Why is there a rise of institutional investors participating in German securities cases?

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Until 2005 participation of institutional investors in securities lawsuits regarding delayed, false or misleading information launched by a public listed company was limited to filing claim forms in already settled cases in US securities class actions. Since 2005 we have seen increasing participation of institutional investors in such securities cases in Germany, and this trend has led to numerous lawsuits. In nearly every lawsuit that has been filed since 2005 regarding false or misleading information launched by a public listed company, institutional investors are a constant player on the plaintiffs' side.

There are four examples that illustrate this current trend. First, the lawsuit against Daimler with regard to the delayed announcement of the resignation of former CEO Juergen Schrempp. The second example is the lawsuit against German bank IKB where plaintiffs allege that they were not informed early enough about the bank's exposure to the US subprime crisis. Third, there are several lawsuits pending against the solar company Conergy in connection with accounting irregularities and a delayed announcement of difficulties with the supply of silicium. And fourth, the lawsuits against Hypo Real Estate with regard to delayed announcements in connection with the bank's exposure to the US subprime crisis.

In all these cases we have seen a rising participation of institutional investors from all over the world. The following article will examine the reasons which have led to this development in Germany.

False capital market information

The first and main reason was the implementation of a liability for damages due to a failure to publish inside information without undue delay and a liability based on the publication of false inside information in sections 37b and 37c of the Securities Trading Act on July 1, 2002. Several scandals of companies listed at the (former) stock market for technology shares in Germany, the Neuer Markt, forced the German legislator to establish such a liability of issuers in order to gain back confidence of market participants.

Under section 37b of the Securities Trading Act an issuer of financial instruments that are admitted to trading on a German stock exchange shall be liable to compensate a third party for damages if it fails to publish, without undue delay, inside information that directly affects that issuer. And section 37c of the Securities Trading Act rules that an issuer shall be liable if it publishes false inside information directly affecting the issuer.

Those issuers who can prove that the omission was made neither deliberately nor in an act of gross negligence or who can prove that they were not aware of the inaccuracy of the inside information and that such lack of awareness does not constitute an act of gross negligence shall not be liable for damages pursuant to this law.

Damage claims are subject to a limitation period of one year from the date on which the third party learned of the omission or inaccuracy, but not more than three years after the omission or after publication.

Jurisdiction of the Federal Court of Justice

The second reason for a rising participation of institutional investors is connected with the jurisdiction of the German Federal Court of Justice with regard to securities cases. With the 'Infomatec' decision of July 19, 2004 the Federal Court of Justice for the first time ruled that members of the managing board of a listed company are personally liable for damages suffered by investors who purchased shares based on false and misleading statements made by the company. The liability was not limited to a difference of the real share price compared with a fair share price, instead the investor received a full reimbursement of the original purchase price.

Nearly a year later the Federal Court of Justice in its 'EM.TV' decision of May 9, 2005 further explained that such a misbehaviour of a board member has to be imputed to the company itself and the court therefore also held the company liable for damages incurred by investors. Furthermore, the court added in this decision, that not only the decision to purchase shares based on false capital market information could lead to a liability for damages but also the decision to refrain from selling the shares based on this information. In this decision the court also rejected

arguments of the defendant company that this would lead to a breach of section 57 of the German Law on Stock Corporations which prohibits a repay of contributions to shareholders.

Subject matter of the 'Daimler' decision of February 25, 2008 was the failure to publish inside information without undue delay. This was the first case based on section 37c of the Securities Trading Act to be decided by the Federal Court of Justice and it was the first case before the court that had been administered by the Capital Investor's Model Proceeding Act (see below).

Background of the case which is still pending before the Higher Regional Court in Stuttgart are allegations that Daimler had sufficient inside information about the resignation of former CEO Juergen Schrempp for several weeks but did not reveal it until the end of July 2005. Plaintiffs, among them several institutional investors, sold their stock before the resignation was announced and therefore missed the boost of the stock-price which went up 20% immediately after the announcement was made public. In a first step the Federal Court of Justice decided that prospective circumstances, like plans or intentions of a CEO, in principle are inside information which have to be published in an ad-hoc release as soon as the occurrence is likely. In this regard the Federal Court ruled that a likelihood of 50% would be sufficient by all means. The Court therefore referred the case back to the Higher Regional Court in order to pursue a hearing of evidence on the circumstances of the resignation.

