating the U.S. securities class action are as follows:

> (1) its broad horizontal scope of application to virtually all causes of action, largely without sectoral limits;
>
> (2) liberal standing requirements, generally allowing any aggrieved member of a designated class to file a class action in a competent court;
>
> (3) the availability of contingency fees for legal services, often referred to as "no cure, no pay," thus eliminating legal fees as barriers to plaintiffs;
>
> (4) freedom from the burden of the "loser pays" rule predominant in jurisdictions worldwide—in the United States, each party generally bears the responsibility for its own litigation costs, regardless of outcome;
>
> (5) liberal document and deposition discovery processes available to plaintiffs' class counsel that can be massively intrusive, expensive, and time-consuming for corporate defendants;
>
> (6) trial by jury, employing jurors as finders of fact, despite jurors' general lack of skill in financial disclosure issues and potential to bring populist or anti-corporate bias issues to bear on outcomes;
>
> (7) the *opt-out* feature,[32] offering global peace for defendants by allowing representation of all individuals and entities falling within a designated class of investors who do not expressly "opt-out" of the class—those investors who take no action and simply let inertia take its course are included in the plaintiff class and thus subject to the preclusive effect of ultimate settlements and judgments; and, lastly,
>
> (8) the availability of punitive damages for claims ancillary to the federal securities fraud cause of action.[33]

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http://convergence.bna.com/ContentDelivery/ContentItem/Article/235278720000000186/354478.

32. The "opt-out" feature of the U.S. class action presents a unique procedural conundrum. Although commonly known as the "opt-out" feature because of the preclusive effects that bind class members to the judgment unless they "opt-out," the procedure actually denies class members any portion of monetary relief unless they essentially "opt-in." This is typically done by filing an individual claim with the class' claims administrator. In essence, it is possible and many times very likely that a member of a U.S. plaintiff class will suffer the preclusive effects of a settlement agreement without ever receiving any proportion of the monetary settlement relief they would have been entitled to if they filed a claim.

33. *See* Richard L. Marcus, *Putting American Procedural Exceptionalism into a Globalized Context*, 53 AM. J. COMP. L. 709, 709–10 (2005); *see also Towards a Coherent European Approach*, *supra* note 3, at 9, para. 21; John C. Coffee, Jr., *Reforming the*

Despite various legislative "reforms" over the years, this lethal combination of facilitative features continues to place experienced securities class action counsel in a favored position to advance both meritorious and non-meritorious claims to advantageous settlements. Notwithstanding continual demands for reform from the securities industry and the defense bar based on perceived threats to the U.S. economy,[34] the securities class action, even as a wounded horse, retains considerable vitality at home. Although it clearly has no "unconquerable soul," it remains "bloody, but unbowed."[35]

III. EUROPEAN UNION'S NATIONAL BARRIERS TO U.S. SECURITIES CLASS ACTIONS

The European Union's member states feature legal cultures which largely are abhorrent to the adversarial legal system and litigious culture of the United States. EU member states generally share a cultural aversion to litigation and traditionally have favored government regulation and public enforcement over private lawsuits.[36] Indeed, the EU's aver-

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Securities Class Action: An Essay on Deterrence and Its Implementation, 106 COLUM. L. REV. 1534, 1535–36 (2006); James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 497–99 (1997).

34. *See, e.g.*, Robert Glauber, *Section II: Regulatory Process*, *in* LUIGI ZINGALES ET AL., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 59 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. In its response to the European Commission's recent public consultation on collective redress, *infra* notes 145–77 and accompanying text, the U.S. Chamber of Commerce's Institute for Legal Reform advised the European Commission of a 2007 study concluding that the permissive rules of the United States' liberal tort system resulted in annual costs of some $865 billion, constituting an annual "tort tax" of $9,827 on a family of four. Response from the U.S. Chamber Inst. for Legal Reform [LIR], to the Eur. Comm'n Public Consultation: Towards a Coherent European Approach to Collective Redress 2 (Apr. 29, 2011), *available at* http://ec.europa.eu/competition/consultations/2011_collective_redress/us_chamber_institute_en.pdf. It also expressed its fears that efforts to reform collective redress schemes in the European Union might erode Europe's traditional safeguards against abusive litigation which, in turn, "would result in an explosion of meritless, abusive litigation." *Id.*

35. William Ernest Henley, *Invictus* (1875), *reprinted in* 8 LEATHERNECK 32 (1925).

36. Indeed, one writer has recently noted Europe's "historical preference for a regulatory rather than a citizen driven litigious response to widespread wrongdoing," a preference that "remains strong despite recent developments in collective redress litigation." Jessica Beess und Chrostin, The Future of Collective Redress in Europe: Where We Are and How to Move Forward 11 (Apr. 2011) (unpublished student paper), *available at* http://blogs.law.harvard.edu/hnmcp/files/2012/02/Fisher-Sander-Prize-2011-Winner-Jessica-Beess-und-Chrostin-May-2011.pdf. Another has observed that "Europe has predominantly punished corporate misconduct with regulatory action, rather than through

sion to U.S.-style class actions "corresponds to sustained critiques of class actions in the United States."[37]

The EU's member states generally have none of the facilitating features credited for the nurture and development of the U.S. securities class action. EU member states generally prohibit plaintiffs' lawyers from collecting contingent fees.[38] Losing parties in litigation are generally liable for the prevailing parties' legal fees and costs.[39] Parties to litigation do not have liberal access to each other's relevant documents and testimony.[40] Jury trials in civil cases are virtually nonexistent and punitive damages are never available.[41] Moreover, even in those member states that do provide for some form of collective redress, they generally provide for class inclusion of only those individuals and entities that expressly *opt-in* to the proceedings, and thus do not preclude actions by claimants who do not.[42] According to one scholar, "the law is unlikely to see anything like a trans-Atlantic convergence toward the specifics of U.S.-style class actions,"[43] and therefore, only a highly unlikely legal and cultural metamorphosis could transform the European Union into a receptive environment for U.S.-style securities class actions.[44] A closer look at these characteristics of the legal scheme of the EU demonstrates why such a structure might be viewed as debilitative to any effort to replicate the U.S.-style class action.

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private enforcement." Tiana L. Russell, *Exporting Class Actions to the European Union*, 28 B.U. INT'L L.J. 141, 142 (2010).

37. *See* Issacharoff & Miller, *supra* note 8, at 180.

38. Mark A. Behrens, Gregory L. Fowler & Silvia Kim, *Global Litigation Trends—Class Actions, Contingency Fees, and Punitive Damages: Moving Toward the American Civil Law Model?*, 17 MICH. ST. J. INT'L L. 165, 166 n.1 (2009) (citing Sabine Chalmers, *US Style Litigation in Europe?*, 26 ACC Docket 16 (Apr. 2008).

39. *Id.* at 168 n.6 (citing Deborah R. Hensler, *The Globalization of Class Actions: An Overview*, 622 ANNALS AM. ACAD. POL. & SOC. SCI., Mar. 2009, at 7, 22).

40. *Id.* at 167, 167 n.3 (citing Richard A. Nagareda, *Aggregate Litigation Across the Atlantic and the Future of American Exceptionalism*, 62 VAND. L. REV. 1, 2 (2009)); Laurel Harbour & Marc Shelley, *Expanding Multi-party Litigation to a Shrinking World*, *in* 2006 ABA ANNUAL MEETING, SECTION OF LITIGATION, THE EMERGING EUROPEAN CLASS ACTION 1, 1 (Aug. 3, 2006), *available at* http://el.shb.com/nl_images/SHBWebsite/PracticeAreas/International/Pubs/The%20Emerging%20European%20Class%20Action_ABA_Meeting.pdf.

41. Behrens et al., *supra* note 38, at 187.

42. *Id.*

43. Nagareda, *supra* note 40, at 6.

44. *See supra* note 2. *See generally* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001).

(1) No Contingency Fees

Contingency fees, which fuel the class action remedy in the United States, have been largely rejected by EU member states.[45] Fees based on a proportion of the sum recovered, *pactum de quota litis*, are prohibited in Germany, France, the Netherlands, Portugal, Austria, Belgium, Cyprus, Malta, Czech Republic, Denmark, Luxembourg, Greece, Ireland, Poland, Romania, and the United Kingdom.[46] Some member states do permit conditional or success fees, payable only upon a successful conclusion of the litigation. Such fees may include an uplift over normal rates but cannot include a proportion of the recovered damages.[47] The prohibition of contingency fees not only serves to restrain aggrieved investors financially unable to pursue costly litigation, it also likely serves as a major restraint on the entrepreneurial zeal of the plaintiffs' bar.

(2) Loser Pays

The "loser pays" or the "English rule" requires the losing party in litigation to pay the winning party's costs.[48] It has been adopted by every EU member state except the Principality of Luxembourg.[49] It is based on a durable and culturally consistent policy of imposing financial risks on would-be complainants in order to discourage unnecessary litigation.[50] Thus, European lawyers are forced to analyze diligently the reasonable prospects for a successful claim and the reasonable quantum of damages to be sought through litigation. By placing the onus of both sides' costs on the party bringing the litigation, only clearly meritorious claims are

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45. Behrens et al., *supra* note 38, at 183–87.

46. *See* Christopher Hodges, Stefan Vogenauer & Magdalena Tulibacka, *Costs and Funding of Civil Litigation: A Comparative Study* 29 (Univ. of Oxford Legal Research Paper Series, Paper No. 55, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1511714.

47. *Id.*; *see also* Eur. Parliament Directorate General for Internal Policies, *Overview of Existing Collective Redress Schemes in EU Member States* 19, 23, 26–28, Comm. on Internal Mkt. & Consumer Prot., Doc. IP/A/IMCO/NT/2011-16 (July 2011) (by Mariusz Maciejewski) [hereinafter EU Overview], *available at* http://www.europarl.europa.eu/document/activities/cont/201107/20110715ATT24242/20110715ATT24242EN.pdf.

48. *See* Shelley Thompson, *The Globalization of Securities Markets: Effects on Investor Protection*, 41 INT'L LAW. 1121 (2007); *see also* Marie Gryphon, *Assessing the Effects of a "Loser Pays" Rule on the American Legal System*, 8 RUTGERS J.L. & PUB. POL'Y 567 (2011).

49. *See* Stefano Grace, *Strengthening Investor Confidence in Europe: U.S–Style Securities Class Actions and the Acquis Communautaire*, 15 J. TRANSNAT'L L. & POL'Y 281, 289 (2006).

50. *See* Gryphon, *supra* note 48, at 567–69; Thompson, *supra* note 48, at 1143.

likely to be prosecuted by plaintiffs and their counsel. While the loser pays rule seriously discourages access to the courts, it avoids the costliness and lack of settlements among weak claims in the U.S. system. The loser pays rule continues to be "a substantial deterrent to private investor enforcement measures in Europe."[51]

(3) Discovery Limitations

In stark contrast to the liberal discovery procedures for document production and deposition testimony available in U.S. litigation, discovery is largely unavailable to the parties in judicial proceedings in the EU member states. EU states mostly subscribe to the civil law tradition that the gathering of evidence is strictly a *judicial function*.[52] There is virtually no documentary discovery and no deposition discovery in the vast majority of EU jurisdictions, and only limited document discovery in the United Kingdom and Ireland.[53] Discovery in the United Kingdom has been described as a "push" rather than a "pull" system, commanding lawyers, as officers of the court, to provide to the adverse party all documents that support either party's position.[54] In other words, the disclosure process is not dependent on requests and responses.[55] In the continental EU member states, litigation is administered by the presiding judge without any discovery process driven by the parties' counsel.[56] The liberal discovery procedures integral to U.S. litigation are simply alien to litigation in Europe.

(4) No Jury Trials

In continental Europe, no member state provides for a jury trial in civil cases.[57] It is rarely used in Scotland and is available in England only for very limited categories of civil cases.[58] Consequently, the success or fail-

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51. Grace, *supra* note 49, at 290.

52. *See* Harbour & Shelley, *supra* note 40, at 1.

53. *See id.*

54. Nigel Murray, *Discovery from the European Perspective*, ABA LAW PRACTICE TODAY (Oct. 2008), http://apps.americanbar.org/lpm/lpt/articles/mgt10081.shtml.

55. *Id.*

56. *Id*. The discovery process is further circumscribed by the EU Data Privacy Directive, which extends individual privacy protection to data on employer-provided computers, thereby according individual privacy the status of a basic human right. *See* Council Directive 95/46, art. 1, 1995 O.J. (L 281) 8 (EC).

57. Danielle Kantor, Note, *The Limits of Federal Jurisdiction and the F-Cubed Case: Adjudicating Transnational Securities Disputes in Federal Courts*, 65 N.Y.U. ANN. SURV. AM. L. 839, 855, 855 n.79 (2010).

58. *See* John Sheldon & Peter Murray, *Rethinking Rules of Evaluating Admissibility in Non-jury Trials*, 86 JUDICATIVE 227, 228 n.3 (Mar.–Apr. 2003).

ure of litigated claims is placed in the hands of non-elected jurists, generally experienced and well-trained in the judicial determination of both the facts and the law in various legal proceedings.[59] The elimination of fact finding by individual jurors with limited understanding of securities issues and possible biases favoring loss-suffering investors forecloses the plaintiff lawyers' appeals to jury sympathies and biases, along with their willingness to roll the dice on questionable or non-meritorious claims.

(5) No Punitive Damages

Punitive damages generally are not awarded by courts in the EU member states, and, accordingly, it is largely impossible to secure punitive damages awards against business enterprises in the EU member states.[60] This rejection of punitive damages is premised largely on the underlying policy that civil lawsuits should permit compensatory recoveries, with punishment to be meted out solely by the criminal justice system.[61] Outsized jury awards of punitive damages in U.S. litigation are universally disfavored in the EU and most jurisdictions worldwide.[62]

These five debilitative factors generally applicable to private civil actions brought in the EU's member states are sufficient in themselves to discourage even the least risk-adverse plaintiffs' securities lawyers from pursuing bona fide claims on behalf of aggrieved investors in the EU's member states. These barriers are considerably heightened for those lawyers considering claims through a collective class action mechanism. The following discussion of the general characteristics of the extant collective redress schemes in the EU's member states reveals three additional debilitative factors that complete the negation of the corollary principles that have nurtured U.S.-style securities class actions.

IV. COLLECTIVE REDRESS AMONG THE EU MEMBER STATES

Among EU member states, there has been no fundamental shift from public enforcement to private enforcement of the member states' securities laws. As previously discussed, the same factors that facilitate class actions in the United States actually deter similar proceedings in the EU

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59. *See, e.g.*, Harbour & Shelley, *supra* note 40, at 1, 7, 13.

60. *See* Adam Liptak, *Embraced by U.S., Punitive Damages Scorned Elsewhere: Many Nations See Practice as Usurping Justice System's Role*, INT'L HERALD TRIB., Mar. 26, 2008, at 4.

61. *See generally* John Gotanda, *Punitive Damages: A Comparative Analysis*, 42 COLUM. J. TRANSNAT'L L. 391, 396–97 nn.24–27 (2004).

62. *Id.* at 393–94.

member states. Consequently, no European member state has yet enacted a U.S.-style securities class action for defrauded investors.

According to a recent EU report, sixteen member states have enacted collective redress schemes, providing "a complex legal patchwork of solutions," but the report concludes that these schemes are "not effective due to disparities and low participation rates."[63] Collective redress, as defined by the report, encompasses "any mechanism that may accomplish the cessation or prevention of unlawful business practices which affect a multitude of claimants or the compensation for the harm caused by such practices," and that provides either for injunctive or compensatory relief.[64] These schemes all "stop markedly short of full-fledged embrace of U.S.-style class actions."[65]

The collective redress schemes adopted by these member states bear little resemblance to each other and are remotely different from the U.S.-style class action. Most of these schemes are subject to *opt-in* requirements, denying preclusive effect against potential claimants who have not consented to inclusion in a given class.[66] Many are limited by sectoral scope to consumer protection, product liability, or antitrust violations, while others have a broader, horizontal scope of coverage.[67] They also have widely-varying standing requirements. Some vest only public authorities with power to bring collective proceedings, some grant standing only to non-profit foundations and consumer organizations, and others permit harmed individuals and entities to use the procedures.[68] In different words, the collective redress schemes thus far enacted by the member states are subject not only to the (above) five common debilitating factors generally applicable to civil actions in the EU's member states, but are also subject to the following three specific debilitating factors, thus completing the negation of the eight previously identified facilitating factors that have long developed and nurtured the U.S. class action.

(1) Limited Scope of Application

Most of the collective redress schemes adopted by the EU's member states are limited in applicability to certain sectors of the law and, ac-

63. EU Overview, *supra* note 47, at 5.

64. *Id.* at 6.

65. Nagareda, *supra* note 40, at 6.

66. *See* EU Overview, *supra* note 47, at 40; *see also* Jules Stuyck, *Class Actions in Europe? To Opt-In or to Opt-Out, That is the Question*, 20 EUR. BUS. L. REV. 483–505 (2009).

67. *See, e.g.*, EU Overview, *supra* note 47, at 11.

68. *Id.*

cordingly, are not necessarily available for violations of a particular member state's securities laws.[69] While some collective redress schemes are horizontal and thus have broad scopes of application,[70] many are limited sectorially to consumer protection claims,[71] product liability claims, antitrust claims,[72] or some combination of these limited areas of application.[73] Consequently, claims made on behalf of a specified group of claimants for securities law violations may have no collective redress scheme available to them, and as a result would be limited only to any individual causes of action available to them under a given member state's applicable law.[74]

(2) Restrictive Standing Requirements

The collective redress schemes adopted by various EU member states generally provide standing only to governmental authorities,[75] consumer associations,[76] and other specified organizations.[77] Individuals, despite their extent of injury as a result of alleged violations, may be able to bring individual actions but are not necessarily entitled to bring a representative action on behalf of a specified class.

(3) Opt-in Requirements

The majority of collective redress schemes in the EU provide for an *opt-in* procedure, thus requiring all claimants to be identified individually, either at the time the action is filed under some statutes or at later

69. *See id.*

70. *Id.* at 39.

71. Finland, for example, has enacted a collective redress mechanism that is limited to consumer disputes. *Id.* at 19.

72. For example, Hungary provides only for group actions under its antitrust laws. *Id.* at 25.

73. Portugal's scheme is applicable to violations related to consumer protection, public health, quality of life and preservation of the cultural and environmental heritage. *Id.* at 32.

74. *Id.* at 39–40.

75. For example, in Finland only the Finnish Consumer Ombudsman may file collective redress claims, with no secondary rights of action for members of the specified group of consumers. *Id.* at 19. Similarly, only the Hungarian Competition authority has standing to assert collective claims under a collective redress scheme limited to antitrust violations. *Id.* at 25.

76. For example, under Greece's collective redress procedures, limited in scope of application to consumer protection claims, only consumer associations having at least 500 active members and registered for at least one year before filing any action, have standing to file group actions. *Id.* at 24.

77. For example, Portugal extends standing to any "associations or foundations that promote certain general interests." *Id.* at 32.

stages of the proceedings under other statutes.[78] Any settlement negotiated or judgment rendered by a competent court will only bind those claimants who have expressly consented to the proceedings.[79] The defendant remains subject to all claims that may be brought by injured parties who have not opted-in, and, consequently, the defendant cannot achieve any national or global peace through settlement with the representative of the designated class.[80] These commonly applicable opt-in requirements generally prevent the global preclusive effect that incentivizes settlements by defendants in U.S.-style class actions. Given the wide range of disparities among the EU member states' collective redress schemes, most of which were adopted during the last ten years, and given the barriers posed by the common and specific debilitating factors accompanying them, it is easy to understand why they have not been effective.

V. THE NETHERLANDS COLLECTIVE REDRESS SCHEMES

The collective redress procedures in the Netherlands have been frequently praised as the most effective of the member states' collective redress schemes, largely due to more frequent use by consumers.[81] In fact, two significant collective redress mechanisms have been adopted in the Netherlands. The first is a representative group action that can only be used for injunctive or declaratory relief and not for monetary damages.[82] The second, the collective settlement mass claims action, *wet collectieve afwikkeling massaschade*, popularly known as "WCAM," is not a class action at all, but a settlement approval procedure providing for judicial approval of out-of-court settlements.[83] It was originally estab-

78. *Id.* at 40.

79. See generally George A. Bermann, *U.S. Class Actions and the "Global Class,"* 19 KAN. J.L. & PUB. POL'Y 91 (2009) for his discussion of the jurisdictional issues that are created by opt-in and opt-or mechanisms. See also Rachael Mulheron, *The Case for an Opt-Out Class Action for European Member States*, 15 COLUM. J. EUR. L. 409 (2009), in which she argues that an opt-out system is better suited for the jurisdictional situation among EU member states.

80. *See, e.g.*, Mulheron, *supra* note 79, at 431–34.

81. EU Overview, *supra* note 47, at 41.

82. M.-J. van der Heijden, *Class Actions/les actions collectives*, 14 ELEC. J. COMP. L., Dec. 2010, para. 4 (Neth.), *available at* http://www.ejcl.org/143/art143-18.pdf.

83. *See* Mulheron, *supra* note 79, at 425–26; *see also* Memorandum from Dr. I.M. Tzankova & D.F. Lunsingh Scheurleer, Tilburg Univ., to Prof. Deborah Hensler, Stanford Law Sch. & Dr. Christopher Hodges, Univ. of Oxford, on Class Actions, Group Litigation and Other Forms of Collective Litigation Dutch Report 3 (Sept. 24, 2007), *available at*

lished for mass personal injury claims,[84] but has been utilized to secure approval of several large securities fraud settlements.[85] Given the substantive differences between these procedures, they will be discussed briefly in turn.[86]

(1) Representative Group Actions

The representative group action may be brought only by representative organizations, including investor or consumer organizations, special purpose vehicles formed expressly to represent aggrieved parties, and by

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http://www.law.stanford.edu/display/images/dynamic/events_media/Netherlands_National_Report.pdf.

84. The WCAM procedure was prompted by claims arising from the use of the drug diethylstilbestrol (DES) and was adopted in 2005. Harbour & Shelly, *supra* note 40, at 7.

85. *See infra* notes 101–20 and accompanying text.

86. Although Representative Group Actions and WCAM settlements are the procedural mechanisms most frequently used for collective relief, a few variations and alternative mechanisms do exist. One variation of Representative Group Actions involves the assignment of a party's individual claims to a legal foundation for a representative group. The representative group may then request monetary damages for the group on the basis of the individual claim; this is in addition to the injunctive or declaratory relief that may be achieved by the group action. Although this procedure seems to be a loophole on the ban on monetary damages, in reality the legal assignment of claims is burdensome and not practical. *See* Ianika Tzankova & Daan Lunsingh Scheurleer, *Section Three: Western Europe: The Netherlands*, 622 ANNALS 149, 151–52 (2009); *see also* Karen Jelsma & Manon Cordewener, *The Settlement of Mass Claims: Hot Topic in the Netherlands*, INT'L L.Q., Summer 2011, at 13. Another alternative is to pursue an action derived from a proceeding in the Enterprise Chamber of the Amsterdam Court of Appeals. The Enterprise Chamber is a specialized business court dealing primarily with issues of corporate governance. Although not an "action," an Enterprise Chamber proceeding uses the "right of inquiry" to conduct an investigation into the facts regarding the corporate conduct at issue. The inquiry proceeding is divided into two phases. First, they must determine whether there is a "well founded reason to investigate." If one exists they will proceed to conducting an investigation into the conduct at issue. In the second phase, the court will determine if the conduct is improper, and if so may order them to cease, or pursue alternative conduct. Although the court will not address liability, the report findings on the corporate conduct may then be used as a springboard to induce settlements from alleged wrongdoers who believe the inquiry supports the finding that they are indeed liable. *See* Stephen Bainbridge, *The Dutch Right of Inquiry*, PROFESSORBAINBRIDGE (July 13, 2009, 4:59 PM), http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-dutch-right-of-inquiry.html; *see also [No. 82] The Purpose of the Right of Inquiry*, THEDEFININGTENSION (July 13, 2009, 2:11 PM), http://www.thedefiningtension.com/2009/07/no-82-the-purpose-of-the-right-of-inquiry.html [hereinafter DEFINING TENSION].

public legal bodies.[87] As previously observed, these actions can be brought solely for injunctive or declaratory relief—*not for monetary damages*—and they focus primarily on the alleged wrongful conduct of the defendant.[88] Resultant judgments are binding solely on the representative organization and the defendant.[89] They are not binding on the individuals or entities purportedly represented or on nonrepresented parties that have not opted-in to the proceeding.[90] Once a favorable judgment has been entered for the plaintiffs, the parties actually injured by the defendant's conduct must then bring their own individual actions on the same grounds and must establish causation, liability, and damages. In other words, the group action is a "stepping stone" or springboard for subsequent individual actions for monetary compensation.[91] Despite the existence of the debilitating factors previously addressed, the Dutch group action procedure was applied thirty-two times in the period 1994–2007.[92] The procedure is now being used by a special purpose vehicle formed solely to bring securities fraud claims against Fortis N.V., after a class action asserting similar claims was dismissed by a federal court in the United States.[93] The plaintiff foundation, directed by a U.S. class action lawyer, has indicated that its Dutch lawsuit is intended to provide a way around the Supreme Court's decision in *Morrison*.[94] The U.S. lawyers involved in the Fortis litigation seem poised to use the leverage of favorable declaratory relief to extract a large out-of-court settlement from the defendant, which could then be submitted for judicial approval and preclusion of further claims pursuant to the collective settlement procedure under WCAM.[95]

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87. EU Overview, *supra* note 47, at 29–30; *see also* Deborah Hensler, *The Future of Mass Litigation: Global Class Actions and Third-Party Litigation Funding*, 79 GEO. WASH. L. REV. 306, 311 (2011) [hereinafter Hensler, *The Future of Mass Litigation*].

88. Rhonda Wasserman, *Transnational Class Actions and Interjurisdictional Preclusion*, 86 NOTRE DAME L. REV. 313, 349–51 (2011).

89. *Id.*

90. *Id.*

91. DEFINING TENSION, *supra* note 86, para. 2.

92. van der Heijden, *supra* note 82, at 4, para. 2.1.

93. In *Copeland v. Fortis*, 685 F. Supp. 2d 498, 501–07 (S.D.N.Y. 2010), the court applied the recent Supreme Court decision of *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010) to find that the plaintiff class did not satisfy the "conducts" or "effects" test for the court to have jurisdiction over the case. The case was dismissed with prejudice.

94. Evan Weinberger, *Fortis Dutch Fraud Suit Could Enable Non-US Claims*, LAW360 (Jan. 10, 2011), http://www.law360.com/articles/219127/print?section=securities.

95. *See generally* Kevin LaCroix, *Plaintiffs' Lawyers Pursue Non-U.S. Securities Litigation Alternatives After Morrison*, D&O DIARY (Jan. 11, 2011),

(2) Collective Settlement Mass Damages Actions

The WCAM statute permits a representative organization, whether preexisting or created solely for the purpose of the proceeding, together with the adverse party alleged as the wrongdoer, to jointly petition the Amsterdam Court of Appeals to approve an out-of-court settlement the parties have voluntarily negotiated.[96] Most significantly, the WCAM statute makes judicial approval of the settlement binding on all class members who do not "opt-out" of the settlement.[97] After the petition has been filed, notice of the proposed settlement must be provided to the designated members of the class.[98] To secure approval of the settlement, the parties must satisfy the following criteria:

(1) the compensation provided is not unreasonable,

(2) the defendant's performance is sufficiently guaranteed,

(3) the representative organization adequately represents the class, and

(4) the number of class members is sufficient to warrant certification.[99]

If the court then approves the settlement, notice of that approved settlement must be provided and class members are given a statutory minimum of three months in which to exercise their rights to opt-out of the class and pursue their own individual actions.[100] The opt-out feature provides significant settlement incentives to defendants who obviously prefer their settlements of disputes to have preclusive, binding effect on both actual and potential claimants.

The WCAM procedure has been used in a number of high-profile securities fraud cases, including the significant Shell Petroleum settlement on

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http://www.dandodiary.com/2011/01/articles/securities-litigation/plaintiffs-lawyers-pursue-nonus-securities-litigation-alternatives-after-morrison/.

96. Hensler, *The Future of Mass Litigation*, supra note 87, at 311; Murtagh, *supra* note 24, at 37.

97. Hensler, *The Future of Mass Litigation*, *supra* note 87, at 311; Murtagh, *supra* note 24, at 37.

98. Hensler, *The Future of Mass Litigation*, *supra* note 87, at 311; Murtagh, *supra* note 24, at 37.

99. van der Heijden, *supra* note 82, at 8, para. 2.5.2.

100. Mulheron, *supra* note 79, at 425 n.94 (citing MARCO LOOS ET AL., CIVIC CONSULTING, EVALUATION OF THE EFFECTIVENESS AND EFFICIENCY OF COLLECTIVE REDRESS MECHANISMS IN THE EUROPEAN UNION—COUNTRY-REPORT THE NETHERLANDS 3–4 (2008), *available at* http://ec.europa.eu/consumers/redress_cons/nl-country-report-final.pdf).

behalf of non-U.S. investors in 2009.[101] The Shell Petroleum settlement was negotiated after class actions had been filed and consolidated in a U.S. federal court on behalf of United States and non-U.S. investors, alleging Shell had misrepresented its oil reserves. During the initial phase of the litigation, the court denied Shell's motion to dismiss the non-U.S. claimants based on lack of jurisdiction, given that they were foreign investors making investments in a foreign company's securities in foreign securities markets, the so-called "F-cubed" jurisdictional scenario later addressed in *Morrison*.[102] Subsequently, and perhaps without full disclosure to class counsel, the law firm for a Dutch pension fund that had filed an individual action against Shell on similar grounds, separately negotiated a settlement with Shell on behalf of non-U.S. investors.[103] Shell advised the federal court of the settlement and sought to dismiss the non-U.S. claims. Class counsel sought to enjoin the settlement, mediation ensued, and ultimately, on a special master's recommendation, the federal court declined jurisdiction over the non-U.S. claims.[104] Shell soon settled with the U.S. investors for roughly $83 million.[105] Then Shell, together with a special purpose foundation representing numerous institutions and various shareholder organizations, a shareholders' advocacy group, and two Dutch pension funds, successfully petitioned the Amsterdam Court of Appeals to approve the settlement of the non-U.S. investors' claims for roughly $354 million.[106] The Dutch court's approval of the settlement agreement purportedly resolved the claims of Dutch investors and all other non-U.S. investors, excluding only U.S. resident purchasers of shares on U.S. exchanges.[107] U.S. counsel that negotiated the Dutch settlement, apparently under contingency fee agreements with the Dutch pension funds, received fees totaling $47 million, while Shell

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101. *See* Michael Goldhaber, *'Shell Model' Opens Door to European Class Actions*, AM. LAW. (Jan. 7, 2008, 3:04 AM), http://www.law.com/jsp/tal/PubArticleFriendlyTAL.jsp?id=900005499991.

102. *In re* Royal Dutch/Shell Transp. Sec. Litig. (Shell I), 380 F. Supp. 2d 509, 573 (D.N.J. 2005).

103. *See* Hensler, *The Future of Mass Litigation*, *supra* note 87, at 315–16.

104. *In re* Royal Dutch/Shell Transp. Sec. Litig. (Shell II), 522 F. Supp. 2d 712, 724 (D.N.J. 2007).

105. Press Release, Shell Worldwide, Shell Announces Settlement of Reserve-Related Claims with U.S. Investors (June 3, 2008), *available at* http://www.shell.com/home/content/media/news_and_media_releases/archive/2008/us_reserves_settlement_06032008.html.

106. *See* Hensler, *The Future of Mass Litigation*, *supra* note 87, at 317.

107. *See id.* The U.S. investors' claims against Shell had already settled in the U.S. for $83 million. It was the exclusion of foreign investors from the American settlement that served as a springboard for the Dutch settlement proceedings. *See id.*

agreed to pay an additional $27 million to U.S. class counsel on top of the $33 million in fees and expenses already awarded in the settlement of the U.S. class action.[108] The settlement agreement specifically provided that Shell would pay reasonable legal fees and expenses to counsel for shareholders and that these payments would not be deducted from the total settlement amount.[109] Interestingly, local Dutch counsel for the foundation charged conventional hourly fees and expenses, while U.S. counsel were paid fees typical under contingency fee arrangements.[110] Apparently, in contrast to U.S. class action procedures, attorney fees in Dutch collective actions do not have to be approved by the court, but rather by the representative foundation.[111] It is unclear how these U.S. law firms avoided the Dutch prohibition on contingency fees, although a plausible argument might be advanced that (1) they were not members of the Dutch bar and not subject to its code of professional responsibility, and (2) there was no *contingency* since substantive litigation was never filed in the Netherlands.

In any event, the Shell case suggests "that the lawyers retained by the association representing the class need not be Dutch and may be paid according to the fee rules of another jurisdiction."[112] The case further intimates that U.S. class counsel, not attorneys from EU member states, will continue to animate, if not dominate, the WCAM procedure for approval of preclusive settlements in securities litigation. A U.S. securities class action lawyer, now directing the representative foundation in the *Fortis* case, stated that the *Shell* case demonstrates "that the Old World is not a toothless tiger anymore."[113]

The WCAM procedure has also been employed to secure approval of a settlement by Converium Holdings, AG, a Swiss company now owned

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108. *See id.*

109. Royal Dutch Shell Settlement Agreement, § I(F) Settlement Payments 10 (Apr. 11, 2007), *available at* https://www.royaldutchshellsettlement.com/Documents/Settlement%20Agreement.pdf.

110. Hensler, *The Future of Mass Litigation*, *supra* note 87, at 317–18.

111. *See id.* at 318; van der Heijden, *supra* note 82, at 13, para. 3.4. van der Heijden notes that although the loser pays rule is applied to WCAM settlements, the rule only covers the successful party's expert fees and a small amount of court related lawyer fees from the pre-action phase. Any other negotiation of attorneys' fees is outside of the court's authority to review. van der Heijden, *supra* note 82, at 13, para. 3.4.

112. Hensler, *The Future of Mass Litigation*, *supra* note 87, at 320.

113. Alexander Reus, *A Turning Point for Global Securities Litigation: Royal Dutch Shell Settlement in Europe May Signal Greater Investor Protection for Non-US Investors*, DRRT.COM 4 (2009), http://drrt.com/drrt/images/uploads/A_Turning_Point_for_Global_Securities_Litigation_by_Alexander_Reus_20090629.pdf.

by the French company, SCOR.[114] Following the filing of a securities fraud class action against it in the United States, Converium decided to settle the case. However, it moved to have non-U.S. investors excluded from the class on grounds that the company was pursuing a collective settlement with them in the Netherlands.[115] The court agreed, concluding that the non-U.S. investors' claims should be "rightfully resolved in the courts of another land."[116] Representative associations founded by SCOR represent the non-U.S. investors in the settlement, 97% of whom are not from the Netherlands.[117] The settlement agreement provides for a total gross payment of $58 million, but this includes a 20% contingency fee for U.S. class counsel, amounting to almost $12 million, which was approved by the board of the representative foundation.[118] Again, under WCAM, these attorney fees may not be subject to judicial approval, thus allowing U.S. firms to be paid fees on a basis prohibited by local law. The settlement agreement is widely expected to be approved by the Amsterdam Court of Appeals within the next several months.[119]

Despite these noteworthy successes by U.S. class action counsel utilizing the WCAM procedures to achieve favorable settlements, many question whether the Netherlands will emerge as a transatlantic "red-light district" for class actions.[120] First, both the *Shell* and *Converium* proceed-

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114. Hensler, *The Future of Mass Litigation*, *supra* note 87, at 319.

115. *See* Mulheron, *supra* note 79, at 443; HÉLÈNE VAN LITH, MINISTERIE VAN JUSTITIE, THE DUTCH COLLECTIVE SETTLEMENT ACT AND PRIVATE INTERNATIONAL LAW 22, 22 n.25 (2010) (Neth.), *available at* www.wodc.nl/images/1817_Volledige_tekst_tcm44-303998.pdf.

116. *In re* SCOR Holding (Switzerland) AG Litig., 537 F. Supp. 2d 556, 569 (S.D.N.Y 2008) (citing Fidenas AG v. Compagnie Internationale Pour L'Informatique CII Honeywell Bull S.A., 606 F.2d 5, 10 (2d Cir. 1979)).

