THE ECONOMICS OF D&O LIABILITY FOR FALSE INFORMATION IN GERMAN SECONDARY CAPITAL MARKETS

ALEXANDER MESCHKOWSKI
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Abstract

In recent years, the German capital market was shaken by scandals caused by the insiders of public corporations like Comroad, Metabox, Infomatec, EM.TV et al. The overall damages of the scandals generated in the Frankfurt Stock Exchange’s Neuer Markt are approximated to be close to 200 billion until the market segment was finally closed down. The consequence of the financial scandals is, besides the causation of the tremendous damages to private investors, a substantially spoiled reputation of the capital market itself, whereas the latter adversities seem not yet to be absorbed completely. Even though the criminal procedures in the mentioned cases leaded to the conviction of the responsible insiders, the refurbishment of the scandals in German courtrooms frequently left damaged investors without a remedy for their losses, thereby revealing the jurisdiction’s de lege lata limits. As far as noticed actually none of the damaged investors’ civil claims did yet succeed. A first reaction to the corporate scandals by the German regulator in the fourth capital market advancement act is widely assessed to be insufficient to amend investors’ legal status effectively. The aim of this analysis is to approach the first best solution to minimize the total social costs of false capital market information. It furthermore contributes to the continuing discussion in Germany about the reasons for the financial scandals. Moreover, it makes a contribution to the debate on the issue, whether the damaging events indicate an advanced intervention of the government, and - if so - in which fashion the legal rule should be developed to be an optimal remedy. The capital market scandals are set off by false capital market information that was intentionally or frivolously disseminated by Directors and Officers (D&O) of public corporations, which are in the German two-tier system Vorstand and Aufsichtsrat. Hence, the impact that false material data have on the efficiency of capital markets will be addressed in detail. Its specific effect on the share price is scrutinized by reviewing practical cases that occurred recently in Germany. This might allow a deeper understanding of the different kinds of damages that result from the approval of a frivolous disclosure policy by Board members. By changing the perspectives the hypothesis that Board members have clear incentives to provide capital markets with false information will be verified. The analysis will apply especially insights of Law & Economics - as well as from the developing branch of Law and Behavioral Science - to emphasize the issue’s discussion in traditional legal scholarship. Moreover, as economic theory indicates, a reason for a government intervention is only given in cases of market failures. Thus, the analysis will determine if the inefficient allocation of investors’ funds and the related Pareto suboptimality is grounded on market failures. Especially presumable obstacles with asymmetric information, negative externalities and potential free riding-behavior by competitors appear worthwhile to focus on.
From an economic perspective it is to discuss whether the damages of shareholders that - due to false capital market information - purchased stocks above their actual value, should be recoupable in general. The crucial aspect about influencing the process of disclosure with an effective liability rule is that it could also hinder necessary and valuable truthful information to be available for the market participants. As the economic approach to the law discerns it as a tool to maximize social welfare, the analysis will check whether the drafted German Kapitalmarktinformationshaftungsgesetz (KapInHag) is complying with this prerequisite. It will focus on two aspects that appear crucial for the efficiency of the legal rule. First, the target of the drafted liability rule, i.e. who should be held liable for the dissemination of false information will be focused on. The traditional German liability regime that favors the primary responsibility of the corporation will be depicted and compared with the divergent proposal of the KapInHaG. The main question will be, which liability system provides the optimal setting of incentives for Board members. Second, as the central aspect of a liability rule is the standard of fault that it comprises, it will be analyzed in detail. The German lawmaker suggests in the drafted KapInHag a standard of “gross negligence”. Thus, Board members will compensate damaged investors in every case the court in its ex post evaluation will conclude that the disclosure of false information was grossly negligent. The analysis will examine in detail whether the proposal of the KapInHaG is pinpointing the accurate level of deterrence, while assuring that the necessary information will be disseminated courageously and at the perfect time. Therefore it will specially utilize the Business Judgment Rule, an instrument of US corporate law that might be worthwhile to implement also in German capital market law.
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RECHTSANWALT
DR. ALEXANDER MESCHKOWSKI, LL. M.
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THE ECONOMICS OF D&O LIABILITY FOR FALSE INFORMATION IN GERMAN SECONDARY CAPITAL MARKETS

§ 1. Introduction

In recent years, the German capital market was shaken by scandals caused by the insiders of public corporations like Comroad, Metabox, Infomatec, EM.TV et al. The overall damages of the scandals generated in the Frankfurt Stock Exchange’s Neuer Markt are approximated to be close to 200 billion € until the market segment was finally closed down. The consequence of the financial scandals is, besides the causation of the tremendous damages to private investors, a substantially spoiled reputation of the capital market itself, whereas the latter adversities seem not yet to be absorbed completely.