The Capital Investor's Model Proceeding Act

The implementation of the Capital Investor's Model Proceeding Act on November 1, 2005 is the third reason for the more active role of institutional investors in German securities cases. With this act for the first time special procedural rules for lawsuits involving investor claims came into force in Germany. However, these rules do not adopt the well known US model of class actions in any way.

Under the German rules it is not possible that a class representative files a lawsuit for an unnamed group of investors. Still only those investors will be able to benefit from the results of the model case who themselves have filed a case within the relevant

time limits and who have been named as plaintiffs.

However, the Capital Investor's Model Proceeding Act provides procedural opportunities which have several advantages with regard to the interests and sensitivities of institutional investors. As a general rule one can say that institutional investors, especially large insurance companies and mutual funds, are very reluctant to make failed investments public in any way, which they would have to do in case they had to lead a securities case as plaintiff. Furthermore, existing commercial relationships with the potential defendant often lead to strategies involving a lower level of confrontation in seeking a compensation for suffered losses.

In this context the Capital Investor's Model Proceeding Act provides clear advantages compared to the traditional procedural rules for lawsuits in Germany. Under the Model Act it is possible that private investors take the lead and apply for a model case. To get such a model case started, at least 10 applicants are needed under the act, a number easily gathered under normal circumstances in securities cases. If the court grants the application for a model case all other pending cases and all cases filed afterwards will be suspended without any further hearing. This gives institutional investors the opportunity to file their cases without a large exposure and to await the outcome of the model case. In this regard they also do not have to fear being exposed as a model plaintiff in these cases since the Capital Investor's Model Proceeding Act provides the opportunity to the plaintiffs to reach an agreement about the person or entity that should lead the case. If the plaintiffs do so, the court is bound by their decision.

Beneficial to the institutional investor is also the fact that the question whether inside information was correct and/or published without undue delay will be answered in the model case. There is no longer a need to take evidence in every single case. Any costs that might occur for example in connection with expert hearings will be divided among all plaintiffs, which substantially reduces the financial risk connected with the litigation since the result of the model cases will be applied in all other cases.

Litigation funding

The fourth reason for a rising participation of institutional investors in German securities cases is the possibility to file such lawsuits on a no-win-no-fee basis with the assistance of litigation funders.

In contrast to other jurisdictions, especially in the US, lawyers in Germany are not allowed to take all the risks of a lawsuit and to work on a contingent basis. However, the improvements under German law in this area as described in this article so far have enhanced the willingness of litigation funding companies to take the risks of lawsuits in this field for a share of the profit in case the lawsuit is successful. In particular, the Capital Investor's Model Proceeding Act paves the way for clarification of all relevant circumstances of a case without the potentially high financial risks plaintiffs normally have to fear under German law.

The market leader for funding German securities cases is Austrian AdvoFin AG (www.advofin.at). The company currently funds the cases against IKB, Hypo Real Estate, EADS, Conergy and MLP.

Improved compliance

Improved compliance and a more professional handling of conflicts of interest is another reason for a more active role of institutional investors. The approach even of large German entities like Siemens to throw light on illegal practises of former board members and to treat none of them with excessive care signals a change in how to deal with such scandals in Germany. More and more we see institutional investors present at general meetings of listed companies, asking critical questions and demonstrating an improved awareness of their own customers' needs.

Institutional investors have become aware that they have to weigh the chances and risks of a litigation in connection with the fiduciary duties they have. Especially when litigation funding is available, participation in such a case generally only can lead to an improved position of the customer. This conclusion clearly contributes to a rise in participation of institutional investors in cases involving delayed, false or misleading statements of listed companies in Germany.

Customers' expectations

The expectation of a customer of an institutional investor like a mutual fund has been indicated already. The customer wants an optimal investment success and therefore has the expectation that a mutual fund takes advantage of the options the participation in a funded securities litigation provide. In particular, institutional customers increasingly look after investment companies with an internal or external legal portfolio monitoring in order to take advantage of such lawsuits.

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