117. VAN LITH, *supra* note 115, at 22. Residents from the Netherlands only constituted 3% of the Stichting SCOR Compensation Fund which represents the interests of non-U.S. shareholders. *Id.* Dr. van Lith suggests this creates a wide range of issues including whether the 97% of class members that are not from the Netherlands will be bound by the agreement reached in the Netherlands. *Id.*

118. Converium Settlement Agreement, Ex. 16: Resolution of the Board of Directors (Sept. 21, 2009), *available at* http://www.converiumsettlements.com/EN/Exhibit_16_Foundation_Board_Resolution_21_September_2009.pdf.

119. *See* Quinn, Emanuel, Urquhart & Sullivan, LLP, *Converium Decision by Dutch Court Promotes European Venue for Binding Settlement of Mass Claims*, QUINN EMANUEL 1–3 (Mar. 2011), *available at* http://www.quinnemanuel.com/media/203459/march%202011%20business%20litigation%20report.pdf; *see also* Kevin LaCroix, *A "Global" Approach to Securities Settlement?*, D&O DIARY (May 7, 2008), http://www.dandodiary.com/2008/05/articles/securities-litigation/a-global-approach-to-securities-settlement/.

120. Nagareda, *supra* note 40, at 41.

ings to settle the claims of non-U.S. shareholders arose from pending U.S. securities class actions prior to the Court's decision in *Morrison*. It is reasonable to doubt whether Shell or Converium would have vigorously pursued settlements with non-U.S. investors if those investors had no class action remedies in the United States and had to deal with daunting legal obstacles in the EU member states in filing individual or collective claims. Post-*Morrison*, it appears unlikely that companies accused of securities fraud will be inclined to reach massive settlements with U.S. class action law firms regarding claims of non-U.S. investors that can no longer be asserted in U.S. courts.

Most would acknowledge the practical reality that once a European class complaint has been dismissed by U.S. courts, there is little chance, if any, that the foreign shareholders will ever initiate an action overseas. When plaintiffs have no access to U.S. courts, it is unlikely that foreign corporate defendants will be amendable to settlement with non-U.S. investors.[121] One writer has noted that because WCAM does not provide an avenue for "representative or aggregate litigation, it cannot be used to compel an unwilling defendant to change its behavior (*e.g.*, to reform the prison system) nor can the threat of a damages class action be used to induce the defendant to settle."[122] Similarly, another observed that without access to U.S. courts for non-U.S. investors, it is unlikely that a claim will be initiated in Europe worth settling via WCAM, and, accordingly, the U.S. dismissal of non-U.S. investor claims under *Morrison* is really "tantamount to plaintiffs having no remedy at all."[123]

Moreover, courts in other jurisdictions, whose shareholders may have been purportedly denied their day in court by WCAM procedures, may conclude that the Amsterdam Court of Appeals exceeded its jurisdictional reach. There are major unresolved issues as to whether the Dutch court's judgments will be recognized and enforced in EU member states or in jurisdictions outside the EU. As one scholar has noted, "the landscape for collateral review of such judgments remains . . . uncharted."[124] The EU's Regulation on Jurisdiction and the Recognition and Enforcement of Judgments[125] does not specifically address the recognition of judicially approved collective *settlements*, much less those that

121. *See* Wasserman, *supra* note 88, at 325–29.

122. *Id.* at 359.

123. Derek N. White, *Conducts and Effects: Reassessing the Protection of Foreign Investors from International Securities Fraud*, 22 REGENT U. L. REV. 81, 101 (2010) (citing Thompson, *supra* note 48, at 1133).

124. Nagareda, *supra* note 40, at 45.

125. Council Regulation 44/2001, 2001 O.J. (L 12) (EC).

did not involve substantive pleadings or adjudications in any court.[126] The EU Regulation, however, does deny recognition and enforcement of judgments where it would be "manifestly contrary to public policy in the member state in which recognition is sought."[127] Clearly, the Dutch judgment binding parties who were not represented solely on the basis of their failure to take the initiative to opt-out raises significant policy concerns, including constitutional restraints, among the numerous member states that require voluntary opt-in decisions by those who would be bound by legal judgments.[128] At least one U.S. court has noted that the U.S. class action's opt-out feature might violate French constitutional principles.[129] Certainly, the questions of adequate representation by counsel, among others, provide substantive grounds for collateral attacks of court-approved mass settlements in the Netherlands.

Lastly, it is at least curious that the Netherland's WCAM procedure has been widely heralded by securities class action counsel as the "tiger" of European collective redress schemes.[130] The inherent flaw in this claim is that the Dutch procedure simply cannot be classified as a "class action." There may be a "class," although most investors may not know they are in it, but there certainly is no "action." The WCAM procedure might be better described as a glorified alternative dispute resolution technique, with a kicker that offers preclusion of claimants who fail to opt-out of the settlement. Moreover, no pending lawsuit is even required by the Dutch statute.[131] While the act permits mass *settlement* of unfiled claims, it does not in any sense provide for class action *litigation*.[132] Another scholar has described the procedure as "a composite of a voluntary settlement contract sealed with a 'judicial trust mark.'"[133] It has also been

126. *See* Murtagh, *supra* note 24, at 39–40.

127. Council Regulation 44/2001, *supra* note 125, art. 34, at 10.

128. Nagareda, *supra* note 40, at 45.

129. *See In re* Alstom SA Sec. Litig., 253 F.R.D. 266, 285–87 (S.D.N.Y. 2008); *see also In re* Vivendi Universal, S.A. Sec. Litig., No. 02 Civ. 5571, 2009 U.S. Dist. LEXIS 110283, at *28 (S.D.N.Y. Nov. 19, 2009). *See generally* Stephen Choi & Linda Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465, 479, 502–03 (2009).

130. *See, e.g.*, Geraint Howells, *Collective Consumer Redress Reform—Will it Be a Paper Tiger?*, *in* NEW FRONTIERS OF CONSUMER PROTECTION 329, 329–43 (Fabrizio Cafaggi & Hans-W. Micklitz eds., 2009).

131. Murtagh, *supra* note 24, at 40. Murtagh states that the WCAM "exists only to help promote settlement, not litigation of claims" and that its design can be "described as a composite of a voluntary settlement contract sealed with a 'judicial trust mark.'" *Id.* at 36–37.

132. *Id.* at 36 (quoting Choi & Silberman, *supra* note 129, at 485).

133. *Id.* (quoting Willem H. Van Boom, *Collective Settlement of Mass Claims in the Netherlands*, *in* AUF DEM WEG ZU EINER EUROPÄISCHEN SAMMELKLAGE? 171, 178 (Mat-

referred to as "a back-end device without a front-end," given that the Netherlands has not adopted a class action or collective redress scheme in which a class can pursue monetary damages.[134] If WCAM is the best collective redress scheme currently on offer from the member states, one must ask whether a supranational scheme is likely to soon be on offer from the EU.

VI. SUPRANATIONAL COLLECTIVE REDRESS IN THE EUROPEAN UNION

A. Background

The European Union, beginning with its 1992 initiatives to create a single securities market through a combination of minimum uniform standards and mutual recognition, has long sought to harmonize and strengthen the securities regulatory regimes of the member states.[135] While the European Commission has encouraged the development of competent regulatory authorities in all the member states and broader cooperation among those authorities, it has not extensively addressed issues of private enforcement through private individual or collective civil actions in member state courts to recover damages arising from securities law violations.

The European Commission has begun to address collective redress procedures in fields other than securities law. In 1998 the European Council of Ministers adopted a harmonizing directive in the consumer protection area directing the member states to enact national laws providing for minimum standards for group actions by "qualified entities," such as consumer associations or public entities, for injunctive or declaratory relief.[136] While mandating the development of injunctive and declaratory relief for violations of member state consumer protection laws, it did not provide those organizations with standing to sue for monetary damages.[137] Subsequently, the Council adopted a regulation on consumer pro-

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thias Casper et al. eds., 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456819). Murtagh states that the "Dutch Collective Settlement Act exists only to help promote settlement, not the litigation of claims." However, the lack of any legitimate primary threat of litigation presents obstacles to induce settlement. *Id.* at 37.

134. Hensler, *The Future of Mass Litigation*, *supra* note 87, at 312.

135. *See generally* WARREN, *supra* note 1, at 1–12.

136. Council Directive 98/27, Injunctions for the Protection of Consumers' Interests, 1998 O.J. (L 166) 51, 52–53.

137. *See Commission Green Paper on Consumer Collective Redress*, at 6–7, COM (2008) 794 final (Nov. 27, 2008).

tection cooperation that substantially strengthened public enforcement, but again did not provide for monetary compensation to consumers.[138] Finally, in late 2008, the Commission, concerned that current laws did not allow large number of consumers affected by single violations of consumer protection laws to obtain monetary relief, published its Green Paper on Consumer Collective Redress addressing whether collective redress schemes might provide an appropriate solution.[139]

The European Commission has extended its focus from consumer protection to encompass competition or antitrust law as well. It published its Green Paper on damages actions for breach of EU antitrust rules in 2005,[140] which emphasized the importance of private as well as public enforcement of competition law. Expressing concerns that the system for private enforcement was inadequate, it proposed consideration of collective redress schemes.[141] In 2008, the Commission followed up on this initiative with publication for public consultation of its White Paper on damages actions for breach of EC antitrust rules.[142] In this report, the Commission concluded that competition law was an area where collective redress could enhance consumers' access to justice.[143] It recommended EU legislation to establish an opt-in collective action that could be brought by public entities, consumer organizations, and trade associations to pursue damages claims on behalf of victims.[144]

B. The European Commission's Public Consultation on Collective Redress

The European Commission recently shifted its focus on sectoral areas like antitrust and consumer protection to a broader, horizontal approach to collective redress. In February 2011, the Commission launched for public consultation its working document, *Towards a Coherent European Approach to Collective Redress*.[145] The purpose of the consultation was to identify common legal principles on collective redress among the

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138. Council Regulation 2006/2004, of the European Parliament and of the Council of 27 October 2004 on Cooperation Between National Authorities Responsible for the Enforcement of Consumer Protection Laws, 2004 O.J. (L. 364).

139. *Commission Green Paper on Consumer Collective Redress*, *supra* note 137, at 2–3.

140. *Commission Green Paper on Damages Actions for Breach of the EC Antitrust Rules*, at 9, COM (2005) 672 final (Dec. 19, 2005).

141. *Id.* at 8–9.

142. *Commission White Paper on Damages Actions for Breach of the EC Antitrust Rules*, COM (2008) 165 final (Apr. 2, 2008).

143. *Id.* at 4.

144. *Id.*

145. *See Towards a Coherent European Approach*, *supra* note 3.

member states.[146] The consultation was designed to determine how those common principles could fit into the EU legal system and into the legal orders of the member states.[147] The objective, according to the Commission, was "to ensure from the outset that any proposal in this field, while serving the purpose of ensuring a more effective enforcement of EU laws, fits well into the *EU legal tradition* and into the set of procedural remedies already available for the enforcement of EU law."[148] These common legal principles and the EU legal tradition certainly include, among others, those features previously identified as debilitative for U.S.-style class actions. Moreover, the Commission reiterated in its working document that "a system of collective redress that results in lengthy and costly litigation is neither in the interests of consumers nor business and should be avoided."[149]

The Commission's working document sets forth in some detail its opposition to most of the features that have long facilitated class actions in the United States. The Commission's guidance in its public consultation document demonstrates rather dramatically that any collective redress scheme ultimately proposed must be modeled to avoid any close resemblance to the U.S.-style class action and the legal system in which it has flourished.[150] The Commission, in the section of its working document entitled, *Strong Safeguards against Claims Litigation*, states as follows:

> Any European approach to collective redress (injunctive and/or compensatory) would have to avoid from the outset the risk of abusive litigation. Many stakeholders have expressed concern that they wish to avoid certain abuses that have occurred in the U.S. with its "class actions" system. This system contains strong economic incentives for parties to bring a case to court even if, on the merits, it is not necessarily well founded. These incentives are the result of a combination of several factors, in particular, the availability of punitive damages, the absence of limitations as regards standing (virtually anybody can bring an action on behalf of an open class of injured parties), the possibility of contingency fees for attorneys and the wide-ranging discovery procedure for procuring evidence. The Commission believes that these features taken together increase the risk of abusive litigation to an extent

146. *Id.* at 5.

147. *Id.*

148. *Id.* (emphasis added).

149. *Id.* at 7, para. 16.

150. *See id.*; *see also* Response from Prof. Christopher Hodges, Univ. of Oxford, to Eur. Comm'n Public Consultation: Towards a Coherent European Approach to Collective Redress 3 (Apr. 28, 2011) [hereinafter Hodges, Response to Consultation], *available at* http://ec.europa.eu/competition/consultations/2011_collective_redress/university_of_oxford_en.pdf.

> which is not compatible with the European legal tradition . . . . Any European approach to collective redress (injunctive and/or compensatory) should not give any economic incentive to bring abusive claims. In addition, effective safeguards to avoid abusive collective actions should be defined. These should be inspired by the existing national judicial redress systems in the EU Member States. The existing national mechanisms show that various safeguards, or their combinations, can be used.[151]

The Commission's insistence on inclusion of its member states' debilitative factors as safeguards against abuse creates what one noted scholar has characterized as "an inherent and inescapable problem—*either the procedure does not work effectively, or it will produce abuse*."[152] What Europeans see as abuses in the American system "are the *intended* consequences of a policy of private enforcement based on a *post facto* deterrence policy."[153] In other words, if European safeguards are put in place, collective redress schemes in the EU are unlikely to provide any significant degree of compensatory redress.[154] Obviously, the Commission has not labeled all U.S.-style class actions as abusive, but it does suggest that the basic features of the U.S. litigation scheme are anathema to litigation in the member states of the EU. Not to unduly belabor the point, but it is critical to appreciate what the Commission believes are U.S. principles to be avoided in the development of collective redress schemes for the EU member states. Instead of an outright rejection of the U.S. class action model, the Commission rejects bedrock U.S. civil litigation principles that it believes have combined to result in abuse:

(1) liberal standing requirements,

(2) contingency fees,

(3) the absence of the loser pays rule,

(4) liberal discovery processes, and

(5) the availability of punitive damages.[155]

Presumably because juries largely play no role in European civil actions, the Commission had no basis for adding this feature as another

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151. *Towards a Coherent European Approach*, *supra* note 3, at 9, paras. 21–22.

152. Hodges, Response to Consultation, *supra* note 150, at 3, para. 9.

153. *Id.* at 3, para. 12.

154. *Id.* at 3–4.

155. *See Commission Green Paper on Consumer Collective Redress*, *supra* note 137; *Commission Green Paper on Damages Actions for Breach of the EC Antitrust Rules*, *supra* note 140; *Commission White Paper on Damages Actions for Breach of the EC Antitrust Rules*, *supra* note 142.

principle contributing to the abuse. In the evolutionary development of collective redress schemes, the U.S. class action and litigation rules have become "the model of what not to do." The European Commission's working document poses some thirty-four questions for public comment, including, among others, the following:

> (1) Should private redress be independent of, complementary to, or subsidiary to enforcement by governmental authorities?[156]
>
> (2) Should the scope of relief be extended from injunctive relief to monetary damages?[157]
>
> (3) Should proposals on collective redress be compliant with a set of common principles?[158]
>
> (4) Should ADR be promoted for resolution of multiple claims?[159]
>
> (5) Should prior efforts to resolve disputes through collective consensual dispute resolution be a mandatory prerequisite to collective redress in the courts?[160]
>
> (6) Which safeguards should be considered particularly successful in limiting abusive litigation?[161]
>
> (7) Should "loser pays" principles be applied to injunctive or compensatory collective redress schemes?[162]
>
> (8) Who should be allowed to bring collective redress actions?[163]
>
> (9) Are non-public solutions like third party funding or legal costs insurance advisable in achieving the right balance between providing access to justice and avoiding abuse?[164]
>
> (10) "Should the Commission's work on compensatory collective redress be extended to other areas of EU law besides competition and consumer protection," *e.g.*, financial services law or securities regulation?[165]

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156. *Towards a Coherent European Approach*, *supra* note 3, at 6.
157. *Id.*
158. *Id.* at 7.
159. *Id.* at 9.
160. *Id.*
161. *Id.* at 10.
162. *Id.*
163. *Id.*
164. *Id.* at 11.
165. *Id.* at 12.

The public consultation process, including the period for public response to these questions, concluded on April 30, 2011.[166] The European Commission received over 300 comments from various institutions, representing the interests of consumers, businesses, lawyers, academia, and member state governments.[167] In addition, it received almost 20,000 comments from individuals.[168] The author reviewed over 200 of the institutional responses and summarized his findings in Appendices 1 and 2 to this Article. The vast majority of the institutional responses rejects contingency fees, supports the loser pays rule, objects to any liberalization of discovery, opposes punitive damages, and overwhelmingly favors opt-in versus opt-out class determination procedures. Although there is a substantial divergence of views regarding a requirement of mandatory prior submission of claims to some alternative dispute resolution mechanism, the responses strongly favor standing to bring collective redress actions for governmental entities. One can only conclude from these responses that the EU will find it politically impractical, if not impossible, to develop a collective redress scheme that incorporates any of the features that facilitate U.S.-style class actions. Indeed, according to the European Federation of Investors, no consumer organization in the EU has ever asked for something "remotely resembling" the American class action.[169]

Notably absent from the debate are the member states' securities regulatory authorities, who seemingly have abstained from expressing any support for collective redress by governmental authorities, investor associations, or individual victims of securities fraud. In addition, the European Securities Committee,[170] created by the Commission in 2001 to advise on securities regulatory policies and legislation, and the European Securities Market Authority[171] created by Council regulation in late 2010

166. *Id.* at 13.

167. Directorate-General Justice, *Public Consultation: Towards a Coherent European Approach to Collective Redress*, EUR. COMM'N JUSTICE, http://ec.europa.eu/justice/news/consulting_public/news_consulting_0054_en.htm (last updated July 14, 2011) [hereinafter *Public Consultation*].

168. *See id.*

169. Response from Eur. Fed'n of Investors's [EuroInvestors], to Eur. Comm'n Public Consultation: Towards a Coherent European Approach to Collective Redress 4 (2011) (Belg.), *available at* http://ec.europa.eu/competition/consultations/2011_collective_redress/euroinvestors_en.pdf.

170. Commission Decision 2001/528, on Establishing the European Securities Committee, 2001 O.J. (L 191/45), *available at* http://www.esma.europa.eu/system/files/establishESCDec_2001_528.pdf.

171. Commission Regulation 1095/2010, 2010 O.J. (L 331/1), *available at* http://www.esma.europa.eu/system/files/Reg_1092_2010_ESRB.pdf.

to promote convergence among member state regulatory authorities and to facilitate stronger investor protection, have apparently been totally silent throughout the consultation process.

Many of the institutional responses to the Commission's public consultation, in addition to expressing their loudly ringing endorsements of the debilitating factors previously discussed, also challenge the Commission's authority to undertake any reform in the area of collective redress. For example, the Law Society of England and Wales has argued that principles of subsidiarity,[172] essentially an EU states' rights concept, foreclose the European Commission's development of a "pan-European procedure for collective redress."[173] In its view, "it is neither appropriate nor proportionate to impose a new set of procedural rules, to be followed in all courts in all member states."[174] Instead, it suggested that the Commission recommend minimum standards for the development of collective redress under national law and focus on the mutual recognition of judgments in collective actions.[175] The European Banking Federation also expressed its doubts regarding the EU's competence in establishing judicial procedures for collective redress in the member states,[176] while also questioning the need for any EU initiative at all.[177] Similarly, the Bar Council of England and Wales commented that the Commission is simply not empowered under the Treaty for European Union[178] to engage in reform of the various member states' collective redress schemes, whether related to the substance or procedure of those schemes.[179]

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172. Response from the Law Society of England & Wales, to Eur. Comm'n Public Consultation: Towards a Coherent European Approach to Collective Redress 1 (2011), *available at* http://ec.europa.eu/competition/consultations/2011_collective_redress/law_society_of_england_and_wales_en.pdf.

173. *See id.* at 1, para. 3.

174. *Id.* at 1, para. 6.

175. *Id*. at 2.

176. Response from the Eur. Banking Fed'n [EBF], to Eur. Comm'n Public Consultation: Towards a Coherent European Approach to Collective Redress 2–3 (Apr. 29, 2011) (Belg.), *available at* http://ec.europa.eu/competition/consultations/2011_collective_redress/ebf_en.pdf.

177. *Id*. The European Banking Federation emphasizes its belief that an EU mechanism is not warranted since procedures for collective relief have been instituted in many Member States. *Id.* at 4. The Federation believes the recently instituted features do not provide any support that a collective overhaul of redress schemes is warranted. *Id.*

178. Response from the Bar Council of England & Wales, to Eur. Comm'n Public Consultation: Towards a Coherent European Approach to Collective Redress 12 (2011), *available at* http://ec.europa.eu/competition/consultations/2011_collective_redress/bcew_en.pdf.

179. *Id.*

C. The Prospects for EU Reform

The European Commission's Justice Commissioner announced in a speech last July her intention to issue a communication by year-end 2011 regarding the Commission's further intentions regarding collective redress.[180] She identified three options that will be considered by the Commission. The first option is to terminate the Commission's collective redress initiative on the basis that the arguments in favor of EU interaction are "not compelling."[181] The second option is for the Commission to issue a Recommendation to the member states for their consideration in developing national collective redress schemes.[182] The final option would be for the Commission to propose EU-level legislation for either a sectoral or horizontal collective redress scheme.[183] She concluded by stating that "any initiative in this area would have to respect the legal traditions of the member states and will have to avoid abuses of the system which have occurred in other legal systems, such as the USA."[184] Her remarks certainly signal adherence to prohibitions on contingency fees, continuation of the loser pays rule, limited discovery, restrictive standing requirements, and rejection of punitive damages.

The Justice Commissioner's speech was followed several days later by a draft report issued by the European Parliament's Committee on Legal Affairs, which set forth a motion for a European parliamentary resolution on collective redress. The proposed resolution, in its recitations, notes the U.S. Supreme Court's "efforts" this year, through its *Wal-Mart Stores, Inc. v. Dukes*[185] decision, "to limit frivolous litigation and the abuse of the U.S. class action system"; stresses that Europe must not introduce a U.S.-style class action or any system which would lend itself to similar abuse; commends member state efforts at collective redress litigation "while avoiding an abusive litigation culture;" and questions the Europe-

180. Viviane Reding, Justice Comm'r, Eur. Comm'n, Speech before the European Parliament Legal Affairs [JURI] Committee: A horizontal instrument for collective redress in Europe? (July 12, 2011) (Belg.), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/517&format=HTML&aged=0&language=EN&guiLanguage=en.

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.*

185. Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011) (plaintiffs, alleging sex discrimination based on a flawed corporate culture but not on specific employment practices, failed to demonstrate the requisite commonality of law and fact). *See generally* Jess Bravin & Ann Zimmerman, *Justices Curb Class Actions: High Court Tosses Wal-Mart Bias Suit, Rules Plaintiffs Had Too Little in Common*, WALL ST. J., June 21, 2011, at A1.

an Commission's authority, under both subsidiarity principles[186] and the European Union Treaty, to even consider collective redress measures.[187] The body of the draft parliamentary motion, among other provisions, underscores the necessity for the following required safeguards:

> (1) Standing must be restricted to representative organizations designated by the member states.[188]
>
> (2) The group members represented must be clearly identified before the claim is brought pursuant to opt-in procedures.[189]
>
> (3) An opt-out system must be rejected on the grounds that it is contrary to many Member States' constitutions and "violates the rights of any victim who might participate in the procedure unknowingly and yet would be bound by the court's decision."[190]
>
> (4) Victims must in all cases have the right to pursue individual compensatory redress in the courts.[191]
>
> (5) Punitive damages must be prohibited.[192]
>
> (6) Compensation must be distributed to individual victims in proportion to their individual harm.[193]
>
> (7) Contingency fees must be prohibited.[194]
>
> (8) Each claimant must provide evidence for his individual claim.[195]
>
> (9) Defendants must not be required to disclose documents to claimants since discovery "is mostly unknown in Europe and must be rejected at [the] European level."[196]
>
> (10) There can be no action "without financial risk," and "the unsuccessful party must bear the costs of the other party."[197]

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186. Rapporteur on Towards a Coherent European Approach to Collective Redress, *Draft Rep. on a Motion for a European Parliament Resolution*, Comm. on Leg. Affairs, Doc. 2011/2089(INI), at 4 (July 15, 2011) (by Klaus-Heiner Lehne) [hereinafter *Draft Rep. on a Motion for a Eur. Parliament Resolution*].

187. *See id.* at 8 (referring specifically to Article 5 of the Treaty on European Union).

188. *Id.*

189. *Id.* at 10.

190. *Id.* at 6.

191. *Id.*

192. *Id.*

193. *Id.*

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

> (11) The Commission must not set any conditions on funding of claims, since "it is mostly unknown in Member States' legal systems to seek third-party funding, for instance, by offering a share of the damages awarded."[198]

These safeguards, as delineated in the draft motion, seem not only to sound the death knell for the development of European class actions, but to almost any meaningful form of collective redress not funded entirely by member state governments. Assuming some form of collective redress mechanism is established, the motion further calls for a legal obligation of the parties to first seek a collective consensual resolution through alternative dispute resolution prior to filing collective court proceedings.[199]

The report's draft parliamentary motion is followed by the Rapporteur's Explanatory Statement that even more strongly adheres to the debilitating features of European legal traditions. He questions the need for any EU action in the field, citing negative responses to the Commission's public consultation by the governments of France and Germany.[200] The Rapporteur then asserts strongly that *public enforcement* of EU and national laws must be predominant, given investigative authority that "cannot be made available to private parties," and that private enforcement should continue to be solely "complementary."[201] He even suggests that any collective redress scheme proposed be limited to claimants who have suffered losses of €2,000 or less.[202] The Rapporteur insists on the loser pays rule, prohibitions on contingency fees and punitive damages, the rejection of third-party funding, and no discovery rights.[203] He states that "a defendant cannot be required to provide evidence for the claimant,"[204] that "it is of decisive importance that collective claimants should not be in a better position than individual claimants when it comes to evidence,"[205] and that "disclosure requirements unnecessarily raise the cost of litigation and encourage unmeritorious claims and must therefore be rejected at the European level."[206] He also slams opt-out provisions as violative of both the constitutions of certain member states and as prob-

198. *Id.*
199. *Id.* at 6, para. 15.
200. *See id.* at 11.
201. *Id.*
202. *Id.* at 8.
203. *Id.* at 9.
204. *Id.* at 11.
205. *Id.*
206. *Id.*

lematic under Article 6 of the European Convention of Human Rights,[207] which provides that "everyone is entitled to a fair and public hearing by impartial tribunals."[208] Although this draft motion and explanatory statement do not yet constitute the official views of the European Commission, the policies expressed may well signal the end for now of any progress toward an effective U.S.-style class action for aggrieved investors. From the European perspective, American class actions remain "the poster children of the 'American litigation disease.'"[209]

European hostility not only to the U.S.-style class action, but also to virtually the entire panoply of private litigation standards in the United States, works a formidable impasse to aggrieved investors seeking redress as victims of securities fraud. In situations where an entire class of a particular company's individual securities investors have been defrauded, important questions exist as to whether such investors would have effective private access to justice in the EU's member states. To the extent the European Commission determines that lack of access raises serious EU-wide public policy concerns, it should strongly consider development of a publicly-administered collective redress scheme. For example, the Commission could direct member states to grant standing either to a competent governmental authority or to a government-funded independent ombudsman to assert claims on behalf of aggrieved classes of investors. These authorities, in addition to public funding, should be granted broad governmental investigatory power and given the competence to pursue monetary recoveries and to establish common funds for distribution to investors. In its development of a publicly funded collective redress authority, the Commission might look to the "fair funds" provisions of the United States' Sarbanes-Oxley Act of 2002.[210] Those provisions, in effect, have established a publicly-administered collective redress scheme for aggrieved securities investors in the United States. These fair funds provisions empower the U.S. Securities and Exchange Commission ("SEC") to impose and collect monetary penalties against companies that have violated the securities laws and authorize the SEC to distribute those penalties to investors who were harmed by those violations.[211] The SEC's imposition of penalties and development of distri-

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207. European Convention for the Protection of Human Rights and Fundamental Freedoms [ECHR] art. 6, Nov. 4, 1950, 213 U.N.T.S. 222.

208. *Draft Rep. on a Motion for a Eur. Parliament Resolution*, *supra* note 186, at 13.

209. Harbour & Shelley, *supra* note 40, at 33.

210. 15 U.S.C. § 7246(a) (2006).

211. *Id.*

bution plans, while subject to a "fair and reasonable" standard,[212] often serve to protect investors by both deterrence of fraudulent conduct and compensation of defrauded investors.[213] The European Commission should consider this model, as opposed to the U.S.-style class action model it abhors, as a platform for constructing a collective redress scheme that pursues monetary recoveries, whether in the form of civil penalties, actual damages or both, on behalf of investors. As the Commission continues to integrate its financial markets and the regulatory scheme governing those markets, it should view development of a publicly-administered collective redress scheme as an integral part of its work by ensuring increased deterrence against securities violations and increased access to monetary recoveries for investors.

CONCLUSION

This Article addresses the major factors in the U.S. litigation system that have developed and nurtured the private class action for investors victimized by securities fraud. The author discusses the negating corollaries of those factors in the EU's member states, both those that are common to civil litigation in Europe generally and those that have been added as specific features of the EU member states' various collective redress schemes. No effective scheme has yet been enacted by any member state, and the one most frequently lauded, the Netherlands' WCAM procedure, does not provide a mechanism for class recovery of monetary damages, but only a mechanism for securing court approval of voluntary out-of-court settlements of class claims.

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212. *See, e.g.*, S.E.C. v. WorldCom, Inc., No. 02 CIV. 4963, 2004 WL 1621185, at * 1 (S.D.N.Y July 20, 2004) aff'd sub nom. Official Comm. of Unsecured Creditors of WorldCom, Inc., v. S.E.C., 467 F.3d 73, 81 (2d Cir. 2006).

213. Incidental to their respective WCAM proceedings, Royal Dutch Shell and Zurich Financial Services separately agreed to pay massive penalties into SEC Fair Funds to be redistributed to harmed investors. *Claims Fund: Zurich Financial Services*, U.S. SEC. & EXCH. COMM'N (Apr. 14, 2010), http://www.sec.gov/divisions/enforce/claims/zurichfinserv.htm. Zurich Financial, for their role in the Converium Holding scandal, paid a $1 disgorgement and a $25 million penalty to the SEC. *Id.* Prior to Fair Funds, only the $1 disgorgement could be redistributed to injured shareholders. *Id.* Due to the Fair Funds provision of Sarbanes-Oxley, the entire Zurich payment of $25,000,001 was redistributed. *Id.* Royal Dutch Shell agreed to pay $113.5 million into an SEC Fair Fund as a penalty for their overstatement of gas reserves. Press Release, Sec. & Exch. Comm'n, SEC Announces $113.5 Million Distribution in Royal Dutch Shell Fair Fund (Apr. 30, 2010), *available at* http://www.sec.gov/news/press/2010/2010-67.htm. Interestingly, the Fair Fund distribution was allocated to over 84,000 investors living in 56 countries. *Id.* Had some of those investors been f-cubed claims, questions might be raised regarding the international dispersal of Fair Funds in the post-*Morrison* world.

Moreover, the European Commission, in its efforts toward the development of more efficient collective redress schemes, whether for horizontal application or for specific application to securities fraud, has not demonstrated any enthusiasm for class-based private remedies. Indeed, its own guidance suggests abhorrence of the U.S.-style class action. The institutional responses to the Commission's recent public consultation evidence overwhelming opposition. Furthermore, securities regulatory authorities both at the EU and member state levels apparently have been silent throughout the consultation process. When those charged with public enforcement of the securities laws, presumably the regulatory zealots, have been unsupportive of stronger private remedies to supplement their work, the alarm bells of prospective failure ring loudly. Perhaps the best outcome would be an EU directive that each member state grant standing to a competent governmental authority, or, in the case of group actions against a government itself, independent ombudsmen to pursue claims on behalf of aggrieved investors, supported by public funds and facilitated by governmental investigatory power, to pursue recoveries and establish common funds for distribution to aggrieved investors. Even this, for now, seems a distant dream.

Appendix 1—Responses to the EU Public Consultation: Towards a Coherent European Approach to Collective Redress

The data below is representative of the responses to the EU Public Consultation *Towards a Coherent European Approach Toward Collective Redress*.[214] Only responses by organizations registered in the EU's Interest Representative Register were included. The statistics display EU member states collective attitude toward various collective redress procedures.[215]

	Percentage of Public Consultation Responses	
Issue	**Support %**	**Oppose %**
Contingency Fees	8.2	91.8
Loser Pays Rule	93.3	6.7
Liberal Discovery Procedures	7.6	92.4
Punitive Damages	4.5	95.5
Opt-In	79.3	20.7
Opt-Out	20.7	79.3
Mandatory Pre-Litigation ADR	19.8	80.2

Notes:

Results reflect 225 responses sampled. Excluded from the data are responses by individuals, responses by organizations or authorities located in non-EU member states, and responses that do not expressly opine on any of the issues studied ("maybe" responses not included).

Although many responses did not support an EU collective redress mechanism, they provided their opinions about the ideal makeup of an EU system if it were to happen. These responses were included in the above data.

The percentages for each issue do not include responses that did not address the specific issue. For example, out of ten responses, if five responses supported an issue, and three were against the issue, the percentages were determined using a denominator of eight, instead of ten.

214. *Public Consultation*, *supra* note 167.

215. Data compilation on file with the author.

Appendix 2—Official Government Responses by EU Member-States

This data set displays the official attitudes taken by various EU member states on the various issues related to the EU Public Consultation: *Towards a Coherent European Approach to Collective Redress*.[216]

Country	Contingency Fees	Loser Pays Rule	Liberal Discovery Procedures	Punitive Damages	Opt-In or Opt-Out	Mandatory or Voluntary ADR
Austria	—*	Support	—	—	In	Voluntary
Bulgaria	Support	Oppose	Oppose	Support	—	Voluntary
Czech Republic	Oppose	Support	—	Oppose	In	Voluntary
France	Oppose	Support	Oppose	Oppose	In	Voluntary
Germany	Oppose	Support	—	Oppose	In	Voluntary
Greece	Oppose	Support	Oppose	Oppose	In	Voluntary
Hungary	Oppose	—	Oppose	Oppose	—	—
Italy	—	Support	—	Oppose	In	Voluntary
Netherlands	Oppose	Support	Oppose	Oppose	Out	Voluntary
Latvia	Oppose	Support	Oppose	Oppose	In	Mandatory
Poland	Oppose	Support	Oppose	—	In	Voluntary
Portugal	—	Support	Support	Oppose	Out	Voluntary
Sweden	Oppose	Support	—	Oppose	In	—
U.K.	Oppose	Support	—	—	Out	Mandatory

Notes:

Only responses provided by federal ministerial agencies were included in the data set. Responses by nongovernmental, nonprofit, or statutorily independent agencies were excluded. European Consumer Centre responses were also excluded.

The * denotes that the member state did not expressly opine on the specific issue. Conditional or non-conclusive discussion of an issue is likewise indicated by the symbol.

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216. *Public Consultation*, *supra* note 167; Data set on file with the author.

Fourteen of the twenty-seven EU member states are represented in the data. The majority of these responses were provided by a member state's Ministry of Justice.

DESIGN PROTECTION IN THE UNITED STATES AND EUROPEAN UNION: PIRACY'S DETRIMENTAL EFFECTS IN THE DIGITAL WORLD

INTRODUCTION: THE CURRENT STATE OF THE FASHION INDUSTRY

The fashion industry is an international business that reaps profits of more than $750 billion annually.[1] Though the industry produces and markets apparel worldwide, the predominant creative centers are within Europe and the United States.[2] Indeed, in the United States alone, the fashion industry produces profits of more than $350 billion annually[3] and houses the headquarters of several major fashion producers[4] including Marc Jacobs, Vera Wang, and Ralph Lauren.

The fashion industry permeates popular culture both in the United States and throughout the European Union ("EU"). For example, in the United States, the movies *The Devil Wears Prada*[5] and *Confessions of a Shopaholic*[6] grossed $27,537,244[7] and $17,809,053[8] in their opening weekends, respectively. The season six premiere of *Project Runway*[9]—a reality television program that offers talented young designers an opportunity to compete and promote their careers in fashion[10]—attracted a rec-

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1. Kal Raustiala & Christopher Sprigman, *The Piracy Paradox: Innovation and Intellectual Property in Fashion Design*, 92 VA. L. REV. 1687, 1693 (2006); *see* Safia A. Nurbhai, Note, *Style Piracy Revisited*, 10 J.L. & POL'Y 489, 489 (2001–2002) (noting "sales of general merchandise and apparel alone were estimated at $784.5 billion [] in 1999").