Even though the criminal procedures in the mentioned cases leaded to the conviction of the responsible insiders, the refurbishment of the scandals in German courtrooms frequently left damaged investors without a remedy for their losses, thereby revealing the jurisdiction’s de lege lata limits. As far as noticed actually none of the damaged investors’ civil claims did yet succeed. A first reaction to the corporate scandals by the German regulator in the fourth capital market advancement act is widely assessed to be insufficient to amend investors’ legal status effectively.

This analysis contributes to the continuing discussion in Germany about the reasons for the financial scandals. Furthermore, it makes a contribution to the debate on the issue, whether the damaging events indicate an advanced intervention of the government, and - if so - in which fashion the legal rule should developed to be an optimal remedy.

The capital market scandals are set off by false capital market information that was intentionally or frivolously disseminated by Directors and Officers (D&O) of public corporations, which are in the German two-tier system Vorstand and Aufsichtsrat (Board of Management and the Supervisory Board – here jointly termed: Board). Hence, the impact that false material data have on the efficiency of capital markets will be

1 This article has been accepted as a Master-Thesis in the Programme European Master of Law and Economics in October 2005 (www.emle.org). I thank Mrs. Prof. Dr. Michal Gal from the University of Haifa and Mr. Prof. Dr. Sharon Hannes from the University of Tel Aviv for their supervision and for valuable suggestions while researching on this paper. Moreover I thank Prof. Dr. Hans-Bernd Schäfer, University of Hamburg, for the second expertise.
3 See Baums, ZHR 167 (2003), 139 et sqq.
4 For instance the recent civil case of EM.TV, which still is not yet decided definitely.
5 See Baums, ZHR 167 (2003), 139, 141.
6 The so-called Viertes Finanzmarktförderungsgesetz.
7 See Kieth, Kurt, Persönliche Organhaftung für Falschinformation des Kapitalmarkts – Anlegerschutz durch Systembruch?, DStR 2003, p. 1982 et sqq; Holzborn, Timo; Foelsch, Eberhard. Schadensersatzpflichten von Aktiengesellschaften und deren Management bei Anlegerverschulden, NJW 2002, p. 2977, 2979. The mainly criticized aspects are that only the corporation is liable, but not the management and that the heavy burden of proof on the investor that impedes an effective protection. Furthermore see an overview provided by Ryan, Patrick S., "Understanding Director & Officer Liability in Germany for Dissemination of False Information: Perspectives from an Outsider". German Law Journal, Vol. 4, No. 5, 2003, 449.
8 Hence, the notion “false” will not necessarily indicate an intentional conduct of Board members. It refers also to frivolous acts that lead to the dissemination of objectively wrong information.
9 The terminology “Board” will be used for both, the Vorstand and the Aufsichtsrat as long as the arguments are valid coeavally. Necessary differentiations will be particularly indicated. A recent survey on the general duties of the German Vorstand is given by Turiaux, André; Knigge, Dagmar, Vorstandshaftung ohne Grenzen? – Rechtssichere Vorstands- und Unternehmensorganisation als
addressed in detail. Its specific effect on the share price is scrutinized by reviewing practical cases that occurred recently in Germany. This might allow a deeper understanding of the different kinds of damages that result from the approval of a frivolous disclosure policy by Board members.

By changing the perspectives the hypothesis that Board members have clear incentives to provide capital markets with false information will be verified. The analysis will apply especially insights of Law & Economics - as well as from the developing branch of Law and Behavioral Science - to emphasize the issue’s discussion in traditional legal scholarship.

Moreover, as economic theory indicates, a reason for a government intervention is only given in cases of market failures. Thus, the analysis will determine if the inefficient allocation of investors’ funds and the related Pareto suboptimality is grounded on market failures. Especially presumable obstacles with asymmetric information, negative externalities and potential free riding-behavior by competitors appear worthwhile to focus on. From an economic perspective it is to discuss whether the damages of shareholders that - due to false capital market information - purchased stocks above their actual value, should be recoupable in general. The crucial aspect about influencing the process of disclosure with an effective liability rule is that it could also hinder necessary and valuable truthful information to be available for the market participants.

As the economic approach to the law discerns it as a tool to maximize social welfare, the analysis will check whether the drafted German Kapitalmarktinformationshaftungsgesetz (KapInHag) is complying with this prerequisite. It will focus on two aspects that appear crucial for the efficiency of the legal rule.

First, the target of the drafted liability rule, i.e. who should be held liable for the dissemination of false information will be focused on. The traditional German liability regime that favors the primary responsibility of the corporation will be depicted and compared with the divergent proposal of the KapInHaG. The main question will be, which liability system provides the optimal setting of incentives for Board members.