2. Raustiala & Sprigman, *supra* note 1, at 1693.

3. Megan Williams, Note, *Fashioning a New Idea: How the Design Piracy Prohibition Act is a Reasonable Solution to the Fashion Design Problem*, 10 TUL. J. TECH. & INTELL. PROP. 303, 304 (2007); *see A Bill To Provide Protection for Fashion Design: Hearing on H.R. 5055 Before the Subcomm. on Courts, the Internet, and Intellectual Property*, 109th Cong. 9 (2006) [hereinafter *Hearing on H.R. 5055*] (testimony of Jeffrey Banks, Council of Fashion Designers of America).

4. Raustiala & Sprigman, *supra* note 1, at 1693.

5. THE DEVIL WEARS PRADA (20th Century Fox 2006).

6. CONFESSIONS OF A SHOPAHOLIC (Touchstone Pictures 2009).

7. *The Devil Wears Prada (2006)*, IMDB, http://www.imdb.com/title/tt0458352/ (last visited Mar. 3, 2012).

8. *Confessions of a Shopaholic (2009)*, IMDB, http://www.imdb.com/title/tt1093908 (last visited Mar. 3, 2012).

9. *Project Runway* (Lifetime television broadcast Aug. 20, 2010).

10. *See About "Project Runway" Season 9*, MYLIFETIME, http://www.mylifetime.com/shows/project-runway/season-8/about (last visited Mar. 3, 2012).

ord 4.2 million viewers in the United States.[11] The immense popularity of the show led to the production of several international versions in the United Kingdom ("UK"),[12] the Netherlands,[13] and Norway.[14]

Public awareness of high-end fashion gained through popular movies, magazines, and television stimulates the demand for designer and luxury goods[15] within U.S. and European culture.[16] Although media glamorizes the already illustrious fashion industry, the majority of fashion designers in the United States are self-employed[17] and earn modest wages, somewhere between $42,150 and $87,120 annually.[18] Furthermore, these small-business people face competition from large corporate entities that rapidly replicate their designs with minimal, if any, legal restraint.[19]

Design piracy—the replication of a designer's original patterns or conceptions[20]—is considered "a way of life in the garment business."[21] As the Supreme Court of New York noted in *Samuel Winston, Inc. v. Charles James Services, Inc.*,[22] such piracy is "indulge[d]" in the United

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11. R. Thomas Umstead, *'Project Runway' Sets Lifetime Ratings Record* (Aug. 21, 2009, 6:49 PM), http://www.multichannel.com/article/328207-_Project_Runway_Sets_Lifetime_Ratings_Record.php.

12. *See Project Runway*, SKY1 HD, http://sky1.sky.com/project-runway-2 (last visited Mar. 3, 2012).

13. *See Project Catwalk*, RTL.NL, http://www.rtl.nl/programma/projectcatwalk/home/ (last visited June 8, 2012).

14. *See Designerspirene USA*, TV3, http://www.tv3.no/program/designerspirene-usa-6 (last visited Mar. 3, 2012).

15. Nurbhai, *supra* note 1, at 489.

16. Laura C. Marshall, *Catwalk Copycats: Why Congress Should Adopt a Modified Version of the Design Piracy Prohibition Act*, 14 J. INTELL. PROP. L. 305, 308 (2006–2007) (discussing style piracy).

17. BUREAU OF LABOR STATISTICS, U.S. DEPT. OF LABOR, OCCUPATIONAL OUTLOOK HANDBOOK: FASHION DESIGNERS 2 (2010–2011 ed.) [hereinafter OCCUPATIONAL OUTLOOK HANDBOOK], *available at* http://www.bls.gov/oco/pdf/ocos291.pdf.

18. In May 2008, the "median annual wages for salaried fashion designers were $61,160. The middle 50 percent earned between $42,150 and $87,120. *Id.* at 3. The lowest 10 percent earned less than $32,150, and the highest 10 percent earned more than $124,780." *Id.*

19. Marshall, *supra* note 16, at 308.

20. Nurbhai, *supra* note 1, at 489; *see also* Leslie J. Hagin, *A Comparative Analysis of Copyright Laws Applied to Fashion Works: Renewing the Proposal for Folding Fashion Works Into the United States Copyright Regime*, 26 TEX. INT'L L.J. 341, 345 (1991).

21. JEANNETTE A. JARNOW, MIRIAM GUERREIRO & BEATRICE JUDELLE, INSIDE THE FASHION BUSINESS: TEXT AND READINGS 150 (4th ed. 1987) (discussing style piracy). "Within the trade, this practice is know as 'knocking off,'" and some courts refer to it as "style piracy." Hagin, *supra* note 20, at 345.

22. Samuel Winston, Inc. v. Charles James Services, Inc., 159 N.Y.S.2d 716 (Sup. Ct. 1956).

States more "than much lesser offenses involving deprivation of one's rights and property."[23] Design piracy can have detrimental, even career ending, effects on fashion designers, especially young designers who have yet to establish a reputation in the industry and cannot withstand the financial losses resulting from design piracy.[24] In *Filene's Sons Co. v. Fashion Originators' Guild of America*,[25] the Court of Appeals for the First Circuit expressed the perilous effects of piracy on designers and the fashion industry: "[c]opying destroys the style value of dresses which are copied . . . [it] substantially reduces the number and amount of reorders which the original creators get," and "tends to increase the cost of their dresses and the prices at which they must be sold."[26]

To minimize these negative effects, the EU and several European nations, most notably France and the UK, successfully enacted legislation to protect fashion design.[27] In contrast, fashion remains one of the only creative industries in the United States that is not protected by intellectual property laws—a legal shortcoming that copyists routinely exploit.[28] Apart from ornamental features, fashion designs are not eligible for protection under current U.S. intellectual property laws, which encompass copyright protection,[29] trademarks,[30] and patents.[31] However, the federal

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23. *Id.* at 718.

24. *Hearing on H.R. 5055*, *supra* note 3, at 78 (testimony of Susan Scafidi, Professor, Fordham Law School).

25. WM. Filene's Sons Co. v. Fashion Originators' Guild of Am., 90 F.2d 556 (1st Cir. 1937).

26. *Id.* at 558.

27. Williams, *supra* note 3, at 304.

28. *Id.*

29. The Copyright Act of 1976 extends protection to:

> original works of authorship fixed in any tangible mediums of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. Works of authorship include the following categories: (1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sounds recordings; and (8) architectural works.

17 U.S.C. § 102(a) (2006).

30. The Lanham Trademark Act protects against consumer confusion and stipulates that

> (1) Any person who, on or in connection with any goods or services, or any container for goods, uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or

Innovative Design Protection and Piracy Prevention Act ("IDPPPA"), introduced on August 5, 2010 by Senator Charles E. Schumer and ten co-sponsors,[32] not only protects American fashion designers, but also more closely aligns U.S. design law with that of its more progressive European counterparts and ensures that the United States complies with its obligations under the Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS").

This Note considers the current state of design protection in the United States and its obligation, under international agreements, to enact laws that provide more meaningful protection for fashion designs. Part I examines the practice of design piracy in the fashion industry and its increased effects in the digital world. Part II introduces the provisions of the IDPPPA in relation to its failed predecessor, the Design Piracy Prohibition Act. Specifically, Part II concludes that the United States' obligations under the TRIPS Agreement, as well as international design law, require the United States to adopt the IDPPPA and extend copyright protection to fashion designs.[33] Part III examines divergent interpretations of the TRIPS Agreement and the inadequacy of protection available in the United States under current intellectual property laws. Part IV demonstrates that Member States should interpret the TRIPS Agreement broadly to better achieve its purported goal—to further the harmonization of

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> misleading description of fact, or false or misleading representation of fact, which—
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> > (A) is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person or
> >
> > (B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities,
>
> shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.

15 U.S.C. § 1125 (2006).

31. Design Patents may be obtained by "[w]hoever invents any new, original, and ornamental design for an article of manufacture" subject to certain conditions and requirements. 35 U.S.C. § 171 (2006).

32. Louis S. Ederer & Maxwell Preston, *The Innovative Design Protection and Piracy Prevention Act—Fashion Industry Friend or Faux?*, LEXISNEXIS COMMUNITIES (Aug. 25, 2010), http://www.lexisnexis.com/Community/copyright-trademarklaw/blogs/fashionindustrylaw/archive/2010/08/25/the-innovative-design-protection-and-piracy-prevention-act-fashion-industry-friend-or-faux.aspx.

33. Marshall, *supra* note 16, at 308, 319.

intellectual property laws worldwide.[34] It examines intellectual property regimes in European nations and demonstrates that current American law unreasonably impairs designers' ability to seek and obtain protection for their creative works.

I. DESIGN PIRACY: A HISTORICAL PROBLEM FURTHER COMPLICATED BY THE DIGITAL WORLD

Design piracy is a problem that "has long plagued the fashion field."[35] Following World War I and the concurrent growth of the high-end fashion industry, several "French couture houses tacitly sanctioned" limited design piracy.[36] In *The American Fashion Industry*, Jessie Stuart noted that

> when all fashion originated in Paris and 'just clothes' were made in the United [sic] States, the frank adapting and even copying of French styles was recognized and accepted. French models were bought with the actual or implied privilege of copying, since there were few original American styles.[37]

Although French couture houses seemingly allowed this form of design piracy, the remedial technology used to copy designs limited design pirates' ability to make and market copies quickly[38]—the process could take several weeks or even months.[39] One commentator elaborated on the time-consuming practice of appropriating French designs during the 1950s: "The manufacturers flew in from New York, laid the (couture) clothes out on a table, and measured each seam. They went back to New York to copy the dresses and then [the Chicago-based department store Marshall] Field's bought the copies."[40]

Significant advances in technology throughout the latter part of the twentieth century, namely digital photography and the internet, enabled almost instantaneous design piracy. In many instances, design pirates

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34. *Id.* at 319.

35. JESSIE STUART, THE AMERICAN FASHION INDUSTRY 28 (1951) (discussing style piracy).

36. Raustiala & Sprigman, *supra* note 1, at 1696. French couture houses "permitted a few American producers to attend their Paris runway shows in exchange for 'caution fees' or advance orders of couture gowns." *Id.*; STUART, *supra* note 35, at 28; *see also* TERI AGINS, THE END OF FASHION: THE MASS MARKETING OF THE CLOTHING BUSINESS 23–25 (1999).

37. STUART, *supra* note 35, at 28.

38. Raustiala & Sprigman, *supra* note 1, at 1696.

39. *See* Williams, *supra* note 3, at 306. For a more detailed description of the process of copying Parisian designs see AGINS, *supra* note 36, at 23–25.

40. Raustiala & Sprigman, *supra* note 1, at 1696.

may market and distribute their copies long before the original designer.[41] Design pirates no longer need to resort to secretive methods, such as sneaking sketch artists into fashion shows to sketch designs presented on the runway or rummaging through fashion houses' trash receptacles for discarded sketches to create course patterns of designs.[42] Instead, copyists can simply conceal digital cameras at fashion shows and produce and send digital photographs of designs before the models leave the runway.[43] Jeffrey Banks, a menswear fashion designer and former spokesman for the Council of Fashion Designers of America ("CFDA"), best described the rapid rate at which designs can be pirated, stating:

> In the blink of an eye, perfect 360 degree images of the latest runway fashions can be sent around the world. And of course, they can be copied. . . . [T]here are even software programs that develop patterns from 360 degree photographs taken at the runway shows. From these patterns, automated machines cut and then stitch perfect copies of a designer's work. Within days of the runway shows, the pirates at the factories in China and other countries where labor is cheap are shipping into this country those perfect copies, before the designer can even get his or her line into the retail stores. Since there is no protection in America, innovation launched on the runway—or the red carpet—is stolen in plain sight.[44]

The rapid rate at which designs can be copied and reproduced[45] gives fashion designers little, if any, opportunity to recoup their investments before their designs become unfashionable or, in the case of popular designs, before the market becomes saturated with cheaper copies.[46] A de-

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41. *Hearing on H.R. 5055*, *supra* note 3, at 77 (testimony of Susan Scafidi); *see also* Williams, *supra* note 3, at 304.

42. *See* Nurbhai, *supra* note 1, at 490. *See generally Hearing on H.R. 5055*, *supra* note 3, at 12 (testimony of Jeffrey Banks in which he describes how the internet has changed the way designs are copied and manufactured).

43. *Hearing on H.R. 5055*, *supra* note 3, at 11–12 (testimony of Jeffrey Banks).

44. *Id.*; *see also* Marshall, *supra* note 16, at 310.

45. The acceleration of the copying process as well as the "greatly increased commercial promotion" of styles has also increased the "life of a fashion"—a style's "introduction, acceptance, and decline." STUART, *supra* note 35, at 27. The "life of fashion" typically does not last longer than three months. Rocky Schmidt, Comment, *Designer Law: Fashioning a Remedy for Design Piracy*, 30 UCLA L. REV. 861, 868 (1982).

46. *Hearing on H.R. 5055*, *supra* note 3, at 82 (testimony of Susan Scafidi). Further, design piracy and the dissemination of cheaper copies not only injures designers financially, but may also irreparably harm their reputations because knockoffs are typically made from inferior materials. Lisa J. Hedrick, Note, *Tearing Fashion Design Protection Apart at the Seams*, 65 WASH. & LEE L. REV. 215, 217 (2008).

signer's investment can be significant; the initial design process—from initial sketches to final garment production[47]—typically takes between eighteen and twenty-four months,[48] and many young designers participate in every aspect of production, including pattern making and physical construction of the garment.[49] Moreover the capital required for the production of a new garment line is sizeable; industry professionals suggest that new designers begin with $1 to $5 million, however, many designers begin with considerably less.[50] Tuleh and Gunmetal launched lines in 1998 with initial investments of $225,000 and $300,000, respectively.[51] In contrast to these originators, design pirates can manufacture copies quickly with the aid of technological advances and endure minimal financial risk because they do not partake in the design process.[52] Furthermore, they can select designs based on their initial success or reception in the fashion community and make an enormous profit.[53] For example, in 1996, American fashion designer Narciso Rodriguez created a dress for Carolyn Bessette worn during her marriage ceremony to John F. Kennedy, Jr.[54] Rodriguez estimated that pirates produced an estimated eight million copies of the dress before he was able to market his design.[55] The copies' wide distribution greatly limited Rodriquez's ability

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> The design pirate, on the other hand, manufactures copies of the original designs and avoids the creative costs the original designer incurs. The presence of pirated copies on the market not only severely depreciates the value of the original designs, but also represents wholesale appropriation of the original designer's work without any corresponding compensation.

Schmidt, *supra* note 45, at 863.

47. Marshall, *supra* note 16, at 310.

48. OCCUPATIONAL OUTLOOK HANDBOOK, *supra* note 17, at 1.

49. Marshall, *supra* note 16, at 310.

50. MARY GEHLHAR, THE FASHION DESIGNER SURVIVAL GUIDE: START AND RUN YOUR OWN FASHION BUSINESS 34 (2008).

51. *Id.*

52. *See also Hearing on Design Law—Are Special Provisions Needed to Protect Unique Industries: Hearings Before the Subcomm. on Courts, the Internet and Intellectual Property of the House Comm. on the Judiciary*, 110th Cong. 22 (2008) [hereinafter *Hearing on Design Law*] (testimony of Narciso Rodriguez, Fashion Designer, Council of Fashion Designers of America) ("With no human or capital investments to make, when pirates copy they spend nothing. They can afford to make the copy in such quantities and low price levels that on just one of my 125 styles they could recoup what I might make on my entire collection.").

53. Hagin, *supra* note 20, at 345.

54. *Hearing on Design Law*, *supra* note 52, at 22 (testimony of Narciso Rodriguez).

55. *Id.*; *see also* Emily S. Day, *Double-Edged Scissor: Legal Protection for Fashion Design*, 86 N.C. L. REV. 237, 242 (2007).

to recoup his initial investment;[56] in total, Rodriguez sold a paltry forty dresses.[57] Though Rodriguez admittedly received greater notoriety from the publicity surrounding his design, he emphatically stated, "all the publicity and the knockoffs didn't pay my bills."[58]

Design piracy's effects are not only endured by luxury designers such as Rodriguez, but also extend to designers of less expensive apparel and accessories.[59] Jennifer Baum Lagdameo—a young wife and self-employed designer who cofounded the Ananas handbag label[60]—successfully promoted a handbag design with a retail value between $200 and $400.[61] However, in 2006, a wholesale buyer cancelled his order for Lagdameo's bag and opted instead to buy a less expensive near-perfect copy made from inferior materials.[62] Though Lagdameo continues to design handbags, the loss of wholesale sales has had damaging effects on her small business; she has experienced a loss in income and is less able to develop new works.[63] Because the United States offers fashion designers virtually no protection from design piracy, as discussed below, rampant copying threatens to quash the stylistic ingenuity of American designers, including Rodriguez and Lagdameo, and destroy their competiveness in the domestic as well as international fashion industries.[64]

I. THE PROPOSED INNOVATIVE DESIGN PROTECTION AND PIRACY PREVENTION ACT: PROTECTION AMERICAN FASHIONS DESIGNERS NEED

Since 1914, Congress has considered over seventy bills aimed at extending copyright protection to fashion designs.[65] Congress consistently opposed these bills, citing two main concerns: first, this form of legislation would extend copyright protection to useful articles, and second, it could potentially increase the number of monopolies in the fashion industry.[66]

Like its most recent failed predecessor the Design Piracy Prohibition Act ("DPPA"), introduced in 2007,[67] the IDPPPA would amend Chapter

56. *Hearing on Design Law*, *supra* note 52, at 22 (testimony of Narciso Rodriguez).
57. *Id.*
58. *Id.*
59. Day, *supra* note 55.
60. *Id.*
61. *Hearing on H.R. 5055*, *supra* note 3, at 78 (testimony of Susan Scafidi).
62. *Id.*
63. *Id.*
64. Hagin, *supra* note 20, at 343.
65. Schmidt, *supra* note 45, at 864–65.
66. *Id.* at 866.
67. The Design Piracy Prohibition Act was introduced on April 25, 2007 by Representative Delahunt for himself and three co–sponsors. H.R. 2033, 110th Cong. (2007).

13 of the Copyright Act and extend copyright protection to fashion designs[68] for a short three-year term.[69] Also, like its predecessor, only non-trivial and unique designs that "are the result of a designer's own creative endeavor" would qualify for protection[70]—commonplace designs and utilitarian aspects of a work would be relegated to the public domain.[71] Though similar to its predecessor with respect to term and scope, the IDPPPA contains several significant changes that make it a more viable and effective piece of legislation. Most notably, the IDPPPA is supported not only by the Council of Fashion Designers of America, but also by the American Apparel & Footwear Association ("AAFA"), which had previously opposed the DPPA.[72] These extremely influential organizations represent the creative talent of the industry as well as over seven hundred manufactures and suppliers that effectuate approximately 75 percent of the industry's business.[73] Further, the AAFA was the primary opponent of the DPPA and ardently criticized its lack of explicit guidelines, ill-defined protection standard, and ambiguous infringement standard. This fierce lobbying effort greatly contributed to the bill's failure.[74]

In an effort to create meaningful legislation supported by the industry it aims to foster, Senator Schumer consulted both the CFDA and AAFA and drafted the IDPPPA with the aim to create unambiguous standards and significant exceptions.[75] First, the proposed Act includes a substan-

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The bill proposed to extend copyright protection to fashion designs, including, but not limited to, garments, gloves, underwear, footwear, handbags, belts, and eyeglasses. *Id.* § 2(a)(2)(B); *see also* Williams, *supra* note 3, at 311.

68. If passed the Act would provide protection for "men's, women's, or children's clothing, including undergarments, outerwear, gloves, footwear, and headgear; handbags, purses, wallets, duffel bags, suitcases, tote bags, and belts; and eyeglass frames." S. 3728, 111th Cong. § 2(a)(2)(B) (2010).

69. Susan Scafidi, *IDPPPA: Introducing the Innovative Design Protection and Piracy Prevention Act, a.k.a. Fashion Copyright*, COUNTERFEIT CHIC (Aug. 6, 2010), http://www.counterfeitchic.com/2010/08.

70. S. 3728, 111th Cong. § 2(a)(2)(B)(i) (2010).

71. Scafidi, *supra* note 69; *see also* David Jacoby & Judith S. Roth, *Finally, A Fair Shake for Fashion Design*, LAW360, at 3 (Sept. 10, 2010), *available at* http://www.schiffhardin.com/binary/jacoby-roth-law360-091010.pdf.

72. Cathy Horyn, *Schumer Bill Seeks to Protect Fashion Design*, N.Y. TIMES (Aug. 5, 2010, 10:43 PM), http://runway.blogs.nytimes.com/2010/08/05/schumer-bill-seeks-to-protect-fashion-design/.

73. *Id.*

74. Ederer & Preston, *supra* note 32. The AAFA argued that under the DPPA "the Copyright Office would never be able to handle the flood of applications" and the Act's provisions were so vague that "the courts would spend years trying to define it, rather than enforcing it." *Id.*

75. Scafidi, *supra* note 69.

tially identical standard for infringement;[76] the party claiming infringement must show that the copied fashion article is so similar to a protected design that it is likely to be mistaken for it and that the copy contains only trivial dissimilarities in construction and design.[77] This heightened infringement standard,[78] as well as special pleading standards, will require aggrieved designers to plead with particularity and will considerably decrease the amount of frivolous litigation.[79] Second, the proposed Act parallels design protection laws enacted in the EU because it does not include a registration requirement. Thus, emerging designers need not partake in the time-consuming and cost-prohibitive registration process, which includes submitting an application for registration, a deposit, and an application fee to the Copyright Office,[80] to protect their designs.[81] Rather, financially frustrated designers can pursue infringement claims against copyists who target specific designs without registering every garment design they produce.[82] Finally, the IDPPPA includes a home sewing exception, which allows individuals to copy protected designs so long as the copy is intended for personal, noncommercial use.[83] This exception would effectively negate individuals' infringement concerns when producing their own clothing.[84] Additionally, as discussed in Part V, the IDPPPA may more closely align domestic and international intellectual property law with respect to fashion design rights and ostensibly ensure that the United States is in compliance with its international agreements.[85]

However, the proposed Act is not without its shortcomings, and several critics, most notably Staci Riordan, an attorney who specializes in fashion law and former chief operating officer of apparel companies,[86]

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76. Ederer & Preston, *supra* note 32.

77. Jacoby & Roth, *supra* note 71.

78. The substantially identical infringement standard is more stringent than the substantially similar infringement standard proposed under the DPPA. *Id.*

79. Scafidi, *supra* note 69.

80. 17 U.S.C. § 408 (2006).

81. Jacoby & Roth, *supra* note 71.

82. *Id.*

83. Ederer & Preston, *supra* note 32.

84. Scafidi, *supra* note 69.

85. Commenting on the proposed Act, Professor Susan Scafidi enthusiastically stated that it "brings the U.S. in line with IP law in other fashion design-producing countries." *Id.*

86. Staci Riordan, *Breaking News: New Design Piracy Bill Introduced into Senate*, FASHION LAW BLOG (Aug. 6, 2010), http://fashionlaw.foxrothschild.com/2010/08/articles/design-piracy-prohibition-act/breaking-news-new-design-piracy-bill-introduced-into-senate/.

have argued that judges are ill-qualified to determine whether a design is "unique, distinguishable, non-trivial and non-utilitarian variation over prior designs for similar types of articles."[87] Moreover, critics contend that there is currently no adequate method of verifying whether a design is new and unique because there is no public database to conduct a search of previous designs.[88] Though these criticisms are well founded, the IDPPPA does not preclude the creation of a public database to conduct searches of previous designs and, without such legislation in place, there has never been a need for one. Further, judges have consistently determined whether an article is "new" and "original" when issuing design patents;[89] it is thus premature to declare that judges cannot create standards and rules applicable to the fashion industry.

II. THE TRIPS AGREEMENT AND THE IDPPPA: HARMONIZATION OF INTELLECTUAL PROPERTY RIGHTS[90]

The Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS")[91] is thus far "the most far-reaching and comprehensive legal regime ever concluded at the multilateral level in the area of intellectual property rights."[92] In 1994, the United States, as well as other members of the World Trade Organization,[93] signed the TRIPS Agree-

87. S. 3728, 111th Cong. § 2(a)(2)(B)(ii) (2010).

88. Riordan, *supra* note 86.

89. For instance, federal courts have determined whether design elements are inherent in prior art and thus not an appropriate subject for patent protection. Atlas Powder Co. v. Ireco, Inc., 190 F.3d 1342 (Fed. Cir. 1999) (holding the patent invalid because it would preclude the practice of a prior art).

90. Marshall, *supra* note 16, at 319.

91. The TRIPS agreement was negotiated during the Uruguay Round of talks of the General Agreement on Tariffs and Trade in 1986. DONALD G. RICHARDS, INTELLECTUAL PROPERTY RIGHTS AND GLOBAL CAPITALISM: THE POLITICAL ECONOMY OF THE TRIPS AGREEMENT 3 (2004). According to the World Trade Organization, the Uruguay Round negotiations prompted "the biggest reform of the world's trading system" since the creation of the General Agreement on Tariffs and Trade. *The Uruguay Round*, WORLD TRADE ORG. [WTO], http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact5_e.htm (last visited Apr. 23, 2012). In all, 123 countries participated in the largest trade negotiation to ever take place. *Id.*

92. Carlos M. Correa & Abdulqawi A. Yusuf, *Introduction* to INTELLECTUAL PROPERTY AND INTERNATIONAL TRADE: THE TRIPS AGREEMENT, at xvii, xvii (Carlos M. Correa & Abdulqawi A. Yusuf eds., 1998).

93. The World Trade Organizations, established in 1995, is an "international organization whose primary purpose is to open trade for the benefit of all." *About the WTO*, WTO, http://www.wto.org/english/thewto_e/whatis_e/wto_dg_stat_e.htm (last visited June 8, 2012). The WTO provides "a forum for negotiating agreements aimed at reducing obstacles to international trade," "[administers and monitors] the application of the

ment in an effort to "harmonize international intellectual property rights."[94] To accomplish this harmonization, the TRIPS Agreement prescribes a minimum level of intellectual property protection each Member State must provide and creates international rules for compliance and enforcement.[95] Each Member State must comply with the minimum requirements of protection, however, they may, at their discretion, prescribe more extensive and comprehensive protection.[96] Further, Member States may determine the appropriate methods of implementing the TRIPS Agreement within their domestic legal systems.[97]

The scope of the TRIPS Agreement is incredibly broad—it covers almost all trade-related subjects, including banking, telecommunications, and AIDS treatments.[98] Article 25(2) focuses on the protection of textile designs and accounts for their short viability, typically no longer than three months, and the vast number of new designs introduced to the market each year;[99] it states:

> Each Member shall ensure that requirements for securing protection for textile designs, in particular in regard to any cost, examination or publication, do not unreasonably impair the opportunity to seek and obtain such protection. Members shall be free to meet this obligation through industrial design law or through copyright law.[100]

This provision, and the amount of protection it affords to textile designs, has been interpreted both narrowly and broadly.[101] A narrow interpretation of this provision suggests that nominal, low-cost protection for

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WTO's agreed rules for trade in goods, trade in services, and trade-related intellectual property rights," and "[settles] disputes among . . . members regarding the interpretation and application of the agreements." *Id.* The WTO currently has 153 members, including the United States, the United Kingdom, France, Italy, and Spain. *Members and Observers*, WTO, http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (last visited Mar. 3, 2012).

94. Marshall, *supra* note 16, at 320.

95. *Id.*

96. *Overview: the TRIPS Agreement*, WTO, http://www.wto.org/english/tratop_e/trips_e/intel2_e.htm (last visited Mar. 3, 2012).

97. *Id.*

98. *The Uruguay Round*, *supra* note 91.

99. M. BHASKARA RAO & MANJULA GURU, UNDERSTANDING TRIPS: MANAGING KNOWLEDGE IN DEVELOPING COUNTRIES 139 (2003).

100. Agreement on Trade-Related Aspects of Intellectual Property Rights, Marrakesh Agreement Establishing the World Trade Organization, arts. 25, 33, Annex 1C, Apr. 15, 1994, 869 U.N.T.S. 299.

101. Marshall, *supra* note 16, at 319; *see also* Anne Theodore Briggs, *Hung Out to Dry: Clothing Design Protection Pitfalls in United States Law*, 24 HASTINGS COMM. & ENT. L.J. 169, 209 (2001–2002).

fashion designs[102] through either industrial design law or copyright law is necessary.[103] Accepting this interpretation, the United States arguably meets its obligations under the TRIPS Agreement because it extends limited design protection for textiles through design patents, copyrights, and trademarks;[104] most notably, U.S. courts have held that designers can receive protection for ornamental elements of their works through design patents[105] and for artistic features that are separable from the overall appearance of a garment through copyrights.[106] Additionally, the current American design protection regime is consistent with one of the TRIPS Agreement's main goals—the reduction of trade barriers.[107] U.S. intellectual property law affords American and foreign designers the same limited protection for their creative works irrespective of their origin.[108]

However, if Article 25(2) is interpreted broadly as mandating protection for fashion designs comparable to other forms of intellectual property, the United States is in gross breach of its duties.[109] Fashion designers rarely, if ever, find effective protection for their creative efforts under current U.S. intellectual property law—specifically, designers have sought and failed to receive meaningful protection for all aspects of their innovative works under patent, trademark, and copyright law.[110]

Patent protection for fashion designs is often impracticable and—more often than not—impossible to attain.[111] Design patents extend a fourteen-year term of protection[112] to "new, original, and ornamental design[s] for an article of manufacture."[113] To qualify for design patent protection articles of manufacture must meet rigorous standards of innovation; they must not only be new and original, but also novel and nonobvious.[114] These qualifications were best articulated by the Court of Appeals for the

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102. Briggs, *supra* note 101, at 209.

103. RAO & GURU, *supra* note 99, at 139.

104. Briggs, *supra* note 101, at 209; *see also* Marshall, *supra* note 16, at 320.

105. *See* Schmidt, *supra* note 45, at 867.

106. *See* Williams, *supra* note 3, at 307.

107. Briggs, *supra* note 101, at 209.

108. *Id.*

109. *Id.*

110. Hedrick, *supra* note 46, at 217. For a discussion of other bodies of law, including the doctrines of unfair competition and misappropriation, conversion, and trade restrictions, and their failed application to design piracy cases, see Schmidt, *supra* note 45, at 869–72. For a discussion of trade dress in relation to fashion designs see Raustiala & Sprigman, *supra* note 1, at 1702–04 and Williams, *supra* note 3, at 307–08.

111. *See* Raustiala & Sprigman, *supra* note 1, at 1704–05; Nurbhai, *supra* note 1, at 502–03; Schmidt, *supra* note 45, at 867–68; Williams, *supra* note 3, at 308–09.

112. 35 U.S.C. § 173 (2006).

113. *Id.* § 171.

114. Schmidt, *supra* note 45, at 867.

Second Circuit in *Gold Seal Importers, Inc. v. Morris White Fashions, Inc.*,[115] in which the Court stated that

> it is not enough for patentability to show that a design is novel, ornamental and pleasing in appearance . . . it must be the product of invention; that is, the conception of the design must require some exceptional talent beyond the range of the ordinary designer familiar with the prior art.[116]

Theoretically, fashion designers can apply for design patents and receive protection for their creative works, however, designers often find these requirements insurmountable obstacles.[117] Specifically, many, if not all, fashion designs are reworkings of or references to previously existing garments.[118] As such, most designs cannot meet the high standards for originality required for patent protection.[119] Furthermore, design patents fail to provide practicable protection for fashion designs because the patent application process is time consuming—the average length of time between filing an application and receiving final approval or disapproval from the United States Patent and Trademark Office ("USPTO") is approximately two years.[120] This lengthy waiting period, coupled with the expense of preparing an application, discourages many designers from seeking patent protection.[121] Moreover, designs have a relatively short life span and may become unfashionable within a single season; consequently, a fashion work may completely lose its commercial value by the time the USPTO grants a design patent.[122] Appreciating the high originality standard and the length and expense of the application process, design patents are an ineffective means of fashion design protection.

Trademarks are also ill suited to protect creative fashion works from design piracy.[123] Trademarks protect fashion designers from the unau-

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115. Gold Seal Imp. v. Morris White Fashions, 124 F.2d 141, 141 (2d Cir. 1941).

116. *Id.* at 142 (internal quotation marks omitted) (denying design patent protection for a handbag design).

117. Williams, *supra* note 3, at 308; *see also* Raustiala & Sprigman, *supra* note 1, at 1704 (noting that the average waiting period for patent application approval or disapproval is "more than eighteen months, on average").

118. Williams, *supra* note 3, at 308.

119. *Id.*

120. *Id.*

121. Schmidt, *supra* note 45, at 868.

122. Nurbhai, *supra* note 1, at 502; *see also* Raustiala & Sprigman, *supra* note 1, at 1705 (noting that patent protection is ill-suited for fashion designs given their short shelf-lifes).

123. *See* Raustiala & Sprigman, *supra* note 1, at 1700–04; Schmidt, *supra* note 45, at 868–69; Williams, *supra* note 3, at 307–08.

thorized use of their marks—"any word, term, name, symbol, or device, or any combination thereof"[124]—to distinguish apparel and prevent consumer confusion.[125] Thus, trademark protects fashion designers from counterfeiters—individuals who create original apparel and accessories, but represent these works as those of well-known designers by attaching their trademarks.[126] Design pirates, however, do not represent their apparel as that of the original designer. Instead, pirates simply copy designs and represent them as their own or promote them as manufactured by themselves but designed by a well-known designer.[127] Trademark law protects against the unauthorized use of a designer's mark,[128] not the underlying garment design.[129] Subsequently, trademark law only affords designers adequate protection against counterfeiters[130]—it does not prevent the vast majority of design pirates from deliberately and openly appropriating design elements of an original fashion work[131] and reaping the benefits of another's creative endeavors.

Finally, copyright law does not effectively protect fashion designs from piracy because it denies protection to "useful articles" defined as "having an intrinsic utilitarian function that is not merely to portray the appearance of the article."[132] Apparel serves an undeniably utilitarian purpose, that is to cover an individual's body and to protect him or her from the elements.[133] It is therefore likened to furniture and lighting fixtures under the current copyright regime and receives protection only to the extent that artistic features are separable.[134] This exiguous exception to the useful article doctrine affords minimal copyright protection for portions of fashion designs, including appliqués, embellishments, fabric patterns, and lace patterns,[135] but does not extend protection to the over-

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124. 15 U.S.C. § 1125 (2006).

125. Williams, *supra* note 3, at 307.

126. Schmidt, *supra* note 45, at 868; *see also* Williams, *supra* note 3, at 307.

127. Schmidt, *supra* note 45, at 868.

128. In some instances, most notably Burberry's trademarked plaid incorporated into the design of scarves and apparel and Louis Vuitton's "LV" mark on handbags, a fashion design "will visibly integrate a trademark to an extent that the mark becomes an element of the design . . . [f]or these goods, the logo is part of the design, and thus trademark provides significant protection against design copying." Raustiala & Sprigman, *supra* note 1, at 1701.

129. Williams, *supra* note 3, at 307.

130. Schmidt, *supra* note 45, at 869.

131. Raustiala & Sprigman, *supra* note 1, at 1701.

132. 17 U.S.C. § 101 (2006).

133. Celebration Int'l, Inc. v. Chosun Int'l, Inc., 234 F. Supp. 2d 905, 912 (S.D. Ind. 2002); *see also* Day, *supra* note 55, at 246.

134. Williams, *supra* note 3, at 309.

135. Briggs, *supra* note 101, at 191.

all design of a garment. For example, courts have extended copyright protection to costume hoods[136] and ornamented surfaces of belt buckles,[137] but not to an entire garment. Thus, copyists can create a fabric pattern or motif that is extremely similar to an original design and produce a near-perfect copy without impunity.[138]

Though the separability doctrine provides a modicum of protection for portions of designs, most artistic features are inseparable from the overall design of the garment; "the expressive elements in most garments are not 'bolted on' . . . but are instilled in the form of the garment itself—in the 'cut' of a sleeve, the shape of a pant leg, and the myriad design variations that give rise to the variety of fashions for both men and women."[139] The inseparable nature of these artistic elements from the functionality removes most fashion products from the realm of protection created by current copyright law.[140] Because American intellectual property laws only provide protection for portions of fashion designs and not the designs themselves, the United States fails to fulfill its obligations under the TRIPS Agreement and stifles the harmonization of international intellectual property rights.

III. A BROAD INTERPRETATION OF ARTICLE 25(2) OF THE TRIPS AGREEMENT: PROTECTIONIST TENDENCIES ABROAD AND BENEFITS TO THE FASHION INDUSTRY

A broad interpretation of Article 25(2) of the TRIPS Agreement that requires protection for fashion designs equivalent to other forms of intellectual property would further the harmonization of intellectual property rights by compelling the United States to more closely align its design law with that of its protectionist counterparts abroad. Specifically, a broad interpretation would reduce the differences in national criteria, imposed at the discretion of Member States, for determining design rights and ensuring that designs are afforded similar protection internationally. Subsequently, designs legally created or copied under the laws

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136. *Celebration Int'l*, 234 F. Supp. 2d at 914 (holding that the hood of a tiger costume was separable from the clothing garment because it "was in no way required by the clothing garment aspect of the costume;" specifically, the hood of the costume depicting a tiger's head "could easily be removed from the hood, and the remaining garment's utility would be unaltered").

137. Kieselstein-Cord v. Accessories by Pearl, Inc., 632 F.2d 989, 993 (2d Cir. 1980) (holding that the ornamented surfaces of belt buckles were conceptually separable because the "buckles rise to the level of creative art").

138. Briggs, *supra* note 101, at 192.

139. Raustiala & Sprigman, *supra* note 1, at 1700.

140. *Id.*

of one Member State, if exported, would be less likely to infringe the laws of another Member State.[141]

Several Member States of the TRIPS Agreements that boast strong fashion industries comparable to the United States have well-established fashion design protection laws, most notably France and the UK.[142] France, the recognized "epicenter of the fashion industry"[143] and originator of haute couture,[144] has afforded fashion designs protection since 1793.[145] Together, the amended Copyright Act of 1793 and Industrial Design Law of 1806 provide perhaps the most liberal copyright protection to fashion designs under the doctrine of the unitary art, which provides that copyright protection cannot be withheld based solely on the fact that the work serves a utilitarian function.[146] Unlike in the UK and elsewhere in the European community, French copyright law does not explicitly require a showing of originality for a design to gain protection;[147] rather, it provides protection at the moment the design draws significant attention from or becomes popular with the general public.[148]

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141. RAO & GURU, *supra* note 99, at 140.

142. Biana Borukhovich, Note, *Fashion Design: The Work of Art That is Still Unrecognized in the United States*, 9 WAKE FOREST INTELL. PROP. L.J. 155, 166 (2008); *see also* Hagin, *supra* note 20, at 370–74.

143. Hagin, *supra* note 20, at 374.

144. Day, *supra* note 55, at 266.

> In France, haute couture confers legal permission to use the label only on those designers designated as such by the Chambre de commerce et d'industrie de Paris . . . recently the term has been loosely used to also include specific fashion that are custom created for an individual customer with high quality fabrics, using extensive hand construction and a seemingly excessive cost.

Id. at 266 n.179.

145. Borukhovich, *supra* note 142, at 167. The original Copyright Act of 1793 provided protection for fashion designs as an applied art. The French government has since extended additional protection, namely protection of nonfunctional designs and patterns, through this Act as amended in 1902 and the 1806 Industrial Design Law amended in 1909. Hagin, *supra* note 20, at 374; Anya Jenkins Ferris, Note, *Real Art Calls for Real Legislation: An Argument Against Adoption of the Design Piracy Prohibition Act*, 26 CARDOZO ARTS & ENT. L.J. 559, 573–74 (2008).

146. Borukhovich, *supra* note 142, at 167–68; *see also* Day, *supra* note 55, at 266.

147. Ferris, *supra* note 145, at 573; *see also* Day, *supra* note 55, at 266. Leslie J. Hagin stated that "originality is at least implicitly required under the French system." Hagin, *supra* note 20, at 374. Accordingly, "French courts determine originality on an ad hoc basis, looking to any works which may have inspired the design at issue." *Id.*

148. Day, *supra* note 55, at 266.

Further, French copyright-holders gain patrimonial[149] and moral[150] rights the moment they create a new article.[151] These unique features of French copyright law create unparalleled intellectual property protection for fashion designs[152] that lasts for an unspecified period of time—the duration of protection is determined on a case-by-case basis and typically lasts between eighteen months and two years.[153] Because of these well-established laws, French designers have been able to protect and develop their creative works throughout their careers; they have been able to use their protected designs as a form of branding for their fashion houses and have gained widespread recognition and acclaim.[154] This in turn has fostered the continued development and growth of the already mature French fashion industry.[155] Further, the French government imposes severe criminal penalties—fines in excess of €300,000 and imprisonment—for infringement of protected designs.[156] These penalties serve to deter the production of pirated fashion articles.

The UK, another country internationally recognized for its prosperous fashion industry, also provides protection for fashion designs albeit less extensive than that offered by France.[157] In the UK, fashion design protection is provided for by the 1988 Copyright, Designs and Patents Act of 1988 and the 2002 Community Design Regulation.[158] Specifically, these acts provide unregistered design rights,[159] registered design rights,[160] and copyright in artistic works.[161] This regime extends stronger

149. Patrimonial rights consist of "the exclusive rights to represent, reproduce, sell or otherwise exploit the copyrighted work of art and to derive a financial compensation therefrom." Marshall, *supra* note 16, at 319.

150. A moral right "is essentially the right for the author to see both his name and his work of art respected;" this nonexpiring right is "granted exclusively to an author or artist and, at his death, to his heirs" and may not be transferred or sold. Marshall, *supra* note 16, at 319; Borukhovich, *supra* note 142, at 168.

151. Marshall, *supra* note 16, at 319; Ferris, *supra* note 145, at 574.

152. Day, *supra* note 55, at 266.

153. Ferris, *supra* note 145, at 574.

154. *Hearing on H.R. 5055*, *supra* note 3, at 83–84 (testimony of Susan Scafidi).

155. *Id.*

156. Marshall, *supra* note 16, at 319.

157. *See* Day, *supra* note 55, at 267; Hagin, *supra* note 20, at 370–73; Marshall, *supra* note 16, at 318; Borukhovich, *supra* note 142, at 168–69; Ferris, *supra* note 145, at 571–73.

158. Marshall, *supra* note 16, at 318.

159. An unregistered design right protects "any aspect of the shape or configuration of an article" of an original design, but "does not extend [to protect] surface decoration." Ferris, *supra* note 145, at 572.

160. A registered design right protects new designs that exhibit an individual character. *Id.*

legislative protection for registered designs than it does for unregistered designs and stipulates that a garment must relate back to a copyrighted drawing to receive copyright protection.[162] Registered designs can potentially receive protection for up to twenty-five years, whereas unregistered designs receive protection for a maximum of fifteen years.[163] Though less protective than their French counterparts, the design laws in the UK have encouraged the development of the domestic fashion industry by allowing designers to protect their signature garments and establish their careers.

In addition to the fashion design protection afforded by national laws in the UK and France, the 1998 European Directive on the Legal Protection of Designs ("Directive") obliges members of the EU to harmonize their domestic laws concerning industrial designs, including apparel designs, and to enact design protection laws.[164] The Directive prescribes minimal requirements for design protection and extends protection to "lines, contours, colours, shape, texture and/or materials"[165] of designs that are registered, display elements of novelty, and possess an individual character.[166] An ascertained design right grants the original designer the exclusive right to use his or her design and to prevent others from using it without consent.[167] Thus, the Directive prohibits the deliberate copying of another's designs and the creation of designs that are sufficiently similar to garments already in existence;[168] it extends protection for five-year periods, up to twenty-five years.[169] The Directive, in conjunction with national laws which may go beyond the minimal requirements set out in the Directive, prescribes effective mechanisms to reduce the market in

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161. *See* Day, *supra* note 55, at 267; Marshall, *supra* note 16, at 318.

162. Day, *supra* note 55, at 267.

163. An unregistered design right expires

> (a) fifteen years from the end of the calendar year in which the design was first recorded in a design document or an article was first made to the design, whichever first occurred, or
>
> (b) if articles made to the design are made available for sale or hire within five years from the end of that calendar year, ten years from the end of the calendar year in which that first occurred.

Copyright, Designs, and Patents Act, 1988, c. 48, § 216(1) (Eng.).

164. Raustiala & Sprigman, *supra* note 1, at 1735; *see also* Day, *supra* note 55, at 266–68.

165. Council Directive 98/71, 1998 O.J. (L 289) 28 (EC).

166. Day, *supra* note 55, at 267.

167. Council Directive 98/71, *supra* note 165.

168. Day, *supra* note 55, at 267.

169. Council Directive 98/71, *supra* note 165.

pirated fashion articles in the European community and affords appropriate redress for designers whose creative works have been exploited by copyists. Moreover, these laws further the development of an already established and influential fashion industry by protecting creativity and innovation and by ensuring that designers reap the benefits of their labor.[170]

Like France, the UK, and members of the EU,[171] other countries that are not recognized for their thriving fashion industries, such as India,[172] provide intellectual property protection for fashion designs.[173] Nevertheless, the protection afforded to fashion designs by these countries is irrelevant once designers export their garments to the United States.[174] Indeed, the United States is one of the few countries with a significant intellectual property system that does not extend protection to fashion designs.[175] The United States' unwillingness to extend protection, specifically to functional articles, may be attributed to its view that fashion is not art.[176] Historically, in the United States and abroad, garment designers were considered artistically inferior to painters, sculptors, and architects because of the intimate relationship between the garments and their wearers.[177] The inferior status of fashion designers in Europe steadily improved, however, with the rise of couture fashion houses in France and

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170. *Hearing on H.R. 5055*, *supra* note 3, at 84 (testimony of Susan Scafidi).

171. Italy and Spain also boast well-established protection for fashion designs. For greater discussion of the national laws of Italy and Spain, see Day, *supra* note 55, at 267 and Marshall, *supra* note 16, at 317–18, respectively.

172. India's 2000 Design Act provides property rights in fashion designs and protection against infringement. Under Chapter 1 Section 2(d) (5) of the Act "design" means

> only the features of shape, configuration, pattern, ornament or composition of lines or colours applied to any article . . . by any industrial process or means, whether manual, mechanical or chemical, separate or combined, which in the finished article appeal to and are judged solely by the eye; but does not include any mode or principle of construction or anything which is in substance a mere mechanical device.

The Designs Act, No. 16 of 2000, INDIA CODE (2000), *available at* http://india.gov.in/outerwin.php?id=http://indiacode.nic.in/rspaging.asp?tfnm=200016. "Where a Design or pattern covers the whole body of goods or is part and parcel of the goods themselves, it falls within the aforementioned definition." RAO & GURU, *supra* note 99, at 141–42.

173. Borukhovich, *supra* note 142, at 167.

174. *Id.* at 170.

175. *Id.*

176. Briggs, *supra* note 101, at 187–90.

177. *Id.* at 187.

the dominance of the Arts and Crafts movement[178] in the UK during the latter half of the nineteenth century. In response to these artistic trends and the public's perception, France and the UK altered their intellectual property laws to include artistic functional articles.[179] In contrast, the United States' view that fashion is purely functional has not evolved significantly and the law's lack of protection for useful articles reflects as much.[180]

The United States' unwillingness to extend protection, and its view that fashion is purely functional, negatively affects domestic and international fashion designers because their garments, when marketed in or exported to the United States, become easy prey for pernicious design pirates who face minimal repercussions. Further, designers are susceptible to piracy even if they do not explicitly market or export their garments; so long as an image of their work is available on the internet, American design pirates can easily produce substantially similar, if not identical, copies. Because the United States refuses to extend design protection, it not only discourages, but also impedes the purported goal of the TRIPS Agreement—to further the harmonization of international intellectual property rights.[181] The United States current intellectual property law does not secure adequate protection for the overall design of a fashion article as stipulated in Article 25(2) of the TRIPS Agreement; rather, it secures protection only for particular elements that are separable, including appliqués and embellishments.[182] Ultimately, the United States' reluctance to extend meaningful intellectual property protection to overall fashion designs, not only limited separable elements, unnecessarily impairs designers' opportunities to seek and obtain protection for their creative works. The current legal scheme forces international designers to either export their garments to the United States with knowledge that pirates may reproduce their successful designs without legal restraint or refrain from exporting and marketing their goods, thereby, losing attendant profits. Furthermore, U.S. law allows copyists to promote the sale of pirated designs; it allows copyists to reference the

178. The Arts and Crafts movement "developed during the last decades of the 19th century, [and] was shaped by the ideas of art critic and writer John Ruskin and William Morris." FRED S. KLEINER & CHRISTIAN J. MAMIYA, GARDNER'S ART THROUGH THE AGES: THE WESTERN PERSPECTIVE 725 (12th ed. 2006). "Members of the Arts and Crafts movement dedicated themselves to producing functional objects with high aesthetic value for a wide public." *Id.*

179. Briggs, *supra* note 101, at 187–88.

180. *Id.*

181. *See* Borukhovich, *supra* note 142, at 170–71.

182. Briggs, *supra* note 101, at 191.

original designer's name in marketing materials and advertisements.[183] This dilemma, more than stifling designers worldwide and promoting a market in pirated goods, demonstrates that the United States is in gross breach of its duties under the TRIPS Agreement regardless of its broad or narrow interpretation.

If the United States does not extend protection to fashion designs and continues to provide a safe haven for copyists,[184] it may be subject to trade sanctions under the TRIPS Agreement. Member States may bring dispute settlement actions before the World Trade Organization's Dispute Settlement Body[185] if they believe another Member State is not performing its obligations satisfactorily.[186] The Dispute Settlement Body assembles an *ad hoc* panel that hears the complaint and adjudicates the matter; either party may appeal a decision to the standing Appellate Body.[187] Once the adjudication is final, the losing Member State must comply with the decision by revising its laws in accordance with the TRIPS Agreement.[188] If a Member States does not comply, the Dispute Settlement Board may authorize retaliation and trade sanctions.[189] Though no Member State has brought an action against the United States thus far, if the United States continues to deny meaningful intellectual property protection to fashion designs it may be susceptible to this form

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183. Nurbhai, *supra* note 1, at 515.

184. *Hearing on H.R. 5055*, *supra* note 3, at 77 (testimony of Susan Scafidi).

185. The Dispute Settlement Body "is composed of representatives of all WTO Members" and is responsible "for overseeing the entire dispute settlement process;" it has the authority "to establish panes, adopt panel and Appellate body reports, maintain surveillance of implementation of rules and recommendations and authorize the suspension of obligations under the covered agreements." *WTO Bodies Involved in the Dispute Settlement Process*, WTO, http://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c3s1p1_e.htm (last visited Mar. 3, 2012).

186. *Settling Disputes*, WTO, http://www.wto.int/english/thewto_e/whatis_e/tif_e/disp1_e.htm (last visited Mar. 3, 2012).

187. The Appellate Body, established in 1995, "is a standing body of seven persons that hears appeals from reports issued by panels in disputes brought by the WTO Members," it "can uphold, modify or reverse the legal findings and conclusions of a panel, and Appellate Body Reports, once adopted by the Dispute Settlement Body (DSB), must be accepted by the parties to the dispute." *Appellate Body*, WTO, http://www.wto.org/english/tratop_e/dispu_e/appellate_body_e.htm (last visited Mar. 3, 2012). Members of the Appellate Body must have a "recognized standing in the field of law and international trade" and cannot be "affiliated with any government." *Settling Disputes*, *supra* note 186.

188. *Settling Disputes*, *supra* note 186.

189. *Id.*

of legal action, especially considering the advances in design copying technology.

CONCLUSION

The proposed IDPPPA would effectively extend American copyright protection to fashion designs and further the interests of both consumers and designers; it would not only allow fashion designers to compete more effectively in the international market, but would also better serve the purpose of copyright law—to secure "[t]he general benefits derived by the public from the labors of authors."[190] Indeed, the extension of American copyright protection would stimulate American innovation and simultaneously nullify designers' legitimate fear that pirates will replicate their successful designs without consequence.[191] Moreover, it would ensure that domestic and international designers are adequately recognized for their artistic endeavors and receive the rewards of their labors from the thriving fashion market in the United States. Though critics of fashion design protection, most notably Professors Kal Raustiala and Christopher Sprigman, argue that design piracy has contributed to the growth and creativity of the fashion industry and made fashion more affordable for the masses, American and international designers deserve, and have fought for, the same amount of protection afforded to artists in similar industries.[192] Furthermore, the extension of copyright protection through the IDPPPA would ensure that the United States does not breach its duties under the TRIPS Agreement, whether interpreted narrowly or broadly; it would create protection for fashion designs similar to other forms of intellectual property.

Katelyn Brandes[*]

190. Fox Film Corp. v. Doyal, 286 U.S. 123, 127, 52 S. Ct. 546, 546 (1932).

191. *See generally Hearing on H.R. 5055*, *supra* note 3 (testimony of Susan Scafidi).

192. *See* Kal Raustiala & Christopher Sprigman, *Why Imitation is the Sincerest Form of Fashion*, N.Y. TIMES, Aug. 13, 2010, at A23; Raustiala & Sprigman, *supra* note 1, at 1687–1777.

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AN ADAPTIVE APPROACH FOR AN EVOLVING CRIME: THE CASE FOR AN INTERNATIONAL CYBER COURT AND PENAL CODE

INTRODUCTION

Technological innovation over the last half-century has bestowed revolutionary advantages upon humanity. Yet for all its brilliant progress, technology's constant state of development has also cultivated an evolving criminal field capable of inflicting unprecedented damage: cybercrime. To date, legislative efforts to fight the numerous forms of cybercrime, from localized mischief-making to highly destructive acts of cyberterrorism, have been largely inefficient and regularly outpaced by dynamic criminal tactics[1] and the mutations of cyberspace itself. As long as the global community continues to take insufficient action to address the threats posed by cybercriminals, the risk of a catastrophic cyberattack—with the potential to eradicate vast quantities of private records, dismantle corporate activities, and suspend entire governments—will persistently increase.[2]

Cybercriminals have been regarded as a serious threat to governments and state security since the dawn of the digital age, costing the global community billions of dollars each year.[3] Today, cybercriminals are playing a more prominent role in geopolitical affairs than ever before as they increasingly direct their focus to nontraditional targets in new and novel ways. In late August 2011, for example, a group of hackers successfully impersonated Google, the popular search engine and e-mail provider, and used their disguise to snoop on Internet users.[4] In an unrelated case from the latter half of 2011, a ruthless Mexican crime syndicate, Los Zetas, found itself in the crosshairs of Anonymous, a well-

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1. *See, e.g.*, Christopher E. Lentz, Comment, *A State's Duty to Prevent and Respond to Cyberterrorist Acts*, 10 CHI. J. INT'L L. 799, 799–801 (2010); Kelly A. Gable, *Cyber-Apocalypse Now: Securing The Internet Against Cyberterrorism and Using Universal Jurisdiction as a Deterrent*, 43 VAND. J. TRANSNAT'L L. 57, 60–66 (2010).

2. *See, e.g.*, Charlotte Decker, Note, *Cyber Crime 2.0: An Argument to Update the United States Criminal Code to Reflect the Changing Nature of Cyber Crime*, 81 S. CAL. L. REV. 959, 960–61 (2008).

3. *Id.* at 961–62; *see generally* Gable, *supra* note 1, at 59–66.

4. The targeted e-mail accounts belonged to people living in Iran. Neither the purpose of the attack, nor its focus on Iranian e-mail accounts, is clear. Somini Sengupta, *In Latest Breach, Hackers Impersonate Google to Snoop on Users in Iran*, N.Y. TIMES, Aug. 31, 2011, at B4.

known collective of hackers from across the globe.[5] After Los Zetas apparently kidnapped one of their hackers, Anonymous—which had illegally accessed confidential NATO documents only months before[6]—released a video on YouTube, the popular video sharing website, in which a masked figure criticized Los Zetas for its criminal behavior and pledged to release the identities of one hundred of Los Zetas' major contacts.[7] The Anonymous member was released within days.[8]

In addition to individuals and collectives perpetrating such novel cyberattacks, sovereign governments are engaging in potentially illegal online behavior with greater regularity. In November 2011, the United States accused China and Russia of using proxy computers and dispersed Internet routers in other countries to spy on Americans over the Internet.[9] The United States itself has admitted to considering the use of cyberattacks during its involvement in 2011's Libyan revolution[10] and may have utilized a computer worm to target uranium-enriching centrifuges in Iranian nuclear facilities.[11] Cybercriminals acting as government agents in such scenarios may be able to cause more widespread damage, and present even more challenging legal and logistical hurdles for law enforcement officials, than isolated actors.

As hackers' capabilities and resources continue to grow, and as more government operations increasingly occur online,[12] the scope of a single

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5. Damien Cave, *After a Kidnapping, Hackers Take On a Ruthless Mexican Crime Syndicate*, N.Y. TIMES, Nov. 1, 2011, at A6.

6. *Hackers Gain Access to NATO Data*, N.Y. TIMES, July 22, 2011, at A7.

7. Cave, *supra* note 5, at A6.

8. Paul Wagenseil, *Anonymous wins victory in drug cartel fight*, MSNBC.COM (Nov. 4, 2011, 5:28 PM), http://www.msnbc.msn.com/id/45169382/ns/technology_and_science-security/t/anonymous-wins-victory-drug-cartel-fight/#.T2eVnXjs620.

9. Thom Shanker, *In Blunt Report to Congress*, *U.S. Accuses China and Russia of Internet Spying*, N.Y. TIMES, Nov. 4, 2011, at A4; *see also* Richard A. Clarke, Op-Ed., *How China Steals Our Secrets*, N.Y. TIMES, Apr. 3, 2012, at A27 (providing an overview of Congressional efforts to address cybercrime and noting that "Robet S. Mueller III, the director of the F.B.I., said cyberattacks would soon replace terrorism as the agency's No. 1 concern as foreign hackers, particularly from China, pentrate American firms' computers and steal huge amounts of valuable data and intellectual property").

10. Eric Schmitt & Thom Shanker, *U.S. Debated Cyberwarfare in Attack Plan on Libya*, N.Y. TIMES, Oct. 17, 2011, at A1.

11. Michael Totty, *The First Virus . . .*, WALL ST. J., Sept. 26, 2011, at R2; Tom Gjelten, *Security Expert: U.S. 'Leading Force' Behind Stuxnet*, NPR (Sept. 26, 2011), http://www.npr.org/2011/09/26/140789306/security-expert-u-s-leading-force-behind-stuxnet.

12. *See, e.g.*, Vivek Kundra, Op-Ed., *Tight Budget? Look to the 'Cloud'*, N.Y. TIMES, Aug. 31, 2011, at A27.

cyberattack's damage becomes increasingly daunting. Though the United States to date has managed to weather most of the cybercrimes perpetrated against it with relatively modest damage, other less fortunate nations provide ominous examples of what could be in store for the global community. In 2007, for one example, Estonia was effectively shut down for three weeks by a series of relatively simple cyberattacks that targeted government, media, and business websites.[13] Estonia made itself particularly vulnerable by being at the vanguard of adopting online processes—the government opted to conduct most of its operations over the Internet while individual Estonians conducted much of their personal affairs, including more than ninety-eight percent of their private banking, online.[14] Despite Estonia's stark example of the risks associated with taking state business online, the number of nations adopting Internet-based operations continues to grow.[15]

Owing perhaps to the ever-expanding list of potential targets, the frequency of cybercrimes is increasing. The U.S. Department of Homeland Security announced that there were eighty-six reported attacks on critical infrastructure computer systems in the United States between October 2011 and February 2012, an increase of seventy-five attacks from the same time-span the previous year.[16] These attacks were just a small part of the more than 50,000 cyberattacks reported to the agency since October 2011.[17]

Due to the uniquely global dimensions of cybercrime and the world's growing reliance on technology, the international community needs to adopt an international penal code for cybercrime and vest jurisdiction over this unique body of law in an international criminal court or tribunal. Such a code is necessary to provide a uniform set of definitions, norms, and standards, and to effectively regulate a crime—evolving faster than many legislatures can operate—that knows no territorial boundaries.

This Note seeks to examine the justification for this new approach and to evaluate the inherent difficulties in regulating cybercrime through traditional criminal systems.[18] Part I, in sections A and B, considers the de-

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13. Lentz, *supra* note 1, at 799–800; Gable, *supra* note 1, at 61.

14. Gable, *supra* note 1, at 61.

15. *See, e.g.*, Kundra, *supra* note 12, at A27.

16. Michael S. Schmidt, *New Interest in Hacking as Threat to Security*, N.Y. TIMES, Mar. 13, 2012, at A16.

17. *Id.* The article also notes that a total of 10,000 attacks were reported the previous year. *Id.*

18. This Note will not discuss the important role that self-governance plays in Internet-based activities as it is focusing primarily on criminal activity intended to cause harm.

velopment of cybercrime and the current methods of combating it. Part I.C considers the historical use of universal jurisdiction and its applicability to cybercrime. Part I.D presents a brief survey of the strengths, weaknesses, and purposes of the International Criminal Court ("ICC"), which provides the most promising model for an international cybercrime court. Part II evaluates three proposals for tackling cybercrime at an international level: extending universal jurisdiction to encompass cyberspace, using traditional treaty law to bind states to domestic incorporation of international cybercrime codes, and finally, the preferred approach of adopting an international penal code under the jurisdiction of an international court or tribunal.

I: THE EVOLVING LANDSCAPE OF CYBERCRIME

Over the past fifty years, technological advancements have radically changed both personal and professional business activities.[19] Since its invention in the late 1940s, the computer has come to play such a dominant role in human culture that it may now be hard to imagine a world without its existence.[20] Springboarding off of the computer came the invention of the Internet and other networks that linked computers and computer systems together from around the globe.[21] Though capabilities to create worldwide computer networks like the Internet had been available since the 1960s, it was not until the end of the Cold War, when the United States government became less concerned about potential security vulnerabilities, that the Internet became widely available for public use.[22] Over the last fifteen to twenty years, the use and accessibility of the Internet have proliferated and web access has become a common feature of mainframe computers,[23] tablet computers, cell phones, and other portable

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For a thorough discussion of property rights, self-regulation in cyberspace, and additional important issues relating to cyberlaw, see generally Nicolas Suzor, *The Role of the Rule of Law in Virtual Communities*, 25 BERKELEY TECH. L.J. 1817 (2010). *See also generally* Paul Schiff Berman, *Cyberspace and the State Action Debate: The Cultural Value of Applying Constitutional Norms to "Private" Regulation*, 71 U. COLO. L. REV. 1263 (2000); Henry H. Perritt, Jr., *Towards A Hybrid Regulatory Scheme for the Internet*, 2001 U. CHI. LEGAL F. 215.

19. *See, e.g.*, Decker, *supra* note 2, at 961.

20. Gable, *supra* note 1, at 67. Gable's article provides a helpful overview of the technological developments of both the computer and the Internet. *See generally id.*

21. *Id.* at 68.

22. *Id.* at 68–69.

23. One of the major factors in the proliferation of the Internet has been declining costs of both personal computers and connectivity. Decker, *supra* note 2, at 960. The increase in availability, coupled with the unparalleled rapidity of technological advance-

electronics like music players.[24] Today, mobile devices provide regular Internet access to as many users as stationary computers.[25]

Recently, a practice known as "cloud computing" has developed in which information is stored and accessed entirely through the Internet and other computer networks.[26] Businesses have shifted toward increasing reliance on cloud computing for the efficiency it can add in storing records, interfacing with customers, and cutting information technology infrastructure costs by eschewing the need to purchase and maintain requisite hardware.[27] Many individuals use cloud computing every day simply by accessing their e-mail or social networking websites; Google's popular e-mail system, "Gmail," and Facebook, the popular social networking site, are two primary examples of cloud computing products targeted toward the masses.[28] As with businesses, individuals often use cloud e-mail accounts because access is available on any computer and there is essentially no technological upkeep necessary—an individual does not have to download new software packages or upgrade computer hardware to keep e-mails up to date.[29] The allure of cloud computing has led to a rapidly expanding use of the practice across many sectors, including government.[30]

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ment, has led to Internet access for an estimated seventy-five percent of Americans. *Id.* at 961.

24. Gable, *supra* note 1, at 68–69.

25. David J. Goldstone & Daniel B. Reagan, *Social Networking, Mobile Devices, and the Cloud: The Newest Frontiers of Privacy Law*, 55-SUM B. B.J. 17, 21 (2011).

26. *Id.* at 21. The exact definition of cloud computing is imprecise, though one clear component is that a user does not own any of the technology involved in operation. The National Institute of Standards & Technology defines it as a

> "model for enabling convenient, on-demand network access to a shared pool of configurable computing resources . . . that can be rapidly provisioned and released with minimal management effort or service provider interaction." Essentially, users store or share their information on the Internet and third-party providers maintain that information on remote servers owned or operated by the provider.

Ilana R. Kattan, Note, *Cloudy Privacy Protections: Why the Stored Communications Act Fails to Protect the Privacy of Communications Stored in the Cloud*, 13 VAND. J. ENT. & TECH. L. 617, 620–21 (2011) (internal citation omitted).

27. *Id.* at 622.

28. *Id.* at 618; *see also* Goldstone & Reagan, *supra* note 25, at 17.

29. Goldstone & Reagan, *supra* note 25, at 17.

30. *Id.* at 18. In a *New York Times* op-ed, Vivek Kundra, the Chief Information Officer for President Obama's administration from 2009–2011, promoted the administration's push into cloud technology. He writes that, "shortly after the Obama administration took office, we instituted a 'Cloud First' policy, which advocates the adoption of cloud serv-

These advancements have ushered in an era of unprecedented efficiency and speed in both personal and business-related Internet activity, but they have also created a user dependency on service providers to maintain and protect personal data.[31] As more personal information is conveyed over the Internet and stored in the cloud, everything from information on bank accounts to federal infrastructure, from personal e-mail to private photos, is increasingly vulnerable to cyberattack.[32] As a result, nearly every person could be victim to a cyberattack, whether they are individual Internet surfers, non-computer-using customers of Internet-using companies, or even citizens of cloud-embracing national governments.[33] Accordingly, governments strive to keep pace with technological advancements and to protect individuals, businesses, and themselves from cybercrime. However, these efforts have not always been sufficient to stem the tide of cybercrime proliferation.[34]

A. Definition of Cybercrime

One of the primary obstacles in combating cybercrime is defining it. No internationally recognized legal definition exists, though there are functional definitions that focus on general offense categories.[35] Cybercrime is, therefore, most accurately defined as crimes that are perpetrated over the Internet and that generally fall into two categories: first, those that target computers and information stored on computers, and second, those that use a computer to facilitate another crime.[36]

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ices by government agencies and mandates the transition of at least three projects for every agency to the cloud by next summer [2012]." Kundra, *supra* note 12, at A27.

31. Kattan, *supra* note 26, at 623.

32. *See, e.g.*, Gable, *supra* note 1, at 68.

33. *Id.* at 59–63.

34. *See id.* at 74–77. *See generally* Haley Plourde-Cole, Note, *Back to* Katz*: Reasonable Expectations of Privacy in the Facebook Age*, 38 FORDHAM URB. L.J. 571 (2010); Miriam F. Miquelon-Weismann, *The Convention on Cybercrime: A Harmonized Implementation of International Penal Law: What Prospects for Procedural Due Process?*, 23 J. MARSHALL J. COMPUTER & INFO. L. 329 (2005).

35. Miquelon-Weismann, *supra* note 34, at 330–31 (drawing the functional defintions from a 1990 document produced by the UN Centre for International Crime Prevention, now integrated into the UN Office on Drugs and Crime); Eighth United Nations Congress on the Prevention of Crime and the Treatment of Offenders, Havana, Cuba, Aug. 27–Sept. 7, 1990, *International Review of Criminal Policy—United Nations Manual on the Prevention and Control of Computer Related Crime* ¶¶ 20–26, *available at* http://www.uncjin.org/8th.pdf.

36. Decker, *supra* note 2, at 964; Neal Kumar Katyal, *Criminal Law in Cyberspace*, 149 U. PA. L. REV. 1003, 1017 (2001).

When a cybercriminal targets a computer, (or, increasingly, someone's mobile device[37]) the computer may be victimized in ways analogous to many other traditional crimes,[38] not unlike a person who is assaulted while walking down a street or a house that is vandalized. Alternatively, the computer may be subjected to crimes that are unique to computers of the Internet era.[39] There are many crimes that fall into the latter category, though the average computer user may not be aware of the distinctions among all of them.

Most of these crimes utilize specific programs to damage software.[40] Viruses, perhaps the most well-known examples of malicious software (sometimes called "malware"[41]), are programs that modify other computer programs and can spread from one computer to another whenever a file is transmitted between them, be it via the Internet, traditional disk, or other means.[42] While viruses generally require human direction before travelling from one host computer to another, some can self-replicate and transfer themselves.[43] These self-replicating programs are called "worms."[44]

Today, viruses and worms often infect a computer through the user's e-mail. Unsolicited bulk e-mails from commercial parties, usually with no preexisting relationship to the recipient, are known as "spam" and are often the vehicle cybercriminals use to distribute their malicious soft-

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37. See, for example, Nick Bilton, *Android Is No. 1 Target of Mobile Hackers*, N.Y.TIMES (Aug. 25, 2011, 9:39 AM), http://bits.blogs.nytimes.com/2011/08/25/android-number-one-target-by-mobile-hackers-report-says/?ref=anonymousinternetgroup, discussing hackers' preference for targeting phones that use Google's Android platform because of Google's lax screening procedures for new mobile applications.

38. Eric J. Sinrod & William P. Reilly, *Cyber-Crimes: A Practical Approach to the Application of Federal Computer Crime Laws*, 16 SANTA CLARA COMPUTER & HIGH TECH. L.J. 177, 187–88 (2000).

39. Dominic Carucci, David Overhuls & Nicholas Soares, *Computer Crimes*, 48 AM. CRIM. L. REV. 375, 378 (2011). The article further differentiates between a computer being the object of a crime and the subject of a crime. Generally, a computer is an object of a crime when its hardware or its software is stolen. A computer is generally the subject of a crime in when it is targeted in other ways, including those listed above the line here. *Id.*

40. *See id.*

41. *Id.* at 379.

42. *Id.* Carucci, Overhuls, and Soares provide an extensive description of the varying kinds of malicious software that is highly informative and provides the foundation for much of the information located herein.