Second, as the central aspect of a liability rule is the standard of fault that it comprises, it will be analyzed in detail. The German lawmaker suggests in the drafted KapInHag a standard of “gross negligence”. Thus, Board members will compensate damaged investors in every case the court in its ex post evaluation will conclude that the disclosure of false information was grossly negligent.

The analysis will examine in detail whether the proposal of the KapInHaG is pinpointing the accurate level of deterrence, while assuring that the necessary information will be disseminated courageously and at the perfect time. Therefore it will specially utilize the Business Judgment Rule, an instrument of US corporate law that might be worthwhile to implement also in German capital market law.
The aim of the analysis is to approach the first best solution to minimize the total social costs of false capital market information.
§ 2. Determining the Problem of False Information in Capital Markets

A. Reviewing Cases of False Information on the German Capital Market

The former Vorstand of Comroad - a firm that provided traffic navigation technology - publicly announced excessively high profits in the years 1999-2001\(^{13}\) that should have been earned by trading with a Hong Kong based contractual partner named „VT Electronics“, which was actually not even existent.\(^{14}\) The influence of the false ad-hoc disclosures that stated the valuable business with VT Electronics on the stock price was the basis for the seven years jail-term for the Vorstandsvorsitzenden\(^ {15}\) Mr. Bodo Schnabel.

In another case in the year 2002, Metabox - a producer of set-top boxes that was to connect televisions with the internet - announced in ad-hoc disclosures various large orders from “abroad” with a value of over 250 million €.\(^{16}\) The market processed this information as the stock price of Metabox increased by 22 % immediately after disclosure.\(^{17}\) However, as investors recognized that these announcements were not realistic and that such deals would not occur at all, the value of the shares decreased sharply and Metabox finally filed for insolvency proceedings on August 30\(^{th}\) 2002. The court judged the false ad-hoc disclosures as fraudulent and convicted the former Vorstandsvorsitzenden of Metabox Mr. Stefan Domeyer to seven months of jail with probation.\(^{18}\)

Moreover, another entity of the New Economy named Infomatec announced in 1999 the “biggest deal in the company’s history …”, based on a contract with the firm Mobilcom worth “at least 22.5 million €”.\(^{19}\) In reality, the value of the contract was less than 4.5 million €. Interestingly enough, the stock price increased after this disclosure, because investors traded shares increasingly but later faced serious damages when prices declined sharply as the market acknowledged the real value of the publicized deal. Infomatec’s insiders stressed that they did not intend to mislead the market and that the press processed their announcement wrongly as they had confused the notion “at least” with “up to”. This case of Infomatec exists on the border between intentional and grossly negligent disclosure of false information.\(^{20}\)

In the case of EM.TV the CEO Thomas Haffa announced that “… (w)e stand entirely by our prognosis … business is going very, very good … there is nothing negative to report.”\(^{21}\) This information was disseminated even though the entrepreneurial setting of the entity was constantly downgrading and the promised earnings of 272 million $ in October 2000 only amounted to approximately 23 million $.\(^{22}\)

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\(^{13}\) Solely 1.4 % of the announced turnovers for the period January-April 2002 amounting to 93.6 million € have been actually achieved. See: http://www.heise.de/newsticker/meldung/26386. (Accessed 20.07.2005)


\(^{15}\) The Vorstandsvorsitzende is the German equivalent of the CEO in the US Corporation.


Haffa still asserts that he never intended to cause damages and that he disclosed prospected earnings in the year 2000 in good faith whose amounts were actually achievable. Even though Mr. Haffa’s affirmations appear quite unbelievable, there are cases easily conceivable in which statements indeed are made in good faith. As the nature of prognoses is that they are about the forecast of uncertain future incidents, they might turn out to be wrong, notwithstanding the fact that the prognosis itself was legitimate.

B. Efficient Capital Markets and False Information

I. The Impact Of False Information on the Share Price

To analyze the impact of false information on the share price, one has to examine the preconditions of a well-developed securities market. Following the common definition, an efficient securities market requires perfect information of all market participants, an immediate reception of new available data and a marketplace with small and numerous participants. The Efficient Market Theory (EMT) asserts that if the former prerequisites are met, the stock price is determined by a discounting process such that it equals the discounted value - i.e. the present value - of expected future cash flows.

If this description of an efficient market is correct, there could not be obstacles with a derogating influence of false information on the share price. As all participants would have perfect information, the incorrectness of the capital market news would be included in the price of the share just at the time of its disclosure. Under this condition a divergence between the corporation’s discounted intrinsic value and its present market value is impossible. However, this depiction does not explain the response of the investors who took the false corporate news of e.g. EM.TV’s or Comroad’s insiders for granted and purchased overpriced shares before the sudden downswing occurred.