43. Sinrod & Reilly, *supra* note 38, at 221.

44. Carucci, Overhuls & Soares, *supra* note 39, at 379–80; Katyal, *supra* note 36, at 1024–25.

ware.[45] This can be similar to a "Trojan horse," a program that has a legitimate function but also contains hidden malicious coding.[46] Where spam is a specific e-mail crime, though, a Trojan horse can come from any type of file or program, such as word processors or music files.[47] Some malicious software programs, known as "logic bombs," may be designed to activate malicious programs upon the occurrence of a specific event or on a specific date, while remaining dormant in the meantime.[48]

Entire computer networks can be specifically targeted by additional kinds of malicious programs. "Sniffers" are programs that monitor and analyze network data and can be used to acquire confidential information including passwords, credit card numbers, and more.[49] "Web Bots" or "spiders" are similar, although they go the extra step of creating searchable indexes of the data passing through the network, often overwhelming that targeted network with requests for information.[50] Whether through the use of spiders or merely as a mischievous end in itself, many cybercriminals target websites or networks with "denial of service attacks," which debilitate sites by sending overwhelming numbers of simple requests for connectivity.[51]

It is important to note that each of the malicious software programs listed above has the potential to be used constructively.[52] For example, a virus could be designed to repair glitchy software while a sniffer could be used as a network security program.[53] However, cybercriminals are particularly adept at utilizing these programs to wreak havoc.[54] One important factor in the success of these cybercrimes is the cybercriminal's ability to use someone else's computer as an agent from which the cy-

45. Carucci, Overhuls & Soares, *supra* note 39, at 379.
46. Katyal, *supra* note 36, at 1026.
47. Carucci, Overhuls & Soares, *supra* note 39, at 380.
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.* at 380–81; Katyal, *supra* note 36, at 1026–27.
52. *See, e.g.*, Geoffrey A. North, *Carnivore in Cyberspace: Extending the Electronic Communications Privacy Act's Framework to Carnivore Surveillance*, 28 RUTGERS COMPUTER & TECH. L.J. 155, 162–63 (2002) (describing the FBI's use of a sniffer program called Carnivore to monitor a suspect's e-mail and Internet activity). Use of these devices by law enforcement has led to numerous debates regarding legal limits on Internet users' reasonable expectations of privacy, both in the U.S. and internationally. *See* Plourde-Cole, *supra* note 34; Kattan, *supra* note 26, *passim*.
53. *See, e.g.*, Carucci, Overhuls & Soares, *supra* note 39, at 380.
54. *See, e.g.*, Lentz, supra note 1, at 800.

bercriminal may then perpetrate more crimes with greater anonymity.[55] For example, one hacker could use a sniffer to track the e-mail addresses of thousands of employees in a particular company and then send each employee spam containing a self-replicating worm program designed to corrupt the user's computer in a number of different ways. Alternatively, a hacker could track each of the employees' e-mail account passwords, transcribing them into a spider-created database. Using these passwords, the hacker would then be able to deliver a denial of service attack to the company's network by overloading the system with requests to log into each e-mail account simultaneously. Such tactics can make policing the Internet and other networks exceptionally challenging.[56]

The second major category of cybercrime uses a computer to facilitate a separate, more traditional crime.[57] Cybercriminals often utilize one or more of the corrupting programs discussed above to glean information from potential victims or to disable security programs in furtherance of committing underlying, non-computer-related crimes.[58] Generally, there are four types of underlying crimes: identity theft or extortion, theft of intellectual property, fraud, and the possession or distribution of child pornography.[59] While these four crimes typically have straightforward statutory definitions, there are a number of areas, particularly those focusing on national security, where it remains unclear whether the use of a computer has led to, or alone constituted, a crime.[60] The confusion stems in equal part from the frequently evolving technological landscape and from the lack of uniformity in cybercrime statutes between international bodies.[61]

B. Legislation and Enforcement

Cybercrime poses unique challenges to law enforcement officials due to three major factors: first, the lack of territorial jurisdictional bounda-

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55. Carucci, Overhuls & Soares, *supra* note 39, at 381.

56. *Id*. at 377. Katyal relates a specific denial of service attack, perpetrated by a fifteen-year-old Canadian citizen in 2000, which underscores the daunting and complex nature of these crimes. The hacker shut down some of the most popular websites, including Amazon.com, CNN.com, Yahoo!, and others, by utilizing remote computers to orchestrate the attack, as well as three "dummy" websites, making it very difficult for law enforcement to trace the attack. The FBI only learned of the hacker's identity after he began bragging about the success of his cybercrime in Internet chartrooms. Katyal, *supra* note 36, at 1027. For further discussion, see *infra* Part I.B of this Note.

57. Carucci, Overhuls & Soares, *supra* note 39, at 378.

58. *Id.*

59. *Id.* at 381; Decker, *supra* note 2, at 967–96.

60. *See, e.g.*, Decker, *supra* note 2, at 962.

61. *See, e.g.*, Gable, *supra* note 1, at 98, 100–04.

ries in cyberspace; second, the lack of uniform cybercrime statutes around the world; and third, the rapid and ongoing evolution of cybercrime.[62] Cybercriminals will continue to outpace law enforcement efforts if states do not tackle each of these interrelating factors.[63]

1. General Challenges

One of the most unique features about cybercrime is that it operates in a nonphysical realm that is free from territorial boundaries.[64] As mentioned in Part I.A, cybercriminals have the capability of targeting computers or networks anywhere in the world and may use third party computers or networks, located in wholly different locations from either themselves or their targets, as instruments.[65] Any country that is trying to prosecute a cybercriminal will find itself forced to contend with the fact that even a local hacker may have used, perhaps even inadvertently, Internet connections in other countries to perpetrate a local cybercrime. Additionally, the cybercriminal may reside in a country with conflicting, or nonexistent, cybercrime statutes.[66]

A notable example of this kind of enforcement challenge occurred in early 2000, when hackers used stolen credit card information to extort money from several American banks.[67] Upon investigation, the Federal Bureau of Investigation ("FBI") identified the suspected hackers as two Russian nationals living in Russia.[68] However, the United States did not have a mutual legal assistance treaty ("MLAT") with Russia that would have allowed for the countries to extradite the suspects to the United States.[69] The FBI eventually tricked the hackers into coming to the United States under false pretenses, monitored their computer activity during their time in America, and then used the information gleaned from

62. *See* Susan W. Brenner & Joseph J. Schwerha, IV, *Transnational Evidence Gathering and Local Prosecution of International Cybercrime*, 20 J. MARSHALL J. COMPUTER & INFO. L. 347, 369–75 (2002); Decker, *supra* note 2; Miquelon-Weismann, *supra* note 34; Amalie M. Weber, *The Council of Europe's Convention on Cybercrime*, 18 BERKELEY TECH. L.J. 425, 446 (2003).

63. Gable, *supra* note 1, at 98.

64. Miquelon-Weismann, *supra* note 34, at 334; Carucci, Overhuls & Soares, *supra* note 39, at 417.

65. Carucci, Overhuls & Soares, *supra* note 39, at 417.

66. Miquelon-Weismann, *supra* note 34, at 335; Carucci, Overhuls & Soares, *supra* note 39, at 417.

67. Weber, *supra* note 62, at 427–28.

68. *Id.*

69. *Id.*

watching the suspects' online movements to arrest them.[70] Any efforts to limit these kinds of transnational law enforcement obstacles will necessarily rely heavily on the existence of shared statutory definitions of cybercrime terminology and the existence of domestic laws in each participating country that will allow for international cooperation.[71]

Establishing such cooperative relationships can be a herculean task as the definitions for cybercriminal statutes vary from state to state in both substance and semantics.[72] This challenge has two components. First, translators struggle to accurately maintain the same meaning of a statutory definition or phrase in each state's official language.[73] Second, the connotative definition of a crime may vary significantly from one culture to the next.[74]

A recent event in Iran provided an illuminating example of the ever-present variances in legal doctrine. Iranian security forces arrested, and in some instances physically beat up, seventeen young men and women who participated in a squirt-gun fight that had been organized on Facebook.[75] In a statement that might seem absurd to Western sensibilities, one of Iran's lawmakers stated that Iranian security forces had to "stop the spreading of these morally corrupt actions," referring to simple squirt-gun fights.[76] Though Internet-based activities played a secondary role to the "criminal" acts of these Facebook users, this episode reveals the challenges in identifying uniform definitions for cybercrimes. A government that is deeply conservative, ideologically extreme, or facing popular unrest may be more likely to consider a cybercrime that which is

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70. *Id.* Weber explains that the two cybercriminals attacked American banks and credit card businesses repeatedly, broke into secured files, and extracted credit card and merchant identification numbers. They used this information to demand that their victims pay for "security 'consulting services,'" which resulted in large damages for the victims. The FBI, after having its request for assistance snubbed by Russian authorities, used a ruse in which it made the Russian hackers false job offers. While the hackers were in the United States for their "interviews," the FBI used its own software to monitor the hackers' communications with their computer servers in Russia to learn their passwords and online identification information, and then accessed the hackers' own files to acquire sufficient proof to make an arrest. *Id.*

71. *See, e.g.*, Jennifer J. Rho, Comment, *Blackbeards of the Twenty-First Century: Holding Cybercriminals Liable under the Alien Tort Statute*, 7 CHI. J. INT'L L. 695, 710 (2007).

72. Miquelon-Weismann, *supra* note 34, at 353.

73. *Id.*

74. Lama Abu-Odeh, *A Radical Rejection of Universal Jurisdiction*, 116 YALE L.J. (Pocket Part) 393, 394 (2007).

75. Farnaz Fassihi, *Iran's Wet Blankets Put a Damper on Water-Park Fun*, WALL ST. J., Aug. 31, 2011, at A1.

76. *Id.*

innocuous in many other countries, such as using social media to organize rallies or protests.[77] Such a discrepancy can, in turn, affect international cooperation. A state may refuse to extradite, investigate, or provide any other kind of assistance to another nation if the two disagree over what modes of online conduct are criminal.[78]

In some instances, states will be incapable of effective international cooperation because statutory and treaty law often lags far behind what is needed to effectively combat cybercrime.[79] States may lack the resources, technology, or procedures to effectively regulate cyberspace.[80] Even in technologically advanced countries like the United States, which have taken a more active stance on legislating against cybercrime, differences of opinion about how best to legislate are abundant.[81] For example, juveniles or first time cybercriminals—committing only minor acts of mischief—may find themselves prosecuted under highly punitive statutes that were intended to deter large scale cybercrimes.[82] A more ubiquitous challenge lies in the time-consuming nature of legislative processes, which hamstring states' ability to prosecute cybercrime whenever a new technology spawns a new form of crime.[83] Treaties and MLATs are subject to similar obstructions, perhaps to an even greater degree.[84]

These three major impediments—jurisdictional disputes, lack of uniform definitions, and the gradual pace of legislation and treaty forma-

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77. *See* Abu-Odeh, *supra* note 74, at 394; *see also* H. Brian Holland, *The Failure of the Rule of Law in Cyberspace?: Reorienting the Normative Debates on Borders and Territorial Sovereignty*, 24 J. MARSHALL J. COMPUTER & INFO. L. 1, 32 (2005). Indeed, several countries have issued bans on social media and specific technologies, particularly in times of political turmoil. Syria, for example, banned certain Facebook features following the Tunisian revolution that launched the "Arab Spring" in 2011. Khaled Yacoub Oweis, *Syria tightens Internet ban after Tunis unrest—users*, REUTERS (Jan. 26, 2011, 11:40 PM), http://in.reuters.com/article/2011/01/26/idINIndia-54427520110126. Similarly, the Democratic Republic of the Congo banned text-messaging after a disputed election led to voter outrage and calls for organized protest. Thomas Hubert, *DR Congo election: Deaf anger at ban on texting*, BBC NEWS (Dec. 14, 2011, 2:14 PM), http://www.bbc.co.uk/news/world-africa-16187051. Even more recently, an Egyptian court made it a crime for Egyptians to view Internet pornography. Amro Hassan, *Court bans Internet pornography in Egypt*, L.A. TIMES: WORLD NOW BLOG (Mar. 29, 2012, 7:09 AM), http://latimesblogs.latimes.com/world_now/2012/03/court-bans-internet-porn-in-egypt.html.

78. Brenner & Schwerha, *supra* note 62, at 357–58.

79. Miquelon-Weismann, *supra* note 34, at 335.

80. Weber, *supra* note 62, at 427–28.

81. Decker, *supra* note 2, at 976–77.

82. Carucci, Overhuls & Soares, *supra* note 39, at 378–79.

83. *See* Miquelon-Weismann, *supra* note 34, at 335.

84. Weber, *supra* note 62, at 443.

tion—can stymie states' effective cybercrime prevention either individually or in conjunction with each other. To date, cybercrime prevention efforts have failed to sufficiently tackle all three factors simultaneously, resulting in a patchwork of cybercrime statutes that leaves gaps for cybercriminals to utilize as "safe data havens."[85] Nevertheless, states have made significant efforts to create anti-cybercrime laws.

2. Preventative Efforts in the United States

In the United States, the first federal laws criminalizing unauthorized access to computers were passed in 1984.[86] The original set of laws comprised several provisions within the Comprehensive Crime Control Act, a general crime statute.[87] Over the next two and a half decades, the computer crime provisions were expanded and recodified five times, most recently in 2008, resulting in what is now known as the Computer Fraud and Abuse Act ("CFAA").[88] The CFAA protects computers used in interstate or foreign commerce or communications by prohibiting seven acts of computer-related crime.[89] Because the law has sought to keep up with the quick clip of cybercrime's development, each of the five major expansions of the CFAA has significantly broadened the scope and jurisdiction of the statute.[90] Though several Circuit Courts have narrowed the application of the law, and despite a required threshold of $5,000 in damage,[91] some legal scholars argue that the CFAA has become dangerously broad in that it potentially grants the United States government jurisdiction over every Internet-connected computer in the world.[92] Oth-

85. Miquelon-Weismann, *supra* note 34, at 336.

86. Orin S. Kerr, *Vagueness Challenges to the Computer Fraud and Abuse Act*, 94 MINN. L. REV. 1561, 1561 (2010). Kerr's article provides a detailed and comprehensive legislative history of the Computer Fraud and Abuse Act, carefully examining each of the major amendments to the bill over the last quarter century. *Id.*

87. *Id.*

88. Fraud and Related Activity in Connection with Computers, 18 U.S.C. § 1030 (2006) (effective Sept. 26, 2008); *see* Kerr, *supra* note 86, at 1561–71; *see also* Carucci, Overhuls & Soares, *supra* note 39, at 392–96.

89. Carucci, Overhuls & Soares, *supra* note 39, at 392–94. The seven specific acts that CFAA prohibits, which are discussed in more detail in Carucci, Overhuls, and Soares's articles are generally 1) accessing and/or transmitting computer files without authorization; 2) obtaining private information without authorization; 3) intentionally accessing a government computer without authorization; 4) accessing a protected computer with intent to defraud; 5) knowingly, recklessly or negligently damaging a protected computer through hacking; 6) knowingly trafficking in passwords with intent to defraud; and 7) transmitting a threat to cause damage or to extort something of value. *Id.*

90. Kerr, *supra* note 86, at 1561.

91. Carucci, Overhuls & Soares, *supra* note 39, at 395.

92. *See generally* Kerr, *supra* note 86, at 1561.

ers, however, warn that CFAA is still not broad enough to sufficiently combat cybercrime because of its inapplicability to as-yet-undeveloped forms of cybercrime and because of its minimum monetary requirement.[93] These contrasting views reveal one of the major tensions in legislating against cybercrime, namely the balancing of individual users' privacy rights with the public's interest in maintaining cybersecurity.[94]

The United States has complemented the CFAA with a slate of additional statutes designed to target more specific cybercrimes.[95] Among these are the Control the Assault of Non-Solicited Pornography and Marketing Act of 2003 ("CAN-SPAM"), which focuses primarily on curtailing spam; the Electronic Communications Privacy Act ("ECPA") and Stored Communications Act ("SCA"), which protect, among other private data, e-mail accounts, voicemail accounts, and television signals; and various copyright, fraud, child pornography, identity theft, and even cyber-bullying statutes.[96] This body of law, taken together, seeks to address four basic needs created by cybercrime: "protection of privacy, prosecution of economic crimes, protection of intellectual property and procedural provisions to aid in the prosecution of computer crimes."[97]

Other countries have tried to employ differing approaches to combating cybercrime, but with little success.[98] Germany and France initially tried to hold Internet Service Providers ("ISPs") liable for the content they were transmitting, while Cuba has simply limited Internet access to 200,000 citizens.[99] Yet most industrialized countries are now adopting statutes, similar to the CFAA, that target unauthorized access to computers and private information by focusing on the four needs identified in

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93. *See, e.g.*, Decker, *supra* note 2, at 1010.

94. *See generally* Kattan, *supra* note 26, *passim*; Goldstone & Reagan, *supra* note 25, *passim*; Plourde-Cole, *supra* note 34, *passim*.

95. Carucci, Overhuls & Soares, *supra* note 39, at 396–410.

96. *Id.*; *see also* Control the Assault of Non-Solicited Pornography and Marketing Act of 2003, Pub. L. No. 108-187, 117 Stat 2699 (2003) (codified at 15 U.S.C. §§ 7701–7713 and 18 U.S.C. § 1937 (2006)); Electronic Communications Privacy Act of 1986, Pub. L. No. 99-508, 100 Stat. 1848 (1986) (codified as amended at 18 U.S.C. §§ 2510–2521, 2701–2710, 3121–3126 (2006)).

97. Carucci, Overhuls & Soares, *supra* note 39, at 418.

98. *Id.* at 417–18.

99. *Id.* However, Cuba has been unsuccessful in completely restricting Internet access. This is primarily because those who have been permitted access, typically doctors or academics, often sell their access information on the black market. *Cuba and the internet: Wired, at last*, ECON. (Mar. 3, 2011), http://www.economist.com/node/18285798. However, the Cuban government may be embracing a different approach to limiting Internet access, given that Venezuela recently spent seventy million dollars to connect a 1,000-mile fiber-optic cable between itself and the island in March 2011. *Id.*

the U.S. statutes listed above.[100] One of the ongoing challenges facing all countries, though, is the procedural and logistical challenges that stem from pursuing cybercriminals who operate in a world free from jurisdictional boundaries.[101]

3. Europe's Convention on Cybercrime

The Council of Europe's Convention on Cybercrime ("the Convention") marks the most ambitious international effort to combat cybercrime to date.[102] The Convention was drafted in 2001 in an effort to address those specific jurisdictional challenges that came about with the evolution of the Internet and to facilitate greater cooperation between nations fighting cybercrime.[103] It entered into force in January 2004 and, as of April 2012, the Convention had been ratified by thirty-three countries, including the United States.[104]

Each signatory to the Convention agrees to three obligations: first, to criminalize certain computer-related conduct by statute; second, to establish investigative and electronic-evidence gathering procedures; and third, to assist in broad, international efforts to prosecute cybercriminals, including cooperation with fugitive extradition efforts.[105] In addition to laying out suggested norms and standards for domestic cybercrime laws and MLATs between party states, the Convention provides uniform definitions of at least four terms indelibly linked to cybercrime: "computer system," "computer data," "service provider," and "traffic data."[106]

In this way, the Convention has made important progress in addressing many of the challenges that plague cybercrime prevention.[107] The four definitions listed at the outset of the Convention mark some progress in

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100. *Id.* at 418.

101. Miquelon-Weismann, *supra* note 34, at 335; Weber, *supra* note 62, at 425.

102. *See, e.g.*, Gable, *supra* note 1, at 93.

103. Weber, *supra* note 62, at 425–26.

104. *Convention on Cybercrime*, COUNCIL OF EUROPE, http://www.conventions.coe.int/Treaty/Commun/ChercheSig.asp?NT=185&CM=8&DF=01/11/2011&CL=ENG (last updated Jan. 1, 2011) [hereinafter *Cybercrime*, COUNCIL OF EUROPE].

105. Miquelon-Weismann, *supra* note 34, at 329–30.

106. Council of Europe, Convention on Cybercrime, Nov. 23, 2001, E.T.S. No. 185 [hereinafter Convention on Cybercrime]. These definitions, listed at the beginning of the convention, were drafted as a direct result of the United Nation's identification of "uniformity in law and consensus over definitional terms as two of the impediments that had to be overcome in order to achieve meaningful cooperation and successful enforcement." Miquelon-Weismann, *supra* note 34, at 338.

107. *See generally* Miquelon-Weismann, *supra* note 34; Weber, *supra* note 62, at 445–46.

unifying terms across languages.[108] Similarly, the document calls for parties to the Convention to criminalize four categories of crime and lists nine specific actions that should be criminalized.[109] Both of these provisions streamline cooperation and enforcement processes, as do the additional provisions that call for signatories to establish a minimum set of standardized legal procedures and to coordinate with each other by means of MLATs and other agreements.[110]

Perhaps the most important feature of the Convention, and the reason for its growing list of participants,[111] is that it allows participating states to retain a sense of total sovereignty.[112] All of the obligations placed on signatories require only the creation of domestic law, not subjugation to extraterritorial legislation,[113] and while MLATs come with ratification of the Convention, they do not supersede preexisting treaties.[114] Furthermore, parties to the convention have the right to make reservations that limit their adherence to certain provisions or MLATs.[115] National governments find the Convention's deference to their own sovereignty reassuring and may be drawn toward it, and future treaties on cybercrime, because of this.[116]

However, the Convention still falls far short of addressing all of the challenges of fighting international cybercrime. At a fundamental level,

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108. Miquelon-Weismann, *supra* note 34, at 338.

109. Weber, *supra* note 62, at 431. The first category of crimes focuses on protecting privacy rights and specifically proscribes illegal access, illegal interception, data interference, system interference, and misuse of devices. The second category outlaws fraud and forgery. The third category centers on content-related crimes, namely child pornography-related offenses. The fourth category deals with copyright protections, as well as supplemental provisions relating to all of the aforementioned activities, such as corporate liability standards and laws that forbid the aiding and abetting of cybercrime. *Id.*

110. Weber, *supra* note 62, at 433–34.

111. As of December 1, 2011, the following countries had ratified the Convention: Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Denmark, Estonia, Finland, France, Germany, Hungary, Iceland, Italy, Latvia, Lithuania, Moldova, Montenegro, the Netherlands, Norway, Poland, Portugal, Romania, Serbia, Slovakia, Slovenia, Spain, Switzerland, the former Yugoslav Republic of Macedonia, Ukraine, United Kingdom, and the United States. *Cybercrime*, COUNCIL OF EUROPE, *supra* note 104.

112. Weber, *supra* note 62, at 442.

113. Convention on Cybercrime, *supra* note 106.

114. Weber, *supra* note 62, at 441–42.

115. *Id.* at 443.

116. Miquelon-Weismann, *supra* note 34, at 354; *see also* David J. Scheffer, *Staying the Course with the International Criminal Court*, 35 CORNELL INT'L L.J. 47, 59–60 (2002) (describing how the incorporation of the complementarity principle played a major role in convincing the Clinton administration to sign the Rome Statute by addressing fears of forfeited sovereignty).

the Convention's deference to national sovereignty prevents the treaty from adequately addressing one of the three major challenges of fighting cybercrime listed earlier: obstructive jurisdictional boundaries.[117] Because not every state in the world is a party to the Convention, and because signatories can water down their own commitment through the use of reservations, safe data havens for cybercriminals will continue to exist throughout the world.[118] Furthermore, the treaty's reliance on local legislation undermines the Convention's progress in harmonizing terminology and criminal statutes—a party to the Convention may simply not meet its obligation to criminalize each of the listed actions, thereby reducing the efficacy of the treaty.[119] The reasons for not enacting a particular law may vary, but the fact remains that the Convention offers no enforceable standards to which participating parties must conform.[120]

The Convention has two other significant weaknesses. First, it fails to provide uniform procedural rules regarding privacy and other due process rights for cybercrime suspects.[121] Even with mutual assistance between two Convention signatories, where both have met all of the obligations laid out by the treaty, there may still be a conflict when one of those two states has more invasive cyber search and seizure statutes than the other.[122] The potential—indeed likelihood—of such discrepancies does much to subvert the sense of cooperation the Convention is designed to foster, as participating countries will balk at full participation in the treaty if they are not guaranteed what they consider fair treatment for their citizens by other states.[123] Second, the Convention, like all treaties, is more difficult to amend than domestic legislation and therefore is still subject to another one of the major obstacles of cybercrime prevention—obsolescence in the face of a rapidly changing environment.[124]

For these reasons, the Convention marks the best effort to date to combat cybercrime yet still falls short of establishing the necessary legal tools and authority to overcome the three major obstacles of traditional territorial jurisdiction, disharmonious definitions of cybercrime terms, and rapid technological advancement.[125] Due to the ever-growing threat

117. Miquelon-Weismann, *supra* note 34, at 359; Weber, *supra* note 62, at 443.
118. Weber, *supra* note 62, at 443–44.
119. *Id.* at 442–43.
120. Miquelon-Weismann, *supra* note 34, at 353–54.
121. *Id.* at 340–41.
122. *Id.*; *see also* Brenner & Schwerha, *supra* note 62, at 350.
123. Miquelon-Weismann, *supra* note 34, at 360.
124. Weber, *supra* note 62, at 443.
125. *Id.* at 445–46. *See generally* Miquelon-Weismann, *supra* note 34.

that cybercrime poses to international security, though, law enforcement agencies are bridging many of the legal gaps at an operational level.[126]

4. The Growing Role of Multinational Task Forces

Whether working through informal, mutually beneficial relationships or through formal mechanisms like Interpol and MLATs, law enforcement agencies are finding methods to work together in order to prosecute cybercriminals to a greater, though still limited, extent than the Convention allows.[127] At a hearing before the United States House Financial Services Committee's Subcommittee on Financial Institutions and Consumer Credit in September 2011, an assistant director of the FBI's Cyber Division testified that strategic discussions between the United States and major allies have "resulted in increased operational coordination on intrusion activity and cyber threat investigations."[128] He added that the United States "currently [has] FBI agents embedded full-time in five foreign police agencies to assist with cyber investigations," and that the FBI has "trained foreign enforcement officers from more than [forty] nations in cyber investigative techniques over the past two years."[129] Similarly, the U.S. Secret Service operates twenty-three offices abroad[130] and deploys 1,400 agents trained in its Electronic Crimes Special Agent Program throughout the world.[131] When testifying to the United States Senate Committee on the Judiciary, a Deputy Special Agent in Charge of the Secret Service's Criminal Investigative Division endorsed such multinational field work and said that "the personal relationships that have been established in those countries [where the Secret Service operates offices] are often the crucial element to the successful investigation and prosecution of suspects abroad."[132] In addition to multinational task forces, law

126. Decker, *supra* note 2, at 1005. See also Brenner & Schwerha, *supra* note 62, at 394, which, written just before the initial development of multinational task forces, calls for just such an integration of law enforcement efforts as an important tool in fighting cybercrime.

127. *See generally* Brenner & Schwerha, *supra* note 62; Carucci, Overhuls & Soares, *supra* note 39, at 419.

128. *Cyber Security: Threats to the Financial Sector: Hearing Before H. Fin. Serv. Comm. Subcomm. on Fin. Insts. & Consumer Credit*, 112th Cong. 8 (2011) (statement of Gordon M. Snow, Assistant Director, Cyber Division, Federal Bureau of Investigation).

129. *Id.*

130. *Cybercrime: Updating the Computer Fraud and Abuse Act to Protect Cyberspace and Combat Emerging Threats: Hearing Before the S. Comm. on the Judiciary*, 112th Cong. 4 (2011) (statement of Pablo A. Martinez, Deputy Special Agent in Charge, Criminal Division, U.S. Secret Service).

131. *Id.*

132. *Id.*

enforcement agencies are increasingly turning to private and nonprofit corporations, particularly those that have international copyright enforcement programs, for assistance in combating cybercrime.[133]

These collaborative efforts exemplify the most promising methods to prevent and prosecute cybercrime. The increased flexibility, rapid response capabilities, and diverse populations within multinational task forces make them better equipped to overcome the three major obstacles of international cybercrime than treaties or any other regulatory mechanism. Yet their efforts are still restricted by the red tape of jurisdictional limits and mercurial relations between states.

C. Universal Jurisdiction

One innovative approach toward combating cybercrime calls for granting every nation the right to prosecute cybercriminals under a universal jurisdiction theory.[134] Such an approach offers immediate benefits as a powerful deterrent and as a means to reduce many of the restrictions that stem from traditional territorial jurisdiction.[135] It is helpful, then, to briefly explore the historical usage of this rare legal principle.

Universal jurisdiction grants any state the right to prescribe, adjudicate, and enforce a law against a person regardless of that person's nationality, the nationality of any victim, or the location at which the crime was committed.[136] Incumbent upon extending jurisdiction to such an expan-

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133. *Id.* Carucci, Overhuls, and Soares provide only one example of a private organization working with law enforcement agencies, a software industry trade group called the Business Software Alliance, but they refer to multiple unnamed groups, as well. Carucci, Overhuls & Soares, *supra* note 39, at 419.

134. *See, e.g.*, Gable, *supra* note 1, at 104–17.

135. *See generally id.*; Rho, *supra* note 71, at 709–10.

136. M. Cherif Bassiouni, *Universal Jurisdiction for International Crimes: Historical Perspectives and Contemporary Practice*, 42 VA. J. INT'L L. 81, 89 (2001). Kenneth C. Randall offers a more detailed definition of universal jurisdiction by describing jurisdiction in this way:

> [it] refers to a state's legitimate assertion of authority to affect legal interests. Jurisdiction may describe a state's authority to make its law applicable to certain actors, events, or things (legislative jurisdiction [sometimes called "prescriptive jurisdiction"]); a state's authority to subject certain actors or things to the processes of its judicial or administrative tribunals (adjudicatory jurisdiction); or a state's authority to compel certain actors to comply with its laws and to redress noncompliance (enforcement jurisdiction). A state may not legally assert legislative, adjudicatory, or enforcement jurisdiction over all persons and things within the state's power and control.

Kenneth C. Randall, *Universal Jurisdiction under International Law*, 66 TEX. L. REV. 785, 786 (1988).

sive degree is the belief that allowing a state the authority to prescribe and adjudicate a certain crime, or set of crimes, on behalf of the international community is instrumental in preserving world order.[137]

For the most part, universal jurisdiction stems from customary law and not from treaties between nations.[138] Because customary law is, generally, a set of rules and norms that affects every state—and creates a sense of legal obligation on all states to conform to that set of rules—universal jurisdiction, when applied to a specific crime, governs the entire community of nations regardless of any country's express willingness to be bound by it.[139]

One of the major obstructions to the expansive use of this legal tool is that states must voluntarily relinquish some sovereign power.[140] Because states are hesitant to give up any jurisdictional power, the global community must unquestionably consider a crime worthy of universal jurisdiction before such broad prosecutorial authority will be enforced. Since the middle of the twentieth century, the "heinousness principle" has been the standard used to justify universal jurisdiction over crimes that are "profoundly despised throughout the world."[141]

Unsurprisingly, universal jurisdiction is rarely applied.[142] The first, and to date most prominent example of universal jurisdiction was the global

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137. Bassiouni, *supra* note 136, at 88.

138. Anthony J. Colangelo, *Constitutional Limits on Extraterritorial Jurisdiction: Terrorism and the Intersection of National and International Law*, 48 HARV. INT'L L.J. 121, 132 (2007).

139. *Id.* at 130–32. Colangelo provides a more detailed definition of customary international law and describes it as being made up of

> two components: (i) a general state practice, and (ii) a belief or intent to act with legal purpose, or what is often called opinio juris. Customary law is universal in its application and is therefore theoretically binding on all states . . . . By contrast, [treaty law] results from formal agreements among states and binds only those states parties to the treaty.

Id. at 131.

140. Eugene Kontorovich, *The Piracy Analogy: Modern Universal Jurisdiction's Hollow Foundation*, 45 HARV. INT'L L.J. 183, 184–85 (2004); *see also* Christopher Harding, *The International and European Control of Crime*, *in* RENEGOTIATING WESTPHALIA 183, 190 (Christopher Harding & C.L. Lim eds., 1999) (noting that the rise in international criminal prevention efforts in Europe toward the end of the twentieth century is "to some extent associated with the weakening of the state structure"); *see also* Christopher Harding & C.L. Lim, *The Significance of Westphalia: An Archaeology of the International Legal Order*, *in* RENEGOTIATING WESTPHALIA, *supra*, at 1, 8 (questioning why states would "contrary to their own immediate self-interest, [accept] a limitation of their own sovereignty" by recognizing international human rights).

141. Kontorovich, *supra* note 140, at 205; *see also* Gable, *supra* note 1, at 108.

142. *See, e.g.*, Bassiouni, *supra* note 136, at 82.

prosecution of piracy[143] that began in earnest in the seventeenth century.[144] Any nation was allowed to try and execute pirates caught on the high seas regardless of the nationality of the vessel the pirates chose to attack or the original nationality of the pirates.[145] Though piracy was governed by universal jurisdiction before the advent of the heinousness principle, any state that prosecuted pirates was nevertheless considered to be preserving world order on behalf of the international community.[146]

The crime of piracy easily lent itself to universal jurisdiction for two interrelated reasons. First, the high seas were extraterritorial spaces that most nations valued as a "global commons" essential for commerce.[147] As a general rule, each state's jurisdiction on the high seas was limited to its own citizens and its own vessels.[148] Thus, in order to adequately protect the communal safety of the high seas, an exception was made to the usual jurisdictional rules and states were allowed uniquely broad authority when prosecuting pirates.[149] Second, pirates voluntarily eschewed their own nationalities and disregarded the laws of all nations, thus making pirates, in the truest sense, outlaws.[150] As the influential, eighteenth century British jurist William Blackstone wrote, a pirate "'declare[ed] war against all mankind' and thus 'all mankind must declare war against him.'"[151]

For centuries, piracy stood alone as the only crime that was governed by universal jurisdiction. Slowly, slave trading became the second.[152] It

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143. Gable notes, "although there does not seem to be a definitive definition of piracy, it [is generally] defined as an act committed by non-state actors aboard a vessel on the high seas or outside of any state's jurisdiction." Gable, *supra* note 1, at 108. Kontorvich offers a more specific definition, stating that while each nation has different statutory descriptions, "the crime of piracy consists of nothing more than robbery at sea." Kontorovich, *supra* note 140, at 191.

144. Kontorovich, *supra* note 140, at 190.

145. *Id.*; Colangelo, *supra* note 138, at 144–45; Randall, *supra* note 136, at 791–98.

146. James D. Fry, Comment, *Terrorism as a Crime against Humanity and Genocide: The Backdoor to Universal Jurisdiction*, 7 UCLA J. INT'L L. & FOREIGN AFF. 169, 175 (2002).

147. Kontorovich, *supra* note 140, at 190.

148. Randall, *supra* note 136, at 793.

149. *Id.*

150. Colangelo, *supra* note 138, at 144–45; Randall, *supra* note 136, at 791.

151. Colangelo, *supra* note 138, at 144. In the famous U.S. Court of Appeals for the Second Circuit case *Filartiga v. Peña-Irala*, the court adopted similar language to Blackstone when discussing the act of torture, conforming to the practice of linking crimes newly held to be under universal jurisdiction to piracy. 630 F.2d 876, 890 (2d Cir. 1980). The court held that "the torturer has become like the pirate and slave trader before him *hostis humani generis*, an enemy of all mankind." *Id.*

152. Bassiouni, *supra* note 136, at 112.

was during the aftermath of World War II, though, that the heinousness principle came into effect and that universal jurisdiction was extended over a slate of new crimes, including genocide, war crimes, and crimes against humanity.[153] There exist additional crimes, like the hijacking of planes, which have been universally condemned but have not yet reached an accepted status under customary law to be governed by universal jurisdiction.[154]

Proponents of expanding the usage of universal jurisdiction emphasize its power to prevent crimes through its immense scope and applicability to potential criminals all over the world.[155] In almost every instance where a theorist seeks to justify extending universal jurisdiction over a new crime, the basis for the extension is the crime's similarity to piracy.[156] Currently, the crime (or class of crimes) that appears to enjoy the most popular justification for universal jurisdiction, and which is most successfully analogized to piracy, is terrorism,[157] though even it stands a slim chance of facing true universal prosecution.

Any expansion of universal jurisdiction is met with persuasive opponents. Critics rightly challenge a number of factors, aside from the sacrifice of state sovereignty,[158] which will be discussed in some detail in Part II.A of this Note. However, one standout criticism regarding universal

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153. Kontorovich, *supra* note 140, at 194, 204–05; *see also* Randall, *supra* note 136, at 800.

154. Bassiouni, *supra* note 136, at 115–34.

155. Gable, *supra* note 1, at 108.

156. Kontorovich, *supra* note 140, at 204–06.

157. Colengelo writes,

> Like pirates, terrorists, and in particular al Qaeda and those like al Qaeda, also have opted out of the "law of society": they "acknowledge obedience to no government whatever and act in defiance of all law," such as the law distinguishing between military and civilian targets . . . and their acts potentially target all states . . . . [B]y "throwing off his national character" in committing his illegal acts of war, the terrorist has, like the pirate, exposed himself to the enforcement jurisdiction of all states. He too wages a lawless war under the color of no state's authority.

Colangelo, *supra* note 138, at 145 (internal citations and punctuation omitted). Many theorists suggest that universal jurisdiction should be applied to a wider array of legal fields, such as drug-related crimes. *See, e.g.*, Anne H. Geraghty, *Universal Jurisdiction and Drug Trafficking: A Tool for Fighting One of the World's Most Pervasive Problems*, 16 FLA. J. INT'L L. 371 (2004). Other scholars have pushed for universal regulation to cover specific, more controversial issues like in vitro fertilization and embryonic regulation. *See, e.g.*, Sherylynn Fiandaca, Comment, *In Vitro Fertilizations and Embryos: The Need for International Guidelines*, 8 ALB. L.J. SCI. & TECH. 337, 395 (1998).

158. *See, e.g.*, Kontorovich, *supra* note 140; Abu-Odeh, *supra* note 74.

jurisdiction over cybercrime, discussed above, is the unresolved set of limitations that stem from a lack of a unified set of cybercrime definitions.[159] Universal jurisdiction proponents point out that even piracy lacks specific international definitions.[160] Theorists on both side of the debate of universal jurisdiction note, under different lines of argument, the troubling fact that if the same acts that generally satisfy the elements of piracy are committed under the auspices of a sovereign state, they are considered acts of privateering, an act neither subject to universal jurisdiction nor universally condemned.[161]

Still, because cybercrime is a uniquely global problem, the debate over whether it should be globally prosecuted via universal jurisdiction becomes a fundamentally important question. As this Note will explore more fully in Part II.A, expanding universal jurisdiction to some degree over cybercrime will be an important element of any effective preventative legislation.

D. The ICC

One relatively recent development in international criminal law has been the establishment of the ICC.[162] Though this institution is still in its infancy, its creation has been a landmark development in international criminal law.[163] Given the global nature of cybercrime, there can be little doubt that international judicial bodies of some form will play at least a limited role in the prevention and prosecution of cybercrime.[164] Any practical solution to the growing threat of cybercrime should therefore include a role for a judicial body similar in design to the ICC.

Representatives from a majority of the world's countries, gathered at the United Nations Diplomatic Conference of Plenipotentiaries in 1998, outlined the structure and powers of the ICC in what is now known as the

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159. *See, e.g.*, Abu-Odeh, *supra* note 74, at 394.

160. *See* Gable, *supra* note 1, at 108; *see also* Kontorovich, *supra* note 140, at 191.

161. Kontorovich, *supra* note 140, at 218–22; Colangelo, *supra* note 138, at 145.

162. *See generally* Remigius Oraeki Chibueze, *The International Criminal Court: Bottlenecks to Individual Criminal Liability in the Rome Statute*, 12 ANN. SURV. INT'L & COMP. L. 185 (2006); James F. Alexander, *The International Criminal Court and the Prevention of Atrocities: Predicting the Court's Impact*, 54 VILL. L. REV. 1 (2009).

163. See, for example, Chibueze, *supra* note 162, at 187, stating that the creation of the ICC "was one of the remarkable achievements of the twentieth century."

164. *See, e.g.*, Miquelon-Weismann, *supra* note 34, at 360–61 (advocating for the passage of a proposed "Treaty to Establish a Constitution for Europe," which would improve upon the Convention on Cybercrime by providing "for the right to an effective remedy and to a fair trial, presumption of innocence and right of defense, principles of legality and proportionality of criminal offenses and penalties, and the prohibition against double jeopardy").

Rome Statute.[165] The Rome Statute calls for a court that would have jurisdiction over "the most serious crimes of concern to the international community"[166]—including genocide, war crimes, and crimes against humanity—and that would be situated in The Hague, the Netherlands.[167] The treaty entered into force and established the ICC in 2002, with 121 countries participating as of July 1, 2012.[168]

The idea of an international criminal court was not entirely a novel one when the Rome Statute was drafted.[169] Beginning with the Nuremburg Trials after World War II, which criminally prosecuted high-ranking Nazi officials for atrocities, the international community has moved steadily in the direction of holding individuals liable for violations of international laws (where before only state-actors might have been held liable for acts of genocide or war crimes).[170] The trend continued throughout the twentieth century, resulting in the creation of specific international criminal tribunals, modeled to an extent on the Nuremburg Trials, for atrocities committed in association with the conflicts in Yugoslavia and Rwanda.[171] These tribunals were generally ad hoc, rendering jurisdiction over only a specific country or over a specific series of events.[172] Establishing a permanent court with potential jurisdiction over all countries was, in many ways, a natural next step.[173]

Because the potentially universal reach of the ICC was a concern for many of the parties involved in drafting the Rome Statute, they reached a series of compromises that limited the ICC's jurisdiction in at least three significant ways.[174] First, the ICC may only exercise its jurisdiction in a particular matter if one or more of the parties has consented, either through ratification of the Rome Statute or by being a citizen (over the

165. Chibueze, *supra* note 162, at 185; Alexander, *supra* note 162, at 2–3.

166. Statute of the International Criminal Court, July 17, 1998, 2187 U.N.T.S. 90 [hereinafter Rome Statute].

167. Alexander, *supra* note 162, at 2.

168. *ICC at a Glance*, INT'L CRIMINAL COURT, http://www.icc-cpi.int/Menus/ICC/About+the+Court/ICC+at+a+glance/ (last visited Apr. 24, 2012).

169. *See* Johan D. ven der Vyver, *Personal and Territorial Jurisdiction of the International Criminal Court*, 14 EMORY INT'L L. REV. 1, 4–9 (2000).

170. *Id.* at 4–9.

171. These tribunals were officially titled the International Criminal Tribunal for the Former Yugoslavia ("ICTY") and the International Criminal Tribunal for Rwanda ("ICTR"). IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 569–71 (6th ed. 2003). As of late 2008, the ICTY had rendered judgments in sixty-seven cases and was proceeding on forty-five more; the ICTR had judged thirty-seven with thirty-seven additional cases in progress. Alexander, *supra* note 162, at 12–13.

172. Alexander, *supra* note 162, at 12.

173. *See id.* at 2–3.

174. ven der Vyver, *supra* note 169, at 2, 60–65.

age of eighteen) of a state over which the ICC held previously-vested authority by treaty.[175] Second, and perhaps most importantly, the ICC must adhere to a policy of complementarity, meaning that it must remain a court of last resort that only reviews an issue if no preexisting domestic legal organism can, or will, hear it.[176] Last, the United Nations Security Council retains the power to request that the ICC defer any investigation or prosecution for one year, a request that may be renewed for additional year-long intervals.[177]

The ICC has the potential to be an extremely effective criminal deterrent and prosecutorial mechanism.[178] However, proponents of the ICC worry that its power is diluted though treaty compromises to a point of being nearly moot.[179] The restrictions, listed above, on its ability to hold jurisdiction over various claims and issues put damaging limits on the court's purposes, they argue.[180] The notion of complementarity, in particular, may allow states to protect their own nationals from ICC prosecution by retaining domestic jurisdiction,[181] and the Security Council's effective blocking power allows states that are not party to the Rome Statute, including the United States, to prevent the court from reaching certain individuals.[182] These jurisdictional handcuffs reveal the major weakness of the ICC: its reliance on states for enforcement and validity.[183] The ICC lacks police or military forces, let alone its own source of funding, and so it cannot apprehend suspects or enforce its own orders.[184] It is therefore subject to the political whims of a state when requesting that state arrest or surrender a defendant.[185] The ICC may also be unable to functionally assist a weak state that seeks assistance in corralling criminals within its borders.[186]

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175. Rome Statute, *supra* note 166.

176. Alexander, *supra* note 162, at 19; ven der Vyver, *supra* note 169, at 66–71.

177. Chibueze, *supra* note 162, at 199–200.

178. Alexander, *supra* note 162, at 19; ven der Vyver, *supra* note 169, at 9–10.

179. Chibueze, *supra* note 162, at 187; Jack Goldsmith, *The Self-Defeating International Criminal Court*, 70 U. CHI. L. REV. 89, 91–92 (2003).

180. *See generally* Chibueze, *supra* note 162.

181. Complementarity provides a comfort to states participating in the Rome Statute similar to the deference to national sovereignty featured in the Cybercrime Convention. Complementarity certainly played a key role in garnering enough support to ratify the Rome Statute from the earliest stages of its inception. *See* JANN K. KLEFFNER, COMPLEMENTARITY IN THE ROME STATUTE AND NATIONAL CRIMINAL JURISDICTIONS 79–80 (2008).

182. Chibueze, *supra* note 162, at 217–18.

183. Alexander, *supra* note 162, at 11.

184. *Id.*

185. *Id.*

186. *Id.*

Ultimately, the success or failure of the ICC has yet to be seen.[187] Too little time has passed for any substantive analyses to be made about the court's effectiveness—to date only fifteen cases have been brought to the court[188] and the court reached its first verdict in March 2012.[189] For the ICC to have a long-term effect, the international community needs to demonstrate a stronger consensus in support of the court's legitimacy and the barriers to its operation need to be removed.[190]

II: THREE APPROACHES TO TACKLING CYBERCRIME ON AN INTERNATIONAL LEVEL

The application and prosecution of criminal law in the international arena always presents practical challenges.[191] The issues of national sovereignty, multinational cooperation, and a lack of enforcement mechanisms, discussed in Part I of this Note, are just the beginning of the list of issues that plague any international efforts to regulate crime. Though cybercrime is uniquely suited to international regulation, many of these same historical obstacles continue to exist.[192]

An analysis of three distinct approaches to international regulation of cybercrime can highlight the way the international community's perception of international regulation—particularly with regard to international courts—should evolve. The first approach calls for universal jurisdiction over cybercrime. The second approach relies on states' domestic ratification of cybercrime statutes that are drafted by international bodies. The third approach is the most radical, and yet the most pragmatic, calling for

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187. *See id.* at 55.

188. *All Cases*, INT'L CRIMINAL COURT, http://www.icc-cpi.int/Menus/ICC/Situations+and+Cases/Cases/ (last visited Mar. 18, 2012); Alexander, *supra* note 162, at 15.

189. Marlise Simons, *Congolese Rebel Convicted of Using Child Soldiers*, N.Y. TIMES, Mar. 15, 2012, at A12. The ICC found Thomas Lubanga guilty of "recruiting and enlisting boys and girls under the age of 15 and using them in war." *Id.* This first conviction was not an overwhelming success for the court, though. The three-year trial was "halting [and] arduous," ending with the three judges, two of whom wrote dissenting opinions, harshly criticizing the prosecution for having been "negligent and ha[ving] delegated investigations to unreliable paid go-betweens who had encouraged witnesses to give false testimony." *Id.*

190. Alexander, *supra* note 162, at 27. Though there have been critics of the ICC from the outset, a significant group of anti-ICC scholars and practitioners point to its slow start as evidence that the court, by its very structure, is incapable of effectively prosecuting international crimes. *See, e.g.*, Elena Baylis, *Reassessing the Role of International Criminal Law: Rebuilding National Courts through Transnational Networks*, 50 B.C. L. REV. 1, *passim* (2009); Goldsmith, *supra* note 179, *passim*.

191. *See, e.g.*, ven der Vyver, *supra* note 169, at 8.

192. *See generally* Holland, *supra* note 77.

an international penal code for cybercrime regulated by an international court and enforced by multinational task forces. As may often be the case with a technology-based issue, traditional legal tactics, including the first two approaches to cybercrime discussed here, are quickly becoming antiquated and fail to meet challenges posed by a dynamic, expansive, and rapidly mutating species of crime.[193]

A. Universal Jurisdiction for Cybercrime

Extending universal jurisdiction over cyberspace and cybercrime can be very attractive at first glance, though careful examination reveals that it fails to address many of the problems presented by cybercrime and, if applied, may create new areas of concern.[194]

In her article "Cyber-Apocalypse Now: Securing The Internet Against Cyberterrorism and Using Universal Jurisdiction as a Deterrent," Kelly A. Gable forcefully lays out the value of universal jurisdiction over cybercrime, with particular focus on the major crimes that may be labeled terrorist acts.[195] The pivotal value of universal jurisdiction, as she argues, is in its impact as a deterrent.[196] Physical prevention being nearly impossible for multiple logistical and practical reasons,[197] deterrence becomes the most viable solution to the challenge of would-be cybercriminals.[198] Universal jurisdiction alone, she argues, can provide the level of deterrence necessary because its broad reach can surmount many of the practical challenges of locating, and then prosecuting, cybercriminals by potentially stripping cybercriminals of any data safe-havens.[199]

Yet the very broadness of universal jurisdiction makes it a controversial approach to any crime.[200] Though, as mentioned in Part I.B of this Note, its application has expanded significantly since the end of World

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193. David R. Johnson & David Post, *Law and Borders—The Rise of Law in Cyberspace*, 48 STAN. L. REV. 1367, *passim* (1996); Weber, *supra* note 62, at 443, 446.

194. *See, e.g.*, Gable, *supra* note 1, at 105; Rho, *supra* note 71, at 699.

195. "Roughly defined, cyberterrorism refers to efforts by terrorists to use the Internet to hijack computer systems, bring down the international financial system, or commit analogous terrorist actions in cyberspace . . . Depending on his or her goal, a hacker could just easily be a cyberterrorist as a cybercriminal." Gable, *supra* note 1, at 62–63.

196. *Id.* at 105.

197. These reasons include, among others, the political, religious and ideological nature of the criminal's motives, along with challenges pinpointing, geographically, a "location" of a crime that may utilize multiple computer systems in multiple countries. *Id.* at 100–05.

198. *Id.* at 105.

199. *Id.*

200. Kontorovich, *supra* note 140, at 184.

War II,[201] the international community has identified compelling reasons to be cautious in allowing its proliferation.[202] Specifically, two sets of hurdles arise when considering the application of universal jurisdiction to cybercrime: first, proponents must justify the use of such unusually expansive prosecutorial power to the international community, and second, they must address the many practical implications in actually pursuing cybercriminals without regard for territorial boundaries.[203]

At the outset, proponents of applying universal jurisdiction to cybercrime must first persuade the international community that the crimes have reached a level of heinousness on par with other crimes granted such an unusual international distinction, such as genocide or crimes against humanity.[204] "Heinous" crimes, as discussed, are generally defined in vague terms, such as those crimes that are "shocking to the conscience."[205] Gable successfully argues that the very extreme acts of cyberterrorism—those that are of such a scale that entire financial or national security systems may be dismantled—may meet this standard.[206] However, any crime that falls short of this conscience-shocking standard may present difficult questions over whether the crime in question truly warrants being subject to universal jurisdiction.[207] This dilemma also brings up the corollary practical concerns regarding the need for uniform terminology and definitions discussed earlier.[208]

Most proponents of universal jurisdiction for cybercrime draw the common analogies to piracy as a method of justification,[209] suggesting that the Internet is like the high seas—a valuable "global commons" essential for commerce. For many of the reasons discussed in Part I.C, however, the historic crime of piracy on the high seas may fail to provide an accurate analogy for cybercrime. States were more comfortable with universal jurisdiction for piracy because pirates were readily identifiable as nonstate actors and because their impact was limited to one ship at a

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201. *See* Fry, *supra* note 146, at 176.

202. *See, e.g.*, Bassiouni, *supra* note 136, at 82.

203. *See, e.g.*, Abu-Odeh, *supra* note 74, at 394. Abu-Odeh, a universal jurisdiction skeptic, suggests that universally prosecuted laws are likely to be promulgated by countries that are either economically or militarily powerful. She questions the impact of such laws, which she suggests would be pro-Israel, and their correlating procedures on Palestinians. *Id.*

204. *See, e.g.*, Kontorovich, *supra* note 140, at 205–06.

205. *Id.* at 206.

206. Gable, *supra* note 1, at 118.

207. *See, e.g.*, Kontorovich, *supra* note 140, at 206–07.

208. *See supra* Parts I.B & I.C.

209. *See, e.g.*, Gable, *supra* note 1, at 116; Kontorovich, *supra* note 140, at 184.

time.[210] Pirates, put simply, did not present the kind of identification and capture challenges posed by today's frequently anonymous cybercriminals, nor were they capable of dismantling entire countries through their plundering.[211] Unlike a physical capture on the high seas, law enforcement agencies may have to contend with cybercriminals hiding out in a host country while their criminal presence is manifested only on the "high seas" of the Internet.[212] Furthermore, the piracy analogy again raises the question of uniform definitions, as highlighted by the example of privateering.[213] Because neither the heinousness standard nor the piracy analogy provide decisive justification for universal jurisdiction, it is unlikely that the international community will be easily convinced that cybercrime meets historical standards for expanding this broad prosecutorial power.

Assuming that universal jurisdiction could be justified, though, the questions of terminology and definition become pivotal.[214] Genocide, for example, may be able to pass muster as a crime worthy of universal jurisdiction because it is universally understood and definable in every language without substantial controversy.[215] Yet cybercrime, or cyberterrorism, can present challenges by being more controversial in definition. The term "terrorism," alone, may not be easily defined as it lacks meaning in any uniform legal sense.[216] The adage of "one man's terrorist is another man's freedom fighter" highlights the subjectivity of the definition of terrorism[217] and, as the Iranian squirt-gun fight episode demonstrated, the same subjectivity may apply to cybercrime, generally.[218]

Norming these standards and defining exactly what constitutes cybercrimes or acts of cyberterrorism—something eminently important to the enforcement of universal jurisdiction—will not be an easy task. There is strong probability that those definitions and norms would be generated

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210. Rho, *supra* note 71, at 715.

211. *See* Kontorovich, *supra* note 140, at 204–07, 210.

212. Rho, *supra* note 71, at 705.

213. Kontorovich, *supra* note 140, at 210–23.

214. Miquelon-Weismann, *supra* note 34, at 338.

215. *See, e.g.*, Bassiouni, *supra* note 136, at 120.

216. Fry, *supra* note 146, at 182.

217. *Id.* Gable makes an unconvincing response to this argument, simply calling the adage absurd for its inapplicability to crimes such as genocide and stressing that it "has outlived its usefulness." Gable, *supra* note 1, at 114.

218. Lentz notes that the rapid pace of the cyberspace's evolution will guarantee that any "workable definition [of cyberterrorism] would quickly grow stale." Lentz, *supra* note 1, at 809–10. He suggests that while large, catastrophic terrorist acts might be easily and universally identifiable, midlevel attacks require some kind of agreement, presumably based on an international consensus, to identify them as "terrorist acts." *Id.*

by the world's more affluent countries, therefore reflecting a limited legal perspective.[219] This kind of political orientation in the actual prosecution of cybercrimes marks an additional concern about the practicality of simply extending jurisdiction beyond territorial borders.

Procedural concerns constitute yet another set of challenges. Even presuming that universal jurisdiction allows for one country to prosecute an identifiable defendant under a clear set of cybercrime statutes, current domestic court structures may not be equipped to handle the unique scope of such cases.[220] A cybercriminal may attack a global network with a virus that can self-replicate and adapt to various computer systems and programs,[221] making the nature and temporal extent of the harm difficult to specify with precision. In the event of such an attack, there may be millions of victims located just within the prosecuting nation's boundaries,[222] not to mention the number of victims that could be affected worldwide on an ongoing basis. Such a vast and complicated case could overwhelm a nation's judicial resources and few procedural mechanisms exist that could effectively control the scope and complexity of these legal actions.[223]

On balance, providing states with universal jurisdiction is impractical as a sole solution to combating cybercrime, though it is an approach that acknowledges many important realities. Gable successfully presents the importance of deterrence in preventing the attacks of would-be cybercriminals and correctly suggests that universal jurisdiction has a role to play in the larger efforts to combat cybercrime.[224]

B. Domestic Adoption of International Statutes

The creation of broad, multinational treaties—premised on traditional notions of territorial sovereignty—provides a less radical solution to dealing with cybercrime on an international level, though the very structure of such an approach threatens to limit its practicability.[225] The Convention on Cybercrime provides a model for this tactic and highlights the

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219. Abu-Odeh, *supra* note 74, at 394. Abu-Odeh suggests that an important concern stems from the application of universal jurisdiction to the Israeli-Palestinian conflict. She predicts that universal jurisdiction would lead to widespread prosecution of "Palestinian Terrorism" but less vociferous prosecution of "Israeli Terrorism" because of Israel's influence with more affluent countries. *Id.*

220. Rho, *supra* note 71, at 715.

221. *Id.*

222. *Id.*

223. *Id.*

224. Gable, *supra* note 1, at 118.

225. *See generally* Miquelon-Weismann, *supra* note 34; Weber, *supra* note 62, *passim*.

important strengths and inherent weaknesses in relying on treaties to address transnational cybercrime.[226]

Multinational treaties can go far in making the initial strides of establishing norms and creating customary international law.[227] Moreover, they can facilitate the domestic internalization of rules among participating states while still allowing each state to retain sovereignty.[228] At the most fundamental level, such treaties (building primarily off of the Cybercrime Convention and UN Security Council resolutions against terrorism and other grave criminal acts) can articulate the existence of state duties to prevent and respond to cybercrime.[229] Without treaties to lead the way on these fronts, nations may struggle to identify the proper avenues through which they can combat cybercrimes that touch so many different jurisdictions and actors.[230]

Yet the value of treaties that rely on domestic legislation is limited to these first normative steps. As discussed in Part I.B, such treaties bind only member parties, who may still exert nonuniform efforts to comply.[231] For example, both Nation A and Nation B might criminalize the same cyberactivity in line with a cybercrime treaty to which they are both members, but they may vary in their approach to computer monitoring measures.[232] Alternatively, Nation A might move rapidly to enact universally agreed upon legal standards but will have the effectiveness of their efforts frustrated by a slower moving legislature in Nation B.[233] Inconsistencies such as these will keep cooperation between member states problematic, particularly with regard to evidence sharing or extradition provisions.[234]

Furthermore, a treaty that is too deferential to the sovereignty of participating states is unlikely to resolve important jurisdictional dilem-

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226. Miquelon-Weismann, *supra* note 34, at 334–35.

227. Weber, *supra* note 62, at 445.

228. *See, e.g.*, Miquelon-Weismann, *supra* note 34, at 340–41.

229. Lentz, *supra* note 1, at 816.

230. Jennifer J. Rho provides one example of the way the United States might fight international cybercrime on its own. She suggests that the Alien Tort Statute, 28 U.S.C. § 1350 (2006), might serve as the legal vehicle to prosecute claims, but concedes that this approach is limited in that it relies either on treaty law or customary international law for standing and generally may not apply for criminal prosecutions. She suggests, ultimately, that the "Convention on Cybercrime's approach may be the best path to take." Rho, *supra* note 71, at 717.

231. Weber, *supra* note 62, at 443–44.

232. Miquelon-Weismann, *supra* note 34, at 340–41.

233. Weber, *supra* note 62, at 428.

234. Lentz, *supra* note 1, at 820–22.

mas.[235] The Convention on Cybercrime, for example, is silent on the proper course of action when more than one country in the treaty has a valid jurisdictional claim over a particular act of cybercrime.[236]

Ultimately, for such treaties to be successful they require universal participation and binding provisions regarding the rules and procedures to which states should adhere in passing their own legislation.[237] However, states would undoubtedly balk at such a powerful treaty and, even if they agreed to sign and ratify it, would undermine the treaty's value through the insertion of numerous reservations that exempted them from the most stringent provisions.[238] A multinational treaty, then, will play an important role in mounting an initial international effort to fighting cybercrime, but it will fail if it relies entirely on domestic action for enforcement.

C. Vesting Jurisdiction in an International Court

The most promising method of preventing and prosecuting cybercrime marries the use of universal jurisdiction and multinational treaties, but goes the extra step of vesting jurisdiction over an international penal code on cybercrime in an international judicial body. By vesting jurisdiction over cybercrime in a court modeled after the ICC, the international community can ensure that the authority of articulating definitions and standards will rest within single entity that can adapt in tandem with this ever-evolving field of crime.

The Convention on Cybercrime, with its efforts to create a short list of universal definitions and its growing list of member parties, provides an important starting point in formulating an international penal code for cybercrime. In her article, "The Council of Europe's Convention on Cybercrime," Amalie M. Weber articulates the values of establishing such a code: "It could be changed more easily as technology develops . . . states could better maintain consistency between their own legislative schemes and the model code [and, finally,] the process of developing such a model code might yield superior solutions to the jurisdictional problems permeating cybercrime legislation."[239] A detailed and specific penal code for cybercrime would also alleviate many of the definitional discrepancies that currently limit effective cooperation between various enforcement agencies and would help web users know more precisely what response their actions are likely to bring from regulators worldwide.[240]

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235. Miquelon-Weismann, *supra* note 34, at 327.
236. *Id.* at 327.
237. Weber, *supra* note 62, at 444.
238. *Id.* at 441.
239. *Id.* at 445.
240. Holland, *supra* note 77, at 32.

An international penal code would require an extraterritorial regulatory power for enforcement and review.[241] Because cyberspace exists without regard to territorial boundaries, universal jurisdiction proponents are correct to view the web as akin to the high seas. Unlike the high seas, though, this is a unique and dynamic realm that requires its own system of legal rules and regulatory processes that can evolve along with the space itself.[242] The potential scope of harm in cyberspace, as mentioned earlier, far exceeds the amount of harm that a single pirate ship might cause on the seas.[243] Thus, tasking individual nations with the duty to regulate cybercrime through universal jurisdiction may fail to address the potentially global implications of a single crime and the potentially competing interests of different states in prosecuting that crime. Moreover, a single state, as discussed earlier, may be overwhelmed by the sheer volume of victims, the complexity of the issues, or other procedural hurdles unique to a major cybercrime.[244]

The structure of the ICC serves as an ideal template for an international court or tribunal holding jurisdiction over cybercrime for at least four compelling reasons. First, the ICC's potential to reach various criminal actors is already internationally (though admittedly not universally) sanctioned. As long as either a cybercriminal or that criminal's victims are citizens of a country that is party to the Rome Statute, the ICC may have jurisdiction over the matter.[245] The international community's landmark creation of the ICC, with its novel jurisdictional scope and structure, suggests that the creation of a similar court focused on cybercrime is not too far-fetched.

Second, a complementarity provision and a focus on only the most serious international crimes, again modeled on the ICC, will ensure that states may continue to exercise jurisdiction over less major cybercrimes or those that only affect domestic actors. An international cybercrime court would exercise jurisdiction over only those cases that affect global classes of victims (those with populations that are enormous, dispersed

241. *Id.* at 9.

242. Holland, *supra* note 77, at 8 (providing an illuminating and comprehensive summary of the views of professors David R. Johnson and David Post, who articulated the unique view of cyberspace as essentially its own territory, and the competing arguments of Jack L. Goldsmith, who challenges their assertions that traditional jurisdictional boundaries are inadequate for effective regulation of cyberspace); *see also* Johnson & Post, *supra* note 193, *passim*.

243. *See supra* Part II.A.

244. *Id.*

245. Chibueze, *supra* note 162, at 187.

across multiple nations, or both), truly heinous crimes or terrorist acts, or even impermissible cyberattacks between states.

Third, an international cybercrime court, much like the Supreme Court in the United States, would have the ability to provide authoritative and final interpretations over the international penal code and thus could quickly adapt the law when necessitated by technological advancements. Should a cybercriminal utilize a new technology to perpetrate a harmful act in an as-yet inconceivable manner, the court would play the critical role of interpreting the international cyber penal laws to evaluate whether the criminal's actions fall within the international community's definitions of illegal conduct. Moreover, the international can be structured to be more liberal with regard to the procedural and privacy rights of defendants than many national court systems,[246] again increasing the likelihood of state participation in an international cybercrime court.

Finally, the rulings of such a court would benefit from the preexisting multinational cybercrime task forces, which will be able to act as the court's otherwise-lacking enforcement mechanism.

The proposal's benefits reveal themselves when considered against a hypothetical situation in which, for example, a cybercriminal, in violation of one of the international cyber penal laws, launches a malicious Trojan Horse through individuals' Facebook accounts. If the cybercriminal was an American, and substantially all of the victims were also Americans, then American courts would exercise jurisdiction over the case. However, in the more likely case that the class of victims contained individuals—including corporations and other organizational groups—from various countries, the international court would exercise jurisdiction over the matter. Multinational law enforcement teams would coordinate the investigation into the precise extent and nature of the harm and would locate, arrest, and detain the criminal. A scenario in which one country accuses another of cyberespionage or a coordinated cyberattack provides a second helpful hypothetical. Before the states escalate to armed conflict, the international court would have the opportunity to rule on whether the actions of the accused nation constituted a violation of the international penal laws and then propose a solution.

Of course, vesting jurisdiction over cybercrime in an international cybercrime court or tribunal would still present a host of challenges. The creation of such a court would surely mirror and perhaps surpass the current hurdles the ICC faces in terms of speed, relevance, and authority

246. Harding, *supra* note 140, at 206. Harding notes that "protective rules [such as double jeopardy] have of course a variable application and resilience at the national level . . . but are increasingly capable of being invoked at the international level." *Id.*

mentioned in Part I.D above. Beyond these initial challenges, implementing this Note's proposal would face at least three specific obstacles. First, states will be hesitant to sacrifice sovereignty to an international body. Some optimists may argue that placing the power to regulate cybercrime in an international court would not necessarily be an extreme act because the regulatory participation of non-state and multi-state entities, in addition to transnational common law-making, may already be blurring the traditional boundaries of jurisdiction.[247] However, giving an international cybercrime court complete regulatory power would be a truly unprecedented shift in international law and will be a hard pill for many sovereign states to swallow. Second, significant efforts would be required to draft both an international penal code and an international treaty creating an international court or tribunal with specific power of review over cybercrimes. As discussed above, the lack of uniformity in cybercrime definitions and the sluggish nature of treaty-making guarantee that producing such documents will be exceptionally difficult. Finally, the new international court will be reliant on independent states to provide enforcement and funding, requiring a mechanism to ensure cooperation between states.[248] Though state enforcement agencies are increasingly working together via multinational taskforces to combat cybercrime, binding them to such efforts may, again, run counter to states' traditional notions of sovereignty.

Still, there is ample support for the belief that a specialized cybercrime court could serve as the most effective answer to cybercrime. The United States may have already blazed the trail in recent years by creating federal courts with specialized jurisdiction, most notably the United State Court of Appeals for the Federal Circuit, which holds exclusive appellate review over almost all patent cases in country.[249] Congress created the Federal Circuit and granted it review over the nation's patent appeals in large part to harmonize the widely divergent approaches to patent law that had evolved in different regions of the United States.[250] By allowing a court to specialize in one area of the law, particularly one that is based on complex and predominantly nonlegal underlying concepts, its judges

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247. Paul Schiff Berman, *The Globalization of Jurisdiction*, 151 U. PA. L. REV. 311, 534–35 (2002).

248. Weber, *supra* note 62, at 445.

249. RICHARD A. POSNER, THE FEDERAL COURTS: CHALLENGE AND REFORM 6 (1996). Additional specialized courts in the United States include, among others, the Court of International Trade, the United States Tax Court, and the United States Court of Military Appeals. 13 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 3508 (3d ed. Supp. 2011).

250. POSNER, *supra* note 249, at 252–53.

can develop an expertise that will be more likely to result in consistent and practical rulings.[251] The success of the Federal Circuit in promulgating a consistent judicial gloss for patent law is likely to be repeated by a cybercrime court. The probable emergence, and then prominence, of "technocratic" judges[252] on a cybercrime court may also alleviate concerns about the courts' inherent biases toward one kind of legal system or set of policies,[253] reduce the chances that judges with no technical savvy will permit overly intrusive search and seizure practices, and perhaps even position it to hear civil cases[254] in addition to criminal.

The ever-evolving and growing threat of cybercrime may serve as a catalyst that pushes the international community to break away from its traditional hesitancy to sacrifice state sovereignty to international organizations. Conceivably, a truly global cyberattack of unprecedented, but plausibly catastrophic, proportions could usher in a rapid global response that could result in an international cybercrime court gaining jurisdiction over an international cyber penal code. States should act responsibly to take decisive action on this issue before such a cyberattack occurs.

CONCLUSION

Cybercrime is a new and rapidly evolving form of crime that is uniquely suited to international regulation and multinational enforcement. Though universal jurisdiction and treaty-based approaches may be effective in combating cybercriminals to a certain extent, such efforts

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251. Edward K. Cheng, *The Myth of the Generalist Judge*, 61 STAN. L. REV. 519, 549 (2008).

252. In his article exploring the policy-making role of ICC judges, Jared Wessel notes, specifically within the realm of humanitarian law, that "the line between the administrative technocrat and the public international legal mind becomes blurred, if not irrelevant" because of the role technocratic bodies have played in addressing global political issues like terrorism. Jared Wessel, *Judicial Policy-Making at the International Criminal Court: An Institutional Guide to Analyzing International Adjudication*, 44 COLUM. J. TRANSNAT'L L. 377, 439–40 (2006).

253. Such biases in international courts may derive from the nationality of judges, their personal philosophical approach to the role of international adjudicatory bodies, or from the political realities that stem from their court's reliance on the cooperation and support of the sovereign governments they may be presiding over. *See* Jacob Katz Cogan, *International Criminal Courts and Fair Trials: Difficulties and Prospects*, 27 YALE J. INT'L L. 111, 115, 135–36 (2002).

254. While this Note is focused primarily on criminal law, Moritz Keller provides an interesting analysis of the role the International Court of Justice can play in handling Internet-based civil cases, with a particular focus on international e-commerce laws. *See generally* Moritz Keller, *Lessons for The Hague: Internet Jurisdiction in Contract and Tort Cases in the European Community and the United States*, 23 J. MARSHALL J. COMPUTER & INFO. L. 1 (2004).

will be most effective in the context of establishing an international cybercrime penal code and vesting jurisdiction over that body of law in an international cybercrime court. While this solution admittedly faces daunting challenges, the preexisting and growing presence of multinational taskforces lends an enforcement mechanism that has heretofore been absent in most international courts—an exception to the norm that makes placing authority in a new international court at once more feasible and, therefore, potentially objectionable to sovereign states. Anything short of this level of action, however, will continue to leave the world in an ever-more precarious position in which cybercriminals threaten to harm individuals, cripple global economies, and disable entire nations.

Nicholas W. Cade[*]

* B.A., Colby College (2008); M.S.T., Pace University (2010); J.D., Brooklyn Law School (expected 2013); Editor-in-Chief, *Brooklyn Journal of International Law* (2012–2013). I owe a special tribute to all of the teachers and professors who played a role in my education and personal growth; whether directly or indirectly, they have each made profound contributions to this Note. I would also like to thank the staff of the *Brooklyn Journal of International Law* for their assistance in preparing this Note for publication. Finally, for her unwavering faith and unending support, I dedicate this Note to Christina Evriviades. All errors or omissions are my own.

THE WESTERN CLIMATE INITIATIVE: THE FATE OF AN EXPERIMENT IN SUBNATIONAL CROSS-BORDER ENVIRONMENTAL COLLABORATION

Alexander Kazazis

PREVENTING SPARKS IN SMOLDERING ASHES: USING SWEDEN'S INTERNET LAW TO COMBAT INCENDIARY SPEECH IN THE SCANDINAVIAN ONLINE COMMUNITY

> And the people under the sky were also very much the same—everywhere, all over the world, hundreds or thousands of millions of people just like this, people ignorant of one another's existence, held apart by walls of hatred and lies, and yet almost exactly the same—people who had never learned to think but were storing up in their hearts and bellies and muscles the power that would one day overturn the world.[1]

INTRODUCTION

On July 22, 2011, Anders Behring Breivik, a thirty-two-year-old Norwegian man, confessed to carrying out a violent rampage that left seventy-seven of his countrymen dead.[2] Before surrendering to police, Breivik detonated a bomb in central Oslo, and then traveled to a political youth camp on the island of Utøya, where he, dressed as a police officer, used a machine gun to shoot sixty-nine campers, many of them young members of Norway's Labor Party.[3] Within hours, a portrait of the killer emerged: "[T]he man behind the worst attack on Norway since the second world war . . . [was] a Christian fundamentalist with a deep hatred of multiculturalism, of the left and of Muslims, who had written disparagingly of prominent Norwegian politicians."[4]

In the wake of Breivik's attacks, Norwegian Prime Minister Jens Stoltenberg urged his countrymen to reflect on "what we have thought, said and written," and that, "We all have something to learn from the trag-

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1. GEORGE ORWELL, 1984, at 181 (1949).

2. Malin Rising & Bjoern H. Amland, *Anders Behring Breivik, Norway Killer, Remains in Detention*, HUFFINGTON POST (Sept. 19, 2011), http://www.huffingtonpost.com/2011/09/19/anders-behring-breivik-detention_n_969900.html.

3. *Id.*; *see also Terrorofrene på Utøya og i Oslo* [*The Terrorist Attacks on Utøya Island and Oslo*], VG NETT, http://www.vg.no/nyheter/innenriks/oslobomben/ofre/ (last visited Feb. 2, 2012).

4. Peter Beaumont, *Anders Behring Breivik: Profile of a Mass Murderer*, GUARDIAN (July 23, 2011), http://www.guardian.co.uk/world/2011/jul/23/anders-behring-breivik-norway-attacks.

edy."[5] Meanwhile, Erik Hellsborn, a member of the anti-immigrant Sweden Democrats party, blogged, "In a Norwegian Norway this tragedy would never have happened . . . . This was caused by multiculturalism."[6] In fact, Breivik left behind a 1500-page manifesto, in which he calls for an end to "the multiculturalist regime of Norway."[7] Moreover, a week before his attacks, Breivik registered a Twitter account and sent off a single tweet: "One person with a belief is equal to the force of 100,000 who have only interests."[8]

With the proliferation of right-wing, anti-immigrant political parties in Scandinavia[9]—specifically the Sweden Democrats,[10] Norway's Progress Party,[11] and the Danish People's Party[12]—the personal statements by

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5. Tony Paterson & Charlotte Sundberg, *Norway's Premier Urges a New Tone in Public Debate*, INDEP. (Aug. 2, 2011), http://www.independent.co.uk/news/world/europe/norways-premier-urges-a-new-tone-in-public-debate-2330216.html.

6. Mark Townsend & Ian Traynor, *In Focus: How the far right's web of influence created a killer*, OBSERVER (July 31, 2011), http://www.guardian.co.uk/world/2011/jul/30/norway-attacks-anders-behring-breivik.

7. *Norway shooting: quotes from Anders Behring Breivik's online manifesto*, TELEGRAPH (Aug. 19, 2011), http://www.telegraph.co.uk/news/worldnews/europe/norway/8657727/Norway-shooting-quotes-from-Anders-Behring-Breiviks-online-manifesto.html. In his manifesto, Breivik takes on the pseudonym of Andrew Berwick, and claims the title of "Justiciar Knight Commander for Knights Templar Europe and one of several leaders of the National and pan-European Patriotic Resistance Movement." *Id.*

8. Beaumont, *supra* note 4.

9. While some colloquially refer to Scandinavia as including Iceland and Finland, traditionally Scandinavia includes only Norway, Sweden, and Denmark. *Scandinavia*, BRITANNICA ONLINE ENCYCLOPÆDIA (Nov. 3, 2011), http://www.britannica.com/EBchecked/topic/526461/Scandinavia. For the purposes of this Note, I will refer to Scandinavia as only including Norway, Sweden, and Denmark.

10. The Sweden Democrats Party was formed in 1988, as an offspring of the Sweden Party and the Keep Sweden Swedish party. *Vårt parti* [*Our Party*], SVERIGEDEMOKRATERNA.SE, http://sverigedemokraterna.se/vart-parti/ (last visited June 8, 2012); *see infra* text accompanying note 44.

11. Norway's Progress Party was formed in 1973 in response to increased social welfare programs. Tor Bjørklund & Jørgen Goul Andersen, *Anti-Immigration Parties in Denmark and Norway*, *in* SHADOWS OVER EUROPE 107, 108 (Martin Schain, Aristide Zolberg & Patrick Hossay eds., 2002). Coinciding with a spike in asylum-seekers in the 1980s, the Progress Party shifted from its anti-tax platform to immigration reform. *Id.* at 113; ELIZABETH CARTER, THE EXTREME RIGHT IN WESTERN EUROPE 31–32 (2005) ("Immigration has also become the most important policy area for the Danish and Norwegian right-wing extremist parties in more recent years.").

12. The Danish People's Party was formed in 1995 as faction of the Danish Progress Party and eventually as its successor when the Progress Party collapsed in 1998. Bjørklund & Andersen, *supra* note 11, at 107. With its initial anti-tax platform, the Danish

party members have been characterized by the media and civic society groups as fostering extremism and, in some cases, inciting violence and hatred.[13] Officially these political parties focus on issues stemming from mass immigration and asylum grants, including increased drugs and crime rates, welfare costs, and cultural clashes such as female genital mutilation, forced marriage, and radicalization.[14] However, a significant anti-multicultural blogosphere is growing, in which hate and violence are celebrated and encouraged.[15]

This Note argues that the Swedish legislature should enforce their hate speech legislation against illegal online activity. In particular, the Swedish government should require Internet Service Providers ("ISPs") to filter content that constitutes hate speech, including all content traveling through their telecommunications systems infrastructure. In the wake of these tragic events, all the Scandinavian countries need to confront the threat of hate speech with open eyes. Given its geographic location and the technological infrastructure of the surrounding countries, the Swedish government is in a key position to address the threat of incendiary speech. Because hate speech is particularly pernicious, increased regulation is necessary in order to uphold the cultural values of Scandinavian society.

This Note explores the limits of freedom of speech in the online community and the extent of the law in controlling these forums, in reference to the outpouring of radical right-wing bloggers in Scandinavia and the anti-immigration platforms they promulgate. Part I of this Note provides background information on the current political climate in Scandinavia, paying particular attention to Norway and Sweden, and discusses existing instruments of international law. Part II illustrates the shortcomings of current legislation in Scandinavia, using Breivik's manifesto as a lens through which to examine the proliferation of hate speech in Scandinavia. Part III proposes a multilateral approach to bridge the gap in the law between hate speech legislation and online enforcement, and provides the rationale for curbing freedom of expression in certain online forums.

Progress Party inspired the formation of the Norwegian Progress Party and witnessed a similar shift in platform in response to increased immigration in the mid-1980s. *Id.* at 113. Political scientists have characterized both the Danish People's Party and the Norwegian Progress Party as right-wing extremist parties whose racist platforms are "of the culturist kind." CARTER, *supra* note 11, at 39 (citing Andreas Widfeldt, *Scandinavia: Mixed Success for the Populist Right*, 53 PARLIAMENTARY AFF. 486, 491 (2000)).

13. Nicholas Kulish, *Norway Attacks Put Spotlight on Rise of Right-Wing Sentiment in Europe*, N.Y. TIMES (July 24, 2011), http://www.nytimes.com/2011/07/24/world/europe/24europe.html?pagewanted=all.

14. Townsend & Traynor, *supra* note 6.

15. *Id.*

I. BACKGROUND

A. The Changing Makeup of the Land

Immigration has effectively addressed two problems facing the European labor market: a smaller workforce caused by a lower birthrate and an aging population across Europe, and a need to fill jobs that Europeans are not willing to perform at the going rate.[16] As a result of generous asylum laws and an even more generous welfare system,[17] Sweden's foreign-born population rate reached 13.4% in 2007.[18] Similarly, Norway's foreign-born population has reached 10%.[19] Because many of these immigrants are willing to work at a lower wage than native Europeans, they represent a stabilizing force in the labor economy.[20]

However, their presence does not come without controversy. In fact, current sentiment across Europe is that there are simultaneously too many and too few people, or as one scholar put it, Europe is plagued with "demographic bulimia."[21] Many native Europeans protest the lowered wages and increased unemployment within the native population that

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16. CHRISTOPHER CALDWELL, REFLECTIONS ON THE REVOLUTION IN EUROPE 34, 39 (2009). As Christopher Caldwell writes, "Today Europe's population is aging, its support ratio is shrinking and due to falling birthrates, there is no sufficiently large 'next generation' of workers to restore it to balance." *Id.* at 39. In fact, according to a study by the United Nations, Europe needs an annual net immigration of 1.4 million people per year in order to meet its labor requirements. Herbert Brücker, Joachim R. Frick & Gert G. Wagner, *Economic Consequences of Immigration in Europe*, *in* IMMIGRATION AND THE TRANSFORMATION OF EUROPE 111, 136 (Craig A. Parson & Timothy M. Smeeding eds., 2006) [hereinafter IMMIGRATION]. For example, in Sweden, the fertility rate between 2000 and 2005 was 1.64 births per 1,000 people, and in 2003, the natural population growth was 0.7%. *Id.* at 12 tbl.1.4 (citing data from United Nations). To put this figure in perspective, the United States had a total fertility rate of 2.04. *Id.* at 3 tbl.1.1 (citing data from Eurostat).

17. Georg Menz, *"Useful" Gastarbeiter, burdensome asylum seekers, and the second wave of welfare retrenchment: Exploring the nexus between migration and the welfare state*, *in* IMMIGRATION, *supra* note 16, at 407–10.

18. *Country Statistical Profile: Sweden 2010*, OECD iLIBRARY, http://www.oecd-ilibrary.org/economics/country-statistical-profile-sweden-2010_20752288-2010-table-swe;jsessionid=mqsh595d1ixh.delta (last updated May 27, 2010).

19. *Norway—Breivik Attacks*, N.Y. TIMES, http://topics.nytimes.com/topics/reference/timestopics/people/b/anders_behring_breivik/index.html (last updated Mar. 7, 2012) ("Immigration has skyrocketed by a factor of five since the early 1970s—more than 10 percent of Norway's population is of foreign origin. In recent years, the biggest groups of asylum seekers have come from Afghanistan, Iraq, Somalia and Eritrea.").

20. Brücker, Frick & Wagner, *supra* note 16, at 112.

21. CALDWELL, *supra* note 16, at 39–41 (quoting HANS MAGNUS ENZENBERGER, DIE GROßE WANDERUNG 31 (1992)).

accompany increases in immigration.[22] Given the strong welfare programs in the Scandinavian countries, immigrants are also characterized as a "welfare drain."[23] Moreover, just because a country is diverse does not mean its society is integrated. In fact, Sweden has been called "the country with the most intractable segregation."[24]

But cultural differences and economics are not the only factors that fuel anti-immigration sentiment. Remarkably, in 2003, 69% of all Europeans surveyed believed that "immigrants make crime 'worse.'"[25] However, this belief has been characterized as inaccurate,[26] and in 2011, the

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22. Brücker, Frick & Wagner, *supra* note 16, at 112. "Unemployment has also frequently been linked to hostility against immigrants. It has been suggested that marginalized groups, not least the unemployed, are particularly inclined to blame immigrants themselves for their problems." Bjørklund & Andersen, *supra* note 11, at 116–17.

23. In part, economic concerns over the "welfare drain" are not unfounded: there is a noticeable difference in employment rates between Swedish and non-Swedish citizens, with 78% of Swedish males and 74.2% of females working versus only 63.1% and 60.3% of their non-Swedish counterparts, respectively. Menz, *supra* note 16, at 407–10. This difference is even starker when you isolate the non-European migrants in Sweden, who have an overall employment rate of only 55%. *Id.* In a country whose generous welfare system is based on a social contract that involves labor contribution, these differences do not go unnoticed. *Id.* This said, the fact that the majority of immigrants coming to Norway and Sweden are asylum seekers—many of whom are coming from countries with civil unrest—can also provide clarity in the discrepancies in employment rates. Amanda Billner, *Regeringen vill jämna ut jobbklyfta*, DAGENS NYHETER (May 30, 2011, 6:38 PM), http://www.dn.se/nyheter/politik/regeringen-vill-jamna-ut-jobbklyfta.

24. CALDWELL, *supra* note 16, at 246. Cultural differences have become intensified by the current segregation. *Id.* According to the Pew Forum on Religion & Public Life, the estimated Muslim population in Sweden in 2010 is 451,000, or 4.9% of the country's population of 9.4 million. *The Future of the Global Muslim Population*, PEW FORUM ON RELIGION & PUB. LIFE (Jan. 2011), http://pewforum.org/future-of-the-global-muslim-population-regional-europe.aspx#ftn39_rtn; *see also* SWEDEN.SE, www.sweden.se (last visited Apr. 24, 2012). Similarly, Norway's Muslim population is 144,000, or 3.0% of their population of 4.9 million, and 12.2% of their population is foreign-born. *Id.* Steven Erlanger & Michael Schwirtz, *In Norway, Consensus Cuts 2 Ways*, N.Y. TIMES (July 29, 2011), http://www.nytimes.com/2011/07/29/world/europe/29norway.html?pagewanted=all; *Norway After Terrorism: Flowers for Freedom*, ECON. (July 30, 2011), http://www.economist.com/node/21524852.

25. Jack Citrin & John Sides, *European Immigration in the People's Court*, *in* IMMIGRATION, *supra* note 16, at 327, 334 (citing 2002–2003 European Social Survey).

26. *Hur många av dem som begår brott är invandrare?* [*How Many of Those Who Commit Crime Are Immigrants?*], BROTTSFÖREBYGGANDE RÅDET (Feb. 8, 2006), http://www.bra.se/extra/pod/?action=pod_show&id=85&module_instance=15; *see also* MICHELLE HALE WILLIAMS, THE IMPACT OF RADICAL RIGHT-WING PARTIES IN WEST EUROPEAN DEMOCRACIES 63 (2006) ("The lack of a direct correlation on the socioeconomic variables supports the argument that backing for radical right-wing parties has less to do with real conditions in European societies and more to do with perceived circumstances.").

Swedish government published an article rebuffing common "myths" about immigration.[27]

B. Proliferation of Political Parties Opposing Immigration

As this "demographic bulimia" becomes epidemic, Europe has experienced a wave of public opinion opposing immigration and multiculturalism.[28] In particular, prominent political parties have embraced these sentiments, imbued them into their platforms, and now wield significant force in the Scandinavian political arena.[29] The Sweden Democrats, Norway's Progress Party, and the Danish People's Party all hold seats in their respective parliamentary bodies.[30] In fact, at the time of Breivik's attacks, the Progress Party was the second-largest party in Norway.[31] Similarly, the Sweden Democrats currently hold twenty seats out of a total of 349 in the parliamentary body, the Riksdag,[32] and the People's

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27. *Vanliga nätmyter om invandrare och minoriteter* [*Common Myths about Immigrants and Minorities*], REGERINGSKANSLIET (Nov. 30, 2011), http://www.regeringen.se/sb/d/2279/a/181576.

28. Ross Douthat, *A Right-Wing Monster*, N.Y. TIMES (July 25, 2011), http://www.nytimes.com/2011/07/25/opinion/25douthat.html. "Mass immigration really has left the Continent more divided than enriched, Islam and liberal democracy have not yet proven natural bedfellows and the dream of a postnational, postpatriotic European Union governed by a benevolent ruling elite looks more like a folly every day." *Id.*

29. Bjørklund & Andersen, *supra* note 11, at 112.

30. *See infra* notes 31–33.

31. Erlanger & Schwirtz, *supra* note 24. In the election held just seven weeks after Breivik's attacks, the Progress Party was displaced by the Conservative Party for the second seat. *Norway: Losses for the Right Wing*, ASSOCIATED PRESS (Sept. 14, 2011), http://www.nytimes.com/2011/09/14/world/europe/norway-losses-for-the-right-wing.html. With the Labor Party winning 33.2% of the vote, the Progress Party decreased from 18.5% of the vote in 2007, to 11.8% of the vote on September 14, 2011. *Id.* The Norwegian government has a 165-member legislative body called the *Storting*, whose members are elected through a direct proportional vote. Patrick Hossay, *Country Profiles*, *in* SHADOWS OVER EUROPE, *supra* note 11, at 322.

32. *Election 2010*, RIKSDAG, http://www.riksdagen.se/templates/R_Page____775.aspx (last updated Sept. 20, 2010). The Swedish government is comprised of a unicameral legislature, called the Riksdag, whose members are directly elected by the people through a proportional representation system. Hossay, *supra* note 31, at 339–40. The elections are held among Sweden's twenty-nine regional electoral constituencies, and in order to gain seats in the Riksdag, a political party must surpass the four percent threshold of the national vote, or obtain 12% of the vote in any regional constituency. *Id.*; SWEDISH INST., FACTS ABOUT SWEDEN: GOVERNMENT 2 (Apr. 2011), *available at* http://www.sweden.se/upload/Sweden_se/english/factsheets/SI/SI_FS55z_The_Swedish_System_of_Government/FS21-The-Swedish-system-of-government-low-resolution.pdf; *see also* CARTER, *supra* note 11, at 149, 150 tbl.5.1.

Party holds twenty-four seats of a total 179 in the Danish Folketing.[33] In order to garner more widespread support and political legitimacy, radical right-wing parties purify their rhetoric to conform to the limits of mainstream politics.[34] The official platforms of these parties are often limited to carefully constructed discourse emphasizing the impact of immigration.[35] Funneling issues such as unemployment, education disparity, crime, and diminishing social values into a single platform, these parties argue that an end to immigration will solve many of the country's socioeconomic concerns.[36]

However, the members—and in many cases, even the leaders—of these political parties have expressed individual opinions that do not disguise their anti-Muslim and anti-immigration, and often racist and xenophobic, thoughts.[37] They have crossed the line of acceptable political

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33. *Who's who in the Folketing and the government*, FOLKETINGET (Mar. 14, 2011), http://www.thedanishparliament.dk/Publications/Who%20is%20who%20in%20the%20Folketing%20and%20the%20government.aspx. The Danish government is comprised of a unicameral legislature, called the Folketing, whose members are elected through a complicated proportional representation system. Hossay, *supra* note 31, at 332, 340. In order to gain seats in the Folketing, a political party must cross a threshold of two percent of the national vote. *Id.*

34. Martin Schain, Aristide Zolberg & Patrick Hossay, *Democracy in Peril?*, *in* SHADOWS OVER EUROPE, *supra* note 11, at 301, 312 [hereinafter Schain et al., *Democracy in Peril?*]. This can be a methodical process:

> As the extreme right cleans up its image to gain electoral credibility and support, it is likely to (1) moderate its rhetoric and program toward a populist but less atavistic alternative; (2) be a more appealing partner to the center right; and (3) inspire additional efforts by more centrist politicians to usurp the populist-nationalist mantle.

Id. at 312.

35. SHADOWS OVER EUROPE, *supra* note 11, at 60.

> The genius or madness of the radical right wing appears to be their innovation at creating a climate of fear upon which their omnibus issue, immigration feeds . . . . Skillfully, they spin the issue to show how governments refuse to address it, placing themselves in the vacuum holding solutions: the radical right wing to the rescue.

Id.

36. WILLIAMS, *supra* note 26, at 60.

37. Furthermore, xenophobic speech has so permeated political discourse that it is now accepted as part of the anti-immigration platform. Bjørklund & Andersen, *supra* note 11, at 112. For instance, in 1997, Thomas Behnke, a member of the Danish Progress Party, suggested that Somalian refugees be repatriated "by parachute." *Id.* at 114. The Danish People's Party is even more extreme in its view of nationalism, specifically that welfare should be limited to Danish citizens and that multiethnicity is "a threat to national culture." *Id.* While these sentiments are not examples of hate speech that must be limited

speech in their public appearances or in writing on their personal blogs. "The climate of fear surrounding immigration appears to have come about as a result of radical right-wing posturing. Fears have been inflated beyond what the realities of conditions ought to produce."[38] Pia Kjaersgaard, the leader of the Danish People's Party, described the arrival of "thousands of persons who apparently civilisationally [sic], culturally and spiritually live in the year 1005 instead of 2005."[39] In 2009, Siv Jensen, the leader of the Progress Party, used the phrase "stealth Islamization" to refer to efforts at multiculturalism,[40] and stated "we must put a stop to that."[41] Moreover, in May 2011, Christian Tybring-Gjedde, the head of the Oslo branch of the Progress Party, characterized Muslims as by nature more aggressive than Norwegians.[42] Tybring-Gjedde has likened Muslim parents dressing their children in a hijab to dressing them in a Ku Klux Klan robe.[43]

In the context of the proliferation of hate speech by right-wing extremist parties, the historical background of these groups is relevant to the study. While native Scandinavians might be reluctant to admit it, xenophobic sentiment is not a new phenomenon stemming from increased immigration and multiculturalism in their region.[44] Scrutiny reveals that

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by the law, they are indicative of the direction that politics are moving and are noteworthy.

38. WILLIAMS, *supra* note 26, at 61.

39. *The Growth of Islamophobia: Can Careless Talk Cost Lives?*, ECON. (July 30, 2011), http://www.economist.com/node/21524862.

40. Erlanger & Schwirtz, *supra* note 24.

41. Shoaib Sultan, *The Muslims of Norway*, FOREIGN AFF. (July 26, 2011), http://www.foreignaffairs.com/articles/67995/shoaib-sultan/the-muslims-of-norway.

42. Erlanger & Schwirtz, *supra* note 24.

43. *Frp-politiker sammenligner hijab med Ku Klux Klan* [*Progress Party Politician Likens Hijab with KKK*], VG NETT (Mar. 3, 2011, 7:31 AM), http://www.vg.no/nyheter/innenriks/norsk-politikk/artikkel.php?artid=593810. Significantly, the incendiary speech that Breivik cited was not just limited to one side of the Atlantic. Breivik also quoted the American blogger Pamela Geller, who has written on her blog *Atlas Shrugs* that, "The Muslims have taken to rampaging, destroying and setting alight the streets of France." Tim Lister, *Suspect Admired Bloggers Who Believe Europe is Drowning in Muslims*, CNN WIRE (July 27, 2011), http://articles.cnn.com/2011-07-27/world/norway.terror.web_1_islamic-muslims-atlas-shrugs?_s=PM:WORLD. Following the attacks, Geller dismissed any responsibility: "If anyone incited him to violence, it was Islamic supremacists. If anything incited him to violence, it was the Euro-Med policy." *Id.* Jeffrey Goldberg criticized Geller's dismissal: "Free speech means free speech. But she should be aware now that violent people look to her for guidance, and she should write with that in mind." *Id.*

44. Townsend & Traynor, *supra* note 6. In fact, the Sweden Democrats party has their roots in a fascist party and had connections with neo-Nazi party members. *Id.*; *see also* Kulish, *supra* note 13. Moreover, the Sweden Democrats have until recently used the

the proliferation of these parties is simply a reshaping of old xenophobic sentiment that became socially unacceptable after World War II.[45]

> The universal delegitimation of right wing ideology brought on by the identification of World War II as a war against fascism . . . as well as the prohibition against blatantly xenophobic rhetoric that emerged as the reality of the Holocaust became public, ensured that right-wing extremists would have a very hard reception in public opinion. This "time in the catacombs," as the Belgian extreme right refers to the three decades following the war, did not mark the end of an ideology; but it did mark its exclusion from polite, public conversation and thus its exclusion from the political scene.[46]

Others might say the proliferation is a response to the perceived threats to deeply-rooted nationalism.[47] For example, one cultural anthropologist characterizes Norwegians as having a "quiet nationalism."[48] This said, "[T]here are some unexamined ugly features of Norwegian nationalism that have to do with ethnic nationalism, a feeling of specialness, an element of racism. Non-ethnic Norwegians are visible and seen as out of place."[49]

Breivik's attacks were not isolated incidents of violence stemming from xenophobic sentiment in Scandinavia. In 1995, the fatal stabbing of a refugee from the Ivory Coast by a sixteen-year-old Swedish neo-Nazi brought racially-motivated violence to the nation's forefront.[50] In a 2002 study by the Expo Foundation,[51] a Swedish Security Police analyst re-

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tagline "Keep Sweden Swedish." Øyvind Strømmen, *Violent "Counter-Jihadism,"* FOREIGN AFF. (July 27, 2011), http://www.foreignaffairs.com/articles/67999/oyvind-strommen/violent-counter-jihadism. Similarly, the Norwegian Progress Party was founded by Anders Lange, an anti-communist who supported the South African apartheid regime. *Id.*

45. Martin Schain, Aristide Zolberg & Patrick Hossay, *The Development of Radical Right Parties in Western Europe*, *in* SHADOWS OVER EUROPE, *supra* note 11, at 3 ("Indeed, parties supporting ideologies that had been relegated to the lunatic fringe in the postwar period have now established a significant and enduring presence in most Western European states.").

46. Schain et al., *Democracy in Peril?*, *supra* note 34, at 304.

47. Erlanger & Schwirtz, *supra* note 24.

48. *Id.* (quoting Thomas Hylland Eriksen, a cultural anthropologist at the University of Oslo who studies efforts at multiculturalism).

49. *Id.* (quoting Thomas Hylland Eriksen).

50. Per-Ola Ohlsson, *Kand nazist tog sitt liv* [*Famous Nazi Took His Own Life*], AFTONBLADET (May 2, 2001), http://www.aftonbladet.se/nyheter/article10208972.ab.

51. Stieg Larsson, *A Study on Racially Motivated Crime and Violence*, EXPO (Sept. 2002), expo.se/www/download/final_sweden_racialviolence_raxen3.pdf. Before he became the internationally acclaimed author of the Millenium triology, Larsson was a well-known journalist and the founder of the Expo Foundation. *Stieg Larsson, 1954-2004*,

ported a considerable increase in hate crime and racial violence in Sweden from 1997 to 2001.[52] In 2009, the Swedish Security Police released an additional study, finding violent extremists to pose a significant threat to national security.[53] Similarly, in February 2011, the Norwegian Police Security Force published a risk analysis study concluding that right-wing extremists posed "no serious threat," but that "a higher level of activity of some anti-Islamic groups" exists, with a greater concentration on social media websites.[54] In the wake of the murder of a young boy of Ghanaian descent by a neo-Nazi gang, the Norwegian government actively engaged in an anti-Nazi campaign.[55] However, while this campaign has resulted in the significant crumbling of neo-Nazi groups in Norway, it has not dissipated the widespread xenophobic opinion in the online world.[56]

C. Instruments of International Law

Sweden, Denmark, and Norway are all members of the United Nations[57] and founding members of the Council of Europe.[58] Sweden and Denmark are both member states of the European Union ("EU"), and thus subject to EU treaties, conventions, and directives.[59] While not an

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EXPO, http://expo.se/2010/stieg-larsson-1954-2004_3515.html (last visited Feb. 2, 2012). The Expo Foundation was founded to "counteract the growth of the extreme right and the white power-culture in schools and among young people." *Id.*

52. MIKAEL JOHANSSON, BROTTSLIGHET KOPPLAD TILL RIKETS INRE SAKERHET 2001: RAPPORT FRÅN SÄKERHETSPOLISEN [CRIME LINKED TO NATIONAL SECURITY 2001: SÄKERHETSPOLISEN REPORT] (2001), *available at* http://www.sakerhetspolisen.se/download/18.7671d7bb110e3dcb1fd80009984/pmv2001.pdf. The report noted that reported crimes increased from 1,752 in 1997 to 2,670 in 2001. *Id.* at 21.

53. SÄKERHETSPOLISEN & BROTTSFÖREBYGGANDE RÅDET, RAPPORT 2009: 15: VÅLDSAM POLITISK EXTREMISM [REPORT 2009: VIOLENT POLITICAL EXTREMISM] 42 (2009), *available at* http://www.sakerhetspolisen.se/download/18.5bf42a901201f330faf80002541/valdsampolitiskextremism.pdf.

54. Strømmen, *supra* note 44.

55. *Id.*

56. *Id.* In the 2009 election, only 362 votes were cast in favor of the two remaining neo-Nazi parties in Norway. *Id.*

57. *Member States of the United Nations*, UNITED NATIONS (July 3, 2006), http://www.un.org/en/members/index.shtml.

58. *Council of Europe in Brief: 47 Countries, One Europe*, COUNCIL OF EUROPE, http://www.coe.int/aboutcoe/index.asp?page=47pays1europe&l=en (last visited Feb. 2, 2012).

59. *Countries*, EUROPA, http://europa.eu/about-eu/countries/index_en.htm (last visited Feb. 2, 2012).

EU member state, Norway is part of Europe and cooperates closely with the EU, electing to participate in many EU initiatives.[60] The relevant international instruments controlling hate speech in Scandinavia include the European Convention on Human Rights,[61] the International Covenant on Civil and Political Rights,[62] the International Convention on the Elimination of All Forms of Racial Discrimination,[63] and the Additional Protocol to the Convention on Cybercrime Concerning the Criminalisation of Acts of a Racist and Xenophobic Nature Committed Through Computer Systems.[64] Sweden, Norway, and Denmark are signatories to each of these instruments.[65]

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60. *About Norway: The European Union (EU)*, NORWAY, http://www.norway.org/aboutnorway/government-and-policy/europe/policy/ (last visited Feb. 2, 2012). Norway is a member of the European Economic Area ("EEA"), in the context of being a member of European Free Trade Association ("EFTA"), or the EU internal market member. *Id.* Norway is also a member of Europol. *Id.*

61. Promulgated by the Council of Europe, the European Convention on Human Rights and Fundamental Freedom was enacted in 1950, in consideration of the 1948 Universal Declaration of Human Rights. Ivan Hare, *Extreme Speech Under International and Regional Human Rights Standards*, *in* EXTREME SPEECH AND DEMOCRACY 62, 65–66 (Ivan Hare & James Weinstein eds., 2009) [hereinafter EXTREME SPEECH].

62. Adopted by the United Nations in 1966 and ratified in 1976, the International Covenant on Civil and Political Rights requires state parties to protect a set of civil and political rights, and establishes a forum, the Human Rights Committee, to hear alleged violations of these rights. International Covenant on Civil and Political Rights, Dec. 19, 1966, 999 U.N.T.S. 171 [hereinafter ICCPR]; *see also* Hare, *supra* note 61, at 63–64.

63. Adopted by the United Nations in 1965 and ratified in 1969, the International Convention on the Elimination of All Forms of Racial Discrimination seeks to "prevent and combat racist doctrines and practices in order to promote understanding between races and to build an international community free from all forms of racial segregation and racial discrimination." International Convention on the Elimination of All Forms of Racial Discrimination, Jan. 4, 1969, 660 U.N.T.S. 195.

64. Adopted in 2003 and entered into force in 2006, the Additional Protocol to the Convention on Cybercrime, Concerning the Criminalisation of Acts of Racist and Xenophobic Nature Through Computer Systems seeks to "harmonise substantive law provisions concerning the fight against racist and xenophobic propaganda" and acknowledges that "computer systems offer an unprecedented means of facilitating freedom of expression and communication around the globe." Additional Protocol to the Convention on Cybercrime Concerning the Criminalization of Acts of a Racist and Xenophobic Nature Committed through Computer Systems, Jan. 28, 2003, E.T.S. No. 189 [hereinafter Additional Protocol to the Convention on Cybercrime], *available at* http://conventions.coe.int/Treaty/en/Treaties/html/189.htm.

65. *Status of Treaties: ECHR*, COUNCIL OF EUROPE TREATY OFF., http://conventions.coe.int/Treaty/Commun/ListeTableauCourt.asp?MA=3&CM=16&CL=ENG (last visited May 22, 2012); *Status of Treaties: ICERD*, U.N. TREATY COLLECTION, http://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=IV-2&chapter=4&lang=en (last visited Mar. 29, 2012); *Status of Treaties: ICCPR*, U.N. TREATY COLLECTION,

The European Convention on Human Rights ("ECHR") protects freedom of expression, but also recognizes the government's power to interfere with this right.[66] Article 10 of the ECHR provides that, "Everyone has the right to freedom of expression."[67] However, this right may be limited:

> in the interests of national security, territorial integrity or public safety, for the prevention of disorder or crime, for the protection of health or morals, for the protection of the reputation or rights of others, for preventing the disclosure of information received in confidence, or for maintaining the authority and impartiality of the judiciary.[68]

Hate speech regulation is considered a means of preventing disorder or crime.[69]

According to the ECHR jurisprudence, the enforcement of hate speech regulations often turns on whether the regulation is necessary in a democratic society.[70] The European Court of Human Rights ("ECtHR") applies a proportionality interest test, and the protection granted varies with the type of speech sought to be limited.[71] In *Jersild v. Denmark*, a

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http://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=IV-4&chapter=4&lang=en (last visited Mar. 29, 2012).

66. Hare, *supra* note 61, at 65–68.

67. European Convention for the Protection of Human Rights and Fundamental Freedoms [ECHR] art. 10, § 1, Nov. 4, 1950, 213 U.N.T.S. 222. The goals of freedom of expression include promoting access to the exchange of information and ideas, allowing individuals to express themselves and participate in a public forum, granting the public the ability to monitor authorities through the "public watchdog" function, and promoting social progress in general. DRAGOS CUCEREANU, ASPECTS OF REGULATING FREEDOM OF EXPRESSION ON THE INTERNET 9 (2008).

68. ECHR, *supra* note 67, art. 10, § 2.

69. CUCEREANU, *supra* note 67, at 9, 13, 16, 20, 31. According to Article 10 § 2 of the Convention, limitations to freedom of expression must be prescribed by law, pursue one of the enumerated aims, and necessary for maintaining a democratic society. *Id.* First, the interference must prescribed by law, which means that there must be some national law or international instrument that forms the basis for the limitation. *Id.* Second, the enumerated aims that are legitimate include protection of national security, territorial integrity or public safety, prevention of disorder or crime, protection of health or morals, protection of reputation or rights of others, preventing disclosure of information received in confidence, and maintaining the authority and impartiality of the judiciary. *Id.* Finally, in determining whether a limitation is necessary for maintaining a democratic society, three interests are balanced: the pressing social need of the limitation, the relevant and sufficient reasons for the limitation, and the proportionality of a measure. *Id.* Proportionality involves considering suitability, whether there is a less restrictive alternative, a balancing of means and ends, and balancing the interests involved. *Id.*

70. *Id.*

71. Thomas Bull, *Freedom of Expression in Sweden: The Rule of Formalism*, *in* FREEDOM OF SPEECH ABRIDGED? 79, 81 (Anine Kierulf & Helge Rønning eds., 2009).

television journalist appealed a conviction of aiding and abetting the dissemination of hate speech to the ECtHR.[72] Jersild was charged after he produced a news report for the Danish Broadcasting Corporation on a gang of young racists who called themselves Greenjackets.[73] In the report, which was broadcast over a Sunday-night television program, members of the gang made derogatory and offensive remarks about immigrants and ethnic minorities in Denmark.[74] The ECtHR found that the Danish Supreme Court had violated Jersild's freedom of expression under the ECHR.[75] While the ECtHR found that the government's actions were "prescribed by law" and did pursue "a legitimate aim," the intrusion on Jersild's Article 10 rights was not "necessary in a democratic society."[76] In dicta, the ECtHR noted that prosecuting the speech of the Greenjackets would not violate Article 10.[77] Thus, "[h]ate speech would be protected if it were part of a 'serious' discussion of societal issues, but not if it were the product of right-wing intolerance."[78]

In *Prosecutor General v. Åke Ingemar Teodor Green*, in which a pastor was charged with hate speech made during a sermon, the outcome again turned on whether the prosecution of a pastor's speech is necessary

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According to Thomas Bull, "Political speech is at the core of the protected area, as it is of great public interest, while obscene and defamatory expressions are at the outer edge." *Id.*

72. Jersild v. Denmark, 298 Eur. Ct. H.R. (ser A) ¶ 12 (1995).

73. *Id.* ¶¶ 12–14.

74. *Id.* ¶ 11. These comments characterized blacks as an inferior race, applauded the Ku Klux Klan in America and advocated for a return to slavery. *Id.* On the local level, the Danish Supreme Court had held that in contacting the members and arranging their interviews, Jersild knew the members would make racist assertions, and in fact, encouraged them to. *Id.* ¶18. Thus, Jersild, in effect, caused the racist assertions to be made. *Id.* The court noted that their judgment did not prevent the reporting of extremist views, but that this reporting must be balanced and comprehensive. *Id.* Thus, freedom of expression would not override the interests of the hate speech legislation, when four to five hours of interview tape was cut down to only a few minutes of the most crude comments made by extreme racists. *Id.*

75. *Id.* ¶ 11. Emphasizing the media's important role as a "public watchdog," the Court found that the journalist did not intend to disseminate racism, but rather to bring a serious issue to the public's attention. *Id.* ¶¶ 35–36.

76. Jean-Marie Kamatali, *The U.S. First Amendment Versus Freedom of Expression in Other Liberal Democracies and How Each Influenced the Development of International Law on Hate Speech*, 36 OHIO N.U. L. REV. 721, 727 (2010) (discussing the court's holding in relation to international hate crime legislation). Specifically, the Court found that the means of the interference was not proportionate to the interest. *Jersild*, 298 Eur. Ct. H.R. (ser A) ¶ 15.

77. *Jersild*, 298 Eur. Ct. H.R. (ser A) ¶ 31. The conviction of the Greenjackets had not been appealed to the European Court, and thus their ruling was limited to the television producer of the television program. *Id.* ¶¶ 31, 37.

78. Bull, *supra* note 71, at 81.

in a democratic society.[79] The Supreme Court of Sweden ("the Swedish Court") noted that while religious sermons presented in a church will be afforded protection, there is "a duty to avoid, to the extent possible, statements that are unjustifiably insulting to others and constitute attacks on their rights. These statements therefore do not contribute to any form of public discourse that will lead to progress in relations among people."[80] Ultimately, the Swedish Court found that in context of a pastor preaching to a congregation, speech would be protected under Articles 9 and 10 of the ECHR.[81] However, the Swedish Court emphasized the religious context in which the statements were made,[82] which is a distinction that can also be drawn between the protected realm of religious ser-

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79. Prosecutor General v. Åke Ingemar Teodor Green, Nytt Juridiskt Arkiv [NJA] [Supreme Court] 2005-11-29 B1050-05 (Swed.), *available at* http://domstol.se/domstolar/hogstadomstolen/avgoranden/2005/dom_pa_engelska_B_1050-05.pdf. Åke Ingemar Teodor Green was charged with agitation against a group on the basis of sexual orientation. *Id.* In Sweden, the law places a limit on the extent of free speech, in that racist speech can be prosecuted under criminal law. *Id.* Under Sweden's Criminal Code, enraging conduct is also a crime. Bull, *supra* note 71, at 87 (citing BROTTSBALKEN [BRB] [CRIMINAL CODE] 16:16 (Swed.)). Enraging conduct is defined as "a person who is noisy in a public place or who otherwise publicly behaves in a manner apt to arouse public indigation." BRB 16:16 (Swed.). In 2006, a Svea Court of Appeals upheld the criminal conviction of the parent of an ice hockey player, who during a youth game yelled the Swedish equivalent of, "Take that [racial expletive] off the ice." Bull, *supra* note 71, at 81 n.34 (citing NJA, Svea Hovrätt [HovR] [Court of Appeal of Svea] 2006-07-04 B8117-05 (Swed.)). In its opinion, the court focused on the effect of the speech on the young hockey players. NJA, HovR, 2006-07-04 B8117-05, at 3 (Swed.). In the opinion, freedom of expression was not considered to be a defense. *Id.* Additionally, Sweden's Penal Code also prohibits inciting rebellion, "[a] person who orally, before a crowd or congregation of people, or in a publication distributed or issued for distribution, or in other message to the public, urges or otherwise attempts to entice people to commit a criminal act." BRB 16:5 (Swed.).

80. *Åke Ingemar Teodor Green*, NJA 2005-11-29 B1050-05, at 13 (Swed.).

81. *Id.* The Court held:

> This even applies to his most extreme statement, in which he describes sexual abnormalities at a cancerous growth, as that statement, viewed in light of what he said in connection with this in his sermon, is not something that can be deemed to encourage or justify hatred of homosexuals. The way he expressed himself perhaps cannot be deemed that much more derogatory than the wording of the Bible verses in question, but must be viewed as extreme also when considering what he was preaching to his audience. He made his statements in a sermon to his congregation regarding a theme found in the Bible.

Id. at 35–36. Moreover, the Swedish Court held that the use of "contempt" in the Swedish law needed to be read narrowly in order to comply with the European jurisprudence. *Id.* at 16.

82. *Id.*

mons and the unprotected online hate speech. Thus, in order to comply with the ECHR when regulating online hate speech, the government must not interfere with the right to discuss serious social issues or religious freedom.

Under Article 20 of the International Covenant on Civil and Political Rights ("ICCPR"), "Any advocacy of national, racial or religious hatred that constitutes incitement to discrimination, hostility or violence shall be prohibited by law."[83] In *J.R.T. and W.G. Party v. Canada*, the Human Rights Commission upheld the decision of the Canadian Human Rights Commission to curtail J.R.T.'s telephone facilities.[84] J.R.T. provided a telephone service in which members of his party could call and listen to a prerecorded message, which warned "of the dangers of international finance and international Jewry leading the world into wars, unemployment and inflation and the collapse of world values and principles."[85] The Human Rights Committee dismissed J.R.T.'s application, holding that "the opinions which Mr. T. seeks to disseminate through the telephone system clearly constitute the advocacy of racial or religious hatred which Canada has an obligation under article 20 (2) of the Covenant to prohibit."[86]

Under Article 4 of the International Convention on the Elimination of All Forms of Religious Discrimination ("CERD"), "State parties condemn all propaganda and all organizations . . . which attempt to justify or promote racial hatred and discrimination in any form."[87] In *Jewish Community of Oslo et al. v. Norway*,[88] the Committee on the Elimination of Racial Discrimination ("the CERD Committee") considered a claim brought by a local Norwegian Jewish organization against Norway for violating Article 4 of the CERD.[89] Norway's highest court had dismissed a claim of hate speech against Terje Sjølie, the leader of a march held in

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83. ICCPR, *supra* note 62, art. 20.

84. J.R.T. & W.G. Party v. Canada, Judgment, U.N. Human Rights Comm'n, Commc'n No. 104/1981, U.N. Doc. CCPR/C/OP/2, at 25 (1984).

85. *Id.*

86. *Id.* at 231.

87. International Convention on the Elimination of all Forms of Rational Discrimination [CERD] art. 4, Dec. 21, 1966, 660 U.N.T.S. 195.

88. In cases brought before the Committee on the Elimination of Racial Discrimination, a citizen or organization can bring a claim against his country for not complying with Article 4 of the CERD. *Id.* Thus in this case, the local Norwegian Jewish organization brought a claim against Norway for failing to uphold Article 4 of the CERD.

89. Jewish Cmty. of Oslo v. Norway, Comm. on the Elimination of Racial Discrimination, Commc'n No. 30/2003, ¶¶ 2.1, 2.7, U.N. Doc. CERD/C/67/D/30/2003 (2005).

honor of Rudolf Hess.[90] At the march, in which participants wore military-like uniforms and made the Nazi salute, Sjølie made a speech applauding Hitler and Hess for "their principles and heroic efforts."[91] In holding that Norway violated Article 4, the CERD Committee found that, "the intent of article 4 is to fight racism at its roots; there is a causal link between hate speech of the type made by Mr. Sjølie, and serious violent racist acts."[92] The CERD Committee continued:

> Thus, to give the right to freedom of speech a more limited role in the context of article 4 does not deprive the due regard clause of significant meaning, all the more so since all international instruments that guarantee freedom of expression provide for the possibility, under certain circumstances, of limiting the exercise of this right.[93]

This strikes at the heart of the issue: the tension between freedom of speech and incendiary speech. The Scandinavian legal systems pride themselves on a liberal approach to freedom of speech.[94] In fact, the Norwegian Constitution lists freedom of speech as an affirmative duty of the government.[95] However, there is a distinction between open and honest dialogue and speech that lends itself to hate, violence, and crime. The instruments of international law, to which the Scandinavian countries are signatories, uphold this distinction, allowing for freedom of expression to

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90. *Id.* The Jewish Community of Oslo had appealed to the CERD Committee on the basis that in dismissing the charges against Sjolie, the Norwegian court's decision, "contributed to an atmosphere in which acts of racism, including acts of violence, are more likely to occur." *Id.* ¶ 7.3. In response, Norway argued that Article 135(a) of the Norwegian penal code, which bans racist propaganda, had to be considered "with due regard to the right of freedom of expression." *Id.* ¶ 8.1.

91. *Id.* ¶ 2.1. In his speech, Sjølie stated, "Every day immigrants rob, rape and kill Norwegians, every day our people and country are being plundered and destroyed by the Jews, who suck our country empty of wealth and replace it with immoral and un-Norwegian thoughts." *Id.*

92. *Id.* ¶ 5.4.

93. *Id.* ¶ 10.5.

94. Bjørklund & Andersen, *supra* note 11, at 109 (citing Jørgen Würtz Sørensen, *Der kom fremmede: Migration, Højkonjunktur, Kultursammenstød. Fremmedarbejderne i Danmark frem til 1970* [*The foreigners arrived: migration, cultural clashes. Guest workers in Denmark up to 1970*] (Åarhus Univ., Working Paper for the Ctr. for Kulturforskning, 1988) (Den.) ("Official ideology has been one of tolerance and humanism even though earlier waves of small-scale immigration has often generated some unrest among ordinary people.").

95. GRUNNLOVA [CONSTITUTION], § E, art. 100 (Nor.). Under Article 100, "It is the responsibility of the authorities of the State to create conditions that facilitate open and enlightened public discourse." *Id.*

be "afforded a lower level of protection in cases of racist and hate speech."[96]

The Council of Europe's Convention on Cybercrime makes hate speech illegal, and thus ISPs must filter or block offending content.[97] Hate speech includes "racist, xenophobic, anti-Semitic, anti-Muslim and generally intolerant speech."[98] Many European countries, including Norway, Sweden, Denmark, and Finland, have already implemented filtering systems to restrict illegal content.[99] However, at present, these systems are mostly tailored to preventing the production and distribution of child pornography.[100] More importantly, the systems are not advanced enough to filter out all hate speech, and thus they do not do enough to combat the proliferation of incendiary speech.[101]

II. THE GAP BETWEEN THE INTERNET AS A GLOBAL MEDIUM AND THE REGULATION OF ILLEGAL ONLINE ACTIVITY

A. Breivik's Manifesto as an Example of the Gap between Internet as a Medium and the Failure of Regulation

Brevik's manifesto provides the link between the growing blogosphere of hate speech and his acts of terrorism. In his 1500-page manifesto,

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96. Jewish Cmty. of Oslo v. Norway, Comm. on the Elimination of Racial Discrimination, Commc'n No. 30/2003, ¶ 10.5, U.N. Doc. CERD/C/67/D/30/2003 (2005).

97. Dawn C. Nunziato, *How (Not) to Censor: Procedural First Amendment Values and Internet Censorship Worldwide*, 42 GEO. J. INT'L L. 1123, 1126 (2011) (providing an overview of global internet censorship).

98. CUCEREANU, *supra* note 67, at 34. The Council of Europe has defined racist and xenophobic materials as:

> any written material, any image or any other representation of ideas or theories, which advocates, promotes or incites hatred, discrimination or violence, against any individual or group of individuals, based on race, colour, descent or national or ethnic origin, as well as religion if used as a pretext for any of these factors.

Additional Protocol to the Convention on Cybercrime, *supra* note 64, art. 1.

99. Nunziato, *supra* note 97, at 1127.

100. *Nordic Countries*, OPENNET INITIATIVE, http://opennet.net/sites/opennet.net/files/ONI_NordicCountries_2010.pdf (last visited Feb. 2, 2012).

101. Additionally, few bloggers who are inciting violence and promoting extremism are being charged for hate speech crimes, and when they are being charged, they are rarely convicted. Townsend & Traynor, *supra* note 6. For example, the leader of the Dutch Freedom Party, Geert Wilders, who—while not Scandinavian—advocated for the rewriting of the Dutch constitution to outlaw the "fascist" Qur'an in the Netherlands, has been tried and acquitted on hate speech charges. *Id.*

Breivik fears the effects of "cultural Marxism," a movement he attributes to the spread of political correctness and multiculturalism.[102] Breivik writes:

> Political Correctness is not at all about "being nice," unless one thinks gulags are nice places. Political Correctness is Marxism, with all that implies: loss of freedom of expression, thought control, inversion of the traditional social order, and, ultimately, a totalitarian state.[103]

While many of the activists cited in the manifesto have sought to distance themselves from the attacks,[104] the extent to which their words fueled Breivik cannot be understated. Marc Sageman, a former CIA officer, described the anti-Muslim and anti-Jihad blogosphere as "the infrastructure from which Breivik emerged."[105] As two prominent Norwegian writers put it: "The racism and bigotry that have simmered for years on anti-Islamic and anti-immigration Web sites in Norway and other European countries and in the United States made it possible for him to believe he was acting on behalf of a community that would thank him."[106] Or as one of Breivik's acquaintances recently stated in a radio interview:

> He [Breivik] felt a sort of desperation, resignation, and panic for the future . . . He saw that there was a big conflict coming, and he didn't want Europe to erupt in flames—or however you call these struggles. And he understood that something was about to go wrong, and obviously, it is going wrong.[107]

While many have drawn parallels between Breivik and Ted Kacyznski,[108] Breivik does not fit neatly into the mold of the "lone wolf" theory

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102. ANDREW BERWICK, 2083: A EUROPEAN DECLARATION OF INDEPENDENCE 18 (2011), *available at* http://www.scribd.com/doc/60739170/2083-a-European-Declaration-of-Independence.

103. *Id.*

104. Scott Shane, *Killings Spotlight Anti-Muslim Thought in U.S.*, N.Y. TIMES (July 25, 2011), http://www.nytimes.com/2011/07/25/us/25debate.html?pagewanted=all. Pamela Geller, a vociferous critic of Islam, wrote on her blog, "If anyone incited him to violence, it was Islamic supremacists." *Id.*

105. Strømmen, *supra* note 44.

106. Kulish, *supra* note 13 (quoting Hajo Funke) ("This may be the act of a lone, mad, paranoid individual, but the far-right milieu creates an atmosphere that can lead such people down that path of violence.").

107. *Verlikgheten i P3: "Han gjorde i alla fall något,"* SVERIGESRADIO (Oct. 11, 2011), http://sverigesradio.se/sida/artikel.aspx?programid=3052&artikel=4742251 (interview by Magnus Arvidson with Erik Walfridsson) (translated by the author).

108. Shane, *supra* note 104. In fact, Breivik's manifesto included passages taken directly from Kaczynski's 1995 manifesto, only making minor alterations including substituting terms like "leftists" with his own "multiculturalists" or "cultural Marxists." *Id.*

of terrorism.[109] Anders Behring Breivik was not merely a deranged person whose political views had taken an extreme turn,[110] but rather he was the product of the blogosphere of hate from which he recognized—and answered—a call to arms.[111] As a prominent Norwegian writer stated, "Indeed, like many of the violent jihadists he so feared—though, notably, did not directly target—Breivik seems to have been radicalized via the Internet."[112] Even though Kaczynski quoted heavily from other scholars who criticized technological advances, including Adolphus Huxley's *Brave New World*, Kaczynski's work appears a reflection of his own troubled mind and his conscious decision to sequester himself from society.[113] Breivik, on the other hand, remained quite social,[114] and it is this continued engagement in the online world that distinguishes him from the lone wolf theory. In fact, "the hatred and contempt from which he drew his deranged determination were shared with many others through the international right-wing blogosphere."[115]

Through online forums and discussion boards, Breivik frequently interacted with other individuals sharing his xenophobic and racist beliefs.[116] Lars Buehler, a Norwegian terrorist expert who had debated with

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While Breivik essentially lifted passages from Kaczynski's writing, only replacing terms to make the passages fit his topic, he did not acknowledge Kaczynski in his work. *Id.*

109. The lone wolves of terrorism have been described as "deranged individuals who were sympathetic to a larger cause—from Oklahoma City bomber Timothy McVeigh to the Washington area sniper John Allen Muhammad." Alexandra Marks, *"Lone Wolves" Pose Explosive Terror Threat*, CHRISTIAN SCI. MONITOR (May 27, 2003), http://www.csmonitor.com/2003/0527/p02s02-usju.html.

110. While court-appointed psychiatrists found Breivik to be insane in their initial assessment, the court has not yet ruled whether he is fit to stand trial. Bjoern H. Amland & Karl Ritter, *Anders Behring Breivik, Norway Killer, Was Insane During July Attacks*, HUFFINGTON POST (Nov. 29, 2011), http://www.huffingtonpost.com/2011/11/29/anders-behring-breivik-legally-insane_n_1118194.html. Moreover, the insanity diagnosis has been criticized by psychologists and psychiatrists in the media. *Id.* In fact, Dr. Tarjei Rygnestad, the head of the panel of the Norwegian Board of Forensic Medicine who will review the assessment, had previously stated, "If you have voices in your head telling you to do this and that, it will disturb everything, and driving a car is very complex." Ian McDougal, *Anders Behring Breivik Insanity Ruling Not Likely In Norway*, HUFFINGTON POST (Aug. 1, 2011), http://www.huffingtonpost.com/2011/07/31/anders-behring-breivik-norway-shooting_n_914309.html.

111. Townsend & Traynor, *supra* note 6.

112. Strømmen, *supra* note 44.

113. Shane, *supra* note 104.

114. *Id.*

115. Jostein Gaarder & Thomas Hylland Eriksen, *A Blogosphere of Bigots*, N.Y. TIMES (July 29, 2011), http://www.nytimes.com/2011/07/29/opinion/Gaarder-Eriksen.html.

116. *Profile: Anders Behring Breivik*, BBC NEWS (Nov. 30, 2011, 7:59 PM), http://www.bbc.co.uk/news/world-europe-14259989.

Brevik on one such forum, stated, "I was the single opposing voice, arguing against the xenophobic, Islamaphobic postings and comments that were the norm on this page, and Breivik did not stand out with a particularly aggressive or violent rhetoric. He was quite mainstream."[117] Breivik also reportedly warned others of the coming war against Muslims in Europe and was a member and participant in Nordisk, an online forum for neo-Nazis in the Nordic countries.[118]

In his manifesto, Breivik cited heavily to a Norwegian blogger who operated under the pseudonym Fjordman.[119] In one entry, Fjordman equated the spread of multiculturalism with a foreign invasion, and stated that "aiding and abetting a foreign invasion in any way constitutes Treason."[120] Fjordman continued, "If non-Europeans have the right to resist colonisation and desire self-determination then Europeans have that right, too. And we intend to exercise it."[121] In another cited section, Fjordman blames the "feminisation" of Europe for the current state of affairs:

> Didn't feminists always claim that the world would be a better place with women in the driver's seat, because they wouldn't sacrifice their own children? Well, isn't that exactly what they are doing now? Smiling and voting for parties that keep the doors open to Muslim immigration, the same Muslims who will be attacking their children tomorrow?[122]

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117. *Id.*

118. Sultan, *supra* note 41; Townsend & Traynor, *supra* note 6.

119. Lister, *supra* note 43. In the wake of the attacks and after extensive questioning by the Norwegian police force, PST, Fjordman has stated that he may never take up blogging again. Jonas Skybakmoen, *Fjordman avviser nye blogg-rykter* [*Fjordman Rejects New Blog Rumors*], ADRESSEAVISEN (Aug. 8, 2011), http://www.adressa.no/nyheter/terrorangrepet/article1676738.ece. However, this sentiment was short-lived and on October 25, 2011, Fjordman wrote an editorial claiming he had been censored by the media. *Fjordman Lives On Despite Media Censorship*, RIGHT SIDE NEWS (Oct. 25, 2011), http://www.rightsidenews.com/2011102514793/editorial/rsn-pick-of-the-day/fjordman-lives-on-despite-media-censorship.html.

120. Strømmen, *supra* note 44.

121. *Id.*

122. BERWICK, *supra* note 102, at 345 (quoting Fjordman). In another section quoted in the manifesto, Fjordman writes,

> While Chinese, Indian, Korean and other Asian Universities are graduating millions of motivated engineers and scientists every year, Western Universities have been reduced to little hippie factories, teaching about the wickedness of the West and the blessings of barbarism . . . . Far worse than failing to compete with non-Muslim Asians is failing to identify the threat from Islamic nations who want to subdue us and wipe out our entire civilisation. That is a failure we

By characterizing Muslim immigrants as having the potential of attacking Norwegian children and instilling fear in his readers, Fjordman's words appear as a call to arms to his countrymen. On July 22, 2011, Anders Behring Breivik answered that call. Because Breivik believed an attack on Norwegians was imminent and his countrymen could no longer be trusted to protect the country, he carried out a massacre leaving seventy-seven dead. If the proper measures were in place regulating hate speech on the Internet, Breivik would not have been engulfed in such a whirlwind of insidious ideas, and the attacks might have been prevented. The lack of content filtering has led to a plethora of misinformation and dangerous rhetoric, which, combined with a society already on edge, poses a serious threat to democracy.

B. The Internet as a Global Medium

Inherent to the discussion of the proliferation of hate speech online is the difference between the speed of information across the Internet and previous means of distributing political speech of decades past. Given the speed with which the Internet allows users to acquire and distribute data, information costs have greatly decreased, "to nearly zero."[123] In the context of online hate speech, information costs refer to the ease with which a user can create, acquire, or distribute illegal materials through the Internet.[124] According to the Council of Europe, "the emergence of international communication networks like the Internet provide certain persons with modern and powerful means to support racism and xenophobia and enables them to disseminate easily and widely expressions containing such ideas."[125]

Because certain media, like television, provide the user with a heightened sensory experience, that particular medium should be considered in determining the effect of hate speech.[126] This view comports with inter-

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> quite simply cannot live with. And we probably won't, unless we manage to deal with it.

Id. at 59.

123. Derek E. Bambauer, *Consider the Censor*, 1 WAKE FOREST J.L. & POL'Y 31 (2011) (citing Derek E. Bambauer, *Conundrum*, 96 MINN. L. REV. 584 (2011)).

124. *Id.*

125. Additional Protocol to the Convention on Cybercrime, *supra* note 64.

126. Bull, *supra* note 71, at 81. "Thus the need for restrictions may be greater in a medium that is very efficient in reaching a wide audience, and the Court has accepted national restrictions on expression in such circumstances that otherwise would perhaps not have been accepted." *Id.* In *Jersild v. Denmark*, the European Court considered the medium with which the speech was distributed. 298 Eur. Ct. H.R. (ser A) ¶ 31 (1995). The Court noted that, "it is commonly acknowledged that the audiovisual media have

national hate speech jurisprudence, which considers the types of harm in context.[127] According to the Canadian Supreme Court, "The courts must determine as best they can what the community would tolerate others being exposed to on the basis of the degree of harm that may flow from such exposure."[128] While this statement was made in reference to a case involving pornography coming into the hands of minors, the notion that harmful content should be evaluated in its context is especially relevant to online hate speech.[129]

Given the speed of technology and Internet as a global medium, harmful online content similarly must be considered in context.[130] Because modern computer technology offers a way to connect quickly, cheaply, and anonymously over the Internet, users enjoy a greater sense of freedom of expression.[131] "The Internet is regarded as the key platform for the dissemination and mediation of the culture of violent extremism."[132] Thus, it is important to consider the Internet as a medium in that, "[a]nonymous forums on the Internet have allowed anti-Muslim bigots to connect and reinforce each other's worldview."[133]

III. SWEDEN'S LAW BANNING HATE SPEECH SHOULD BE ENFORCED AGAINST PERPETRATORS IN THE ONLINE COMMUNITY AND EXTENDED TO ALL CONTENT TRAVELING ALONG SWEDEN'S INTERNET INFRASTRUCTURE.

In order to prevent further violence, the Swedish government should enforce its current law regarding hate speech to all online acts committed using Swedish ISPs. Sweden's telecommunications infrastructure, and geographic location in the center of Scandinavia, provides a unique and extraordinary opportunity for Sweden to assume a leading role in hate speech filtering. Almost all international electronic communications traf-

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often a much more immediate and powerful effect than the print media and reports . . . . The audiovisual media have means of conveying through images meanings which the print media are not able to impart." *Id.* Ultimately, the Court found that the news program was geared towards a serious, well informed audience, and that the material was presented with appropriate care and attention to the sensitivity of the subject, and thus, the medium was used appropriately. *Id.* ¶¶ 9, 34.

127. CUCEREANU, *supra* note 67, at 32.

128. *Id.* at 33 (quoting R. v. Butler, [1992] 1 S.C.R. 452 (Can.)).

129. CUCEREANU, *supra* note 67, at 34.

130. *Id.* at 7.

131. *Id.* at 139.

132. Tufyal Choudhury, *The Terrorism Act 2006: Discouraging Terrorism*, *in* EXTREME SPEECH, *supra* note 61, at 463, 477–78 (citing GABRIEL WEIMANN, TERROR ON THE INTERNET: THE NEW ARENA, THE NEW CHALLENGES (2006)).

133. Sultan, *supra* note 41.

fic both into and out of Norway and Finland cross through Sweden.[134] Additionally, a great deal of Norwegian domestic communications travels through the Swedish telecommunications infrastructure.[135] Following the rationale provided for the Försvarets radioanstalt ("FRA Law"),[136] the Swedish legislature could extend their hate speech laws to restrict the dissemination of all hate speech, which passes over their borders and which is controlled using their Internet infrastructure.[137] By following a similar approach to the filtering of child pornography, terrorism, and racism in France,[138] the proposed measure would establish a quasi-autonomous nongovernmental organization that would monitor offensive content online.[139]

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134. *Nordic Countries*, *supra* note 100.

135. *Norwegian Group Joins Case Against Sweden's Wiretapping Law*, LOCAL (Feb. 13, 2009), http://www.thelocal.se/17578/20090213/.

136. In 2008, the Swedish Parliament enacted the FRA Act, which will "monitor cross-border cable traffic . . . [including] Internet, e-mail, chat, mobile telephony and SMS communication." Joakim Hammerlin, *Anti-Terror Surveillance and Freedom of Expression*, *in* FREEDOM OF SPEECH ABRIDGED?, *supra* note 71, at 98. The passage of this act came with a great deal of criticism, both domestically and internationally, including by those who claimed the act posed a great threat to civil liberties. *Surveillance Sweep*, ECON. (July 22, 2008), http://www.economist.com/node/11778941; *Sweden Passes Eavesdropping Law*, N.Y. TIMES (June 19, 2008), http://www.nytimes.com/2008/06/19/technology/19iht-sweden.4.13838203.html. While part of the Act was repealed and a court order is required for monitoring, a good portion of the act is still in place, and information collected from this monitoring system will be stored for 18 months. Hammerlin, *supra*, at 98; Press Release, Statsrådsberedningen [Prime Minister's Office], Alliansen enig om stärkt integritet, tydligare reglering och förbättrad kontroll i kompletteringar till signalspaningslage [Compromise reached for enhanced privacy, better regulation and improved control of additions to the FRA Act] (Sept. 25, 2008) (Swed.), *available at* http://www.regeringen.se/sb/d/10911/a/112332.

137. While the FRA Act was unpopular in that it provided government surveillance without a court order, this act would be carefully tailored to prevent speech, which is already unlawful in the country from being disseminated using Swedish controlled infrastructure. *Sweden Passes Eavesdropping Law*, *supra* note 136.

138. *France Blocks Online Child Porn, Terrorism, Racism*, USA TODAY (June 10, 2008), http://www.usatoday.com/tech/products/2008-06-10-1132847073_x.htm.

139. This organization could be modeled after the Swedish nongovernmental organization called ECPAT Sweden. *Nordic Countries*, *supra* note 100. As a participant in the International Association of Internet Hotlines project, ECPAT compiles lists of suspicious links to websites that may traffic in child pornography. *Id.* A majority of Swedish ISPs participate in the program, which requires blocking the reported commercial child pornography websites. World Congress Against Commercial Sexual Exploitation of Children, Stockholm, Swed., Aug. 27–31, 1996, ECPAT Sweden, *End Child Prostitution, Child Pornography and Trafficking in Children for Sexual Purposes* (Oct. 11, 1996), *available at* http://www.ecpat.se/images/filer/Organisation/engoct11presentation.pdf.

The organization's role would be two-fold: it would maintain an online forum in which other users could report offensive content, and once identified, the organization would notify Internet ISPs to block access to the flagged content. For instance, a user could flag a posting in which supporters of multiculturalists were called "traitors to their country." Once reported, the organization would make a record of the comment so that prosecutors might identify and hold liable for hate speech the writer or poster of the comment. More importantly, however, the ISPs would filter out or block the content on the page to prevent the further distribution of this illegal content. In order to ensure that users do not abuse the system and report non-offensive materials in an attempt to have it filtered, the organization would have some oversight to ensure that material qualifies as illegal hate speech.

As one prominent Internet Law scholar stated, "Restricting Internet information is a policy question about choosing among multiple regulatory endpoints that are both possible and legitimate."[140] By making it more difficult to post and maintain content without being filtered, the Swedish government can increase these information costs, and in the process, inhibit the proliferation of hate speech over the Internet.[141] Delegated enforcement already plays a major role in hate speech regulation throughout Europe. Google filters its search results to comply with French and German law, particularly in the realm of filtering out Nazi-related speech.[142] Moreover, governmental pressure on the ISPs to comply with filtering, as well as public support for the program, would likely be important factors in the program's success. In 2006, British ISPs agreed to block child pornography on a "voluntary" basis, after Parliament threatened to pass unfavorable legislation if they did not comply.[143] Similarly, many major Swedish newspapers have reacted favorably to media pressure to moderate online commentary. For example, *Aftonbladet*, a major Swedish newspaper, will no longer allow anonymous comments on their website.[144] While this may be in part due to pending enforcement of

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140. Derek E. Bambauer, *Cybersieves*, 59 DUKE L.J. 377, 386 (2009) (citing Peter Hammer).

141. As Derek Bambauer notes, "This point mirrors a lesson drawn from studies of Internet censorship: even imperfect limits can raise costs sufficiently to affect the average user's information consumption." Bambauer, *Consider the Censor*, *supra* note 123, at 40 (citing Bambauer, *Conundrum*, *supra* note 123).

142. CUCEREANU, *supra* note 67, at 3.

143. *United Kingdom: Country Profile*, OPEN NET INITIATIVE (2010), http://opennet.net/research/profiles/united-kingdom#footnote37_hprcd2g.

144. Jon Helin, *Nu slopar vi anonyma kommentarer på nätet* [*We Will Now Put a Stop to Anonymous Online Comments*], AFTONBLADET (Aug. 31, 2011), http://www.aftonbladet.se/debatt/debattamnen/medier/article13544314.ab.

Sweden's Act on Responsibility for Electronic Bulletin Boards, in which media forums have an obligation to erase certain messages,[145] it does foreshadow a favorable outcome to political pressure on online forums.

Moreover, a government's requirement of filtering by ISPs forces private enforcement in some cases. For instance, in 2000, a French court ordered Yahoo, "to take all necessary measures to dissuade and render impossible any access via Yahoo.com to the Nazi artifact auction service and to any other site or service that may be construed as constituting an apology for Nazism or a contesting of Nazi crimes."[146] While the judgment is still valid in France, enforcement of the judgment in the United States became moot after Yahoo abruptly stopped trafficking in Nazi memorabilia.[147] However, the reach of adjudicative jurisdiction did have an effect on the development of technology and the use of greater filtering devices for other international commercial sellers.[148]

CONCLUSION

Anders Behring Breivik's 1,518-page manifesto reflects the perfect storm that was brewing for years in Scandinavia: a whirlwind of hatred and fear, coupled with minimal technological barriers and a high-speed Internet connection. To borrow from George Orwell, "walls of hatred and lies" separate the user from the truth.[149] With the ever-expanding capability of the search engine and the limitless volume of user-generated content, preconceived notions are no longer refuted, but further solidified. Researching political viewpoints can be guided by one's own tailored search terms, and virtually any viewpoint can find traction

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145. LAG (1998:112) OM ANSVAR FÖR ELEKTRONISKA ANSLAGSTAVLOR [ACT ON RESPONSIBILITY FOR ELECTRONIC BULLETIN BOARDS] (Svensk författningssamling [SFS] 1998:112, § 5) (Swed.).

146. Tribunal de grande instance [T.G.I.] [ordinary court of original jurisdiction] Paris, May 22, 2000, Union des Etudiants Juifs de France & Ligue Contre le Racisme et L'Antisemitisme v. Yahoo! Inc. & Yahoo France (Fr.), *translated at* http://www.lapres.net/yahen.html, *reproduced in* Yahoo Inc. v. La Ligue Contre Le Racisme et L'Antisemitisme, 169 F. Supp. 2d 1181 (N.D. Cal. 2001).

147. JACK GOLDSMITH & TIM WU, WHO CONTROLS THE INTERNET? 8 (2008) (citing Troy Wolverton & Jeff Pelline, *Yahoo to Charge Auction Fees, Ban Hate Material*, CNETNEWS.COM (June 27, 2001), http://news.com/2100-1017-250452.html?legacy+cnet).

148. CUCEREANU, *supra* note 67, at 3 (citing T.G.I. Paris, Nov. 20, 2000, *Yahoo! Inc.* (interim court order) (Fr.)). After a French court ordered Yahoo to filter Nazi memorabilia from being accessed by French users, a California district court prevented enforcement of the order in the U.S., but then the decision was reversed by the Ninth Circuit. GOLDSMITH & WU, *supra* note 147, at 8.

149. *See* Orwell, *supra* note 1, at 14.

by someone, somewhere in the blogosphere. Given the speed of the Internet, the nature of trans-border communications has changed.[150] "The internet has become a fertile ground for hate groups, setting up websites to promote prejudice against a wide variety of groups."[151] Especially in Norway and Sweden, these hate groups are increasingly volatile, vociferous, and gaining in numbers. These blogs and forums are not only contributing to the breakdown of barriers between speech and action, but they are inciting violence.

While some may argue that protecting extreme speech curbs intolerance,[152] hate speech regulation is necessary to maintain democratic society in Scandinavia. A society cannot survive if it loses its basis as a "community of ideas,"[153] or a conglomerate of agreed-upon social norms.[154] The law must uphold these social norms:

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150. David Fraser, *"On the Internet, Nobody Knows You're a Nazi": Some Comparative Legal Aspects of Holocaust Denial on the WWW*, *in* EXTREME SPEECH, *supra* note 61, at 511, 513.

151. Helen Ginger Berrigan, *"Speaking Out" About Hate Speech*, 48 LOY. L. REV. 1, 13 (2002) (advocating a balance between European hate speech laws and the United States Constitution).

152. Stephen Gottlieb & David Schultz, *The Empirical Basis of First Amendment Principles*, 19 J.L. & POL. 145, 154 (2003) (citing LEE C. BOLLINGER, THE TOLERANT SOCIETY 107, 119–20 (1986)) (discussing Lee Bollinger's model for protection of freedom of expression in America).

153. The "community of ideas" theory must be distinguished from the American "marketplace of ideas" theory, which advocates for freedom of expression as a rationale against censorship. Robert C. Post, *Hate Speech*, *in* EXTREME SPEECH, *supra* note 61, at 123, 133. The notion of a "marketplace of ideas" is often attributed to Justice Oliver Wendell Holmes Jr.'s dissenting opinion in *Abrams v. United States*. 250 U.S. 616, 630 (1919) (Holmes, J., dissenting) ("[t]hat the best test of truth is the power of the thought to get itself accepted in the competition of the market, and that truth is the only ground upon which their wishes safely can be carried out."). In relationship to the Scandinavian countries, the United States is a very large, very diverse country. Whereas the "marketplace of ideas" theory of freedom of expression may work in the United States, in which there is enough diversity of opinion that the truth will emerge, the same theory cannot be applied to freedom of expression in Europe.

154. Post, *supra* note 153, at 130 (quoting PATRICK DEVLIN, THE ENFORCEMENT OF MORALS 10 (1965)). Devlin writes:

> [S]ociety means a community of ideas; without shared ideas on politics, morals and ethics, no society can exist . . . If men and women try to create a society in which there is no fundamental agreement about good and evil they will fail; if, having based it on common agreement, the agreement goes, the society will disintegrate.

Id.

> That society means a "community of ideas"; without shared ideas on politics, morals, and ethics no society can exist . . . . For society is not something that is kept together physically; it is held by invisible bonds of common thought . . . . A common morality is part of the bondage. The bondage is part of the price of society; and mankind, which needs society, must pay its price.[155]

Hate speech regulation serves an important role in upholding these social norms.[156] When individuals promote hatred against other races, religions, or ethnic groups, they are violating social norms and threatening society. "To the extent that hate speech contributes its ugly perspective, it does double damage. It reinforces those stereotypical and historic prejudices and arguably silences all but the more stalwart of the minority members."[157]

To address the threat of future violence, the Swedish government should establish a filtering program to eliminate illegal content through a quasi-autonomous nongovernmental organization. Because hate speech is especially pernicious, the Swedish government should also require ISPs to filter all online hate speech traffic on its servers. The lesson to be gleaned from Breivik's July 22nd attacks is clear: while the freedom of an open society is valuable, we must not be reticent of the risk of unfettered, extreme speech. In a world with greater information costs, potential terrorists would not come across and collect incendiary materials with the same ease and gusto that Breivik did.

Hanna Li Robinson[*]

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155. DEVLIN, supra note 154, at 10.

156. Post, *supra* note 153, at 123, 132 (citing Robert C. Post, *Democratic Constitutionalism and Cultural Heterogeneity*, 25 AUSTL. J. LEGAL PHIL. 185 (2000) & Robert C. Post, *Cultural Heterogeneity and Law: Pornography, Blasphemy, and the First Amendment*, 76 CAL. L. REV. 297 (1988)) ("[H]ate speech regulation must necessarily enforce social norms that represent the well-socialized intuitions of the hegemonic class that controls the content of the law."). Post departs from Devlin's more static interpretation of a "community of ideas."). *Id.* at 130. ("Once we understand, however, that norms enforced by law . . . are constantly evolving, we can also see that law must continuously choose which kind of community it will sustain.").

157. Berrigan, *supra* note 151, at 9.

* B.A., Macaulay Honors College at Hunter College (2007); J.D., Brooklyn Law School (expected 2013); Managing Editor of the *Brooklyn Journal of International Law* (2012–2013). Thank you to my family, especially my parents, John and Eva Robinson, for their support and encouragement. Thank you to Professors Derek E. Bambauer and Richard N. Winfield for their insightful comments during the writing process. Thank you also to Max Robinson. I am especially grateful to the entire *Brooklyn Journal of International Law* staff for their assistance in the preparation of this Note. All errors and omissions are my own.

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