The German capital market scandal unveils that the condition of accessibly accurate information has pragmatically not been achieved and remains merely a theoretical notion. The real investor’s losses can only be identified as the damage that occurs because of the gap between the market value and the intrinsic or real value of an enterprise. Due to false and extremely positive information, investors trustfully equate the market value with the real entrepreneurial value of an enterprise thus trading in overpriced shares. If the new corporate data emerges on the market, revealing that the previous data have been false, the gap closes, whereby investors indeed face tremendous losses as the share price declines sharply.

This observation is consistent with the semi-strong Efficient Capital Market Hypothesis (ECMH), which central to the EMT. It stresses that share prices adjust instantaneously and in an unbiased fashion to publicly

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23 Indeed the criminal case led to the conviction of Thomas and Florian Haffa, see the judgment, http://www.dasanwaltsbuero.de/fp_files/urteile/bgh_1_str_420-03.pdf.


available new information, so that no excess returns can be earned by trading on that information. 26 Hence, the semi-strong ECMH argues that all public available information - no matter if correct or false (but at least plausible) - will formate the actual share price. The strong ECMH emphasizes the former approach and asserts that literally every information - even the publicly unknown - is incorporated the share price, so that in every moment the stock’s market price is reflecting the intrinsic value of the enterprise. According to the strong ECMH there cannot be a difference between the market and the intrinsic value of an enterprise.

But a closer look reveals that the power of the ECMH is to refuse. A frequently occurring small gap occurs between the investment value and the actual entrepreneurial value, which is a fundamental precondition of a functioning capital market. This follows the “efficiency paradox”, which affirms that an operative capital market cannot be perfectly efficient, because a certain grade of informational intransparency is necessary to assure participants’ incentive to obtain and process information in general. 27 This phenomenon refers to the fact that gathering information is costly and will be neglected by market participants if a positive return from the advantage of superior knowledge is not obtainable. 28 Hence, a functioning market economy is not characterized by perfect information but a certain combination of knowledge and nescience. 29 Clearly, these earnings would be impossible in a perfectly efficient market, in which every participant possesses perfect information. In practice, functioning capital markets face cycles of nearly perfect efficiency followed by relative inefficiency, because participants defer the pricey quest for new data as profits from such activity fade, but at a later term continue the search for new information as markets become more inefficient and so allow a positive return from the acquisition of unknown data. 30

As can be derived from previous observations, the share price is determined by an indispensable divergence between the corporate intrinsic- and its market value, following a necessary degree of intransparency of information. The basic problem with false information is indeed that it is creating the mentioned gap without being essential for the basic functioning of capital markets. It creates a reduction of efficiency that is not required for in providing incentives to quest and process capital market information. Therefore this is superfluous and has to be identified as an obstacle for investors and capital markets at large.

The visible result of this obstacle in the market is that investors who rely on the accurateness of the disclosed information will decide to purchase securities although the market price is actually too high and does not reflect the lower intrinsic value of the corporation’s shares. The share price is influenced by too optimistic information or the not disclosed not good - but realistic information - about the issuer’s situation in it’s given market. If, as in case of the capital market scandal, the disclosed information is eventually evaluated and proven to be false, the perceptive semi-strong ECMH indicates that market participants will quickly process false information as well. This will trigger an abruptly decreasing share price and has frequently initiated it’s

26 An instructive formulation is given by Grossman, Sanford J., On the Impossibility of Informationally Efficient Markets, University of Pennsylvania - Finance Department; National Bureau of Economic Research (NBER), December 19080, NBER Working Paper No. R0121, also available at http://papers.ssrn.com /sol3/papers.cfm?abstract_id = 228054, p. 2.: “ If competitive equilibrium is defined as a situation in which prices are such that all arbitrage profits are eliminated, is it possible that a competitive economy always be in equilibrium? Clearly not, for then those who arbitrage make no (private) return from their (privately) costly activity. Hence the assumptions that all markets, including that for information, are always in equilibrium and always perfectly arbitrated are inconsistent when arbitrage is costly.”


§ 2. Determining the Problem of False Information in Capital Markets

The common and aphoristic definition of an efficient capital market whose prices fully reflect all corporate data that is available\footnote{Gilson, Ronald J./ Kraakman, Reinier, The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias, Columbia Law and Economics Working Paper No. 240; Stanford Law and Economics Olin Working Paper No. 270; Harvard Law and Economics Disc. Paper No. 446 Also available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=462786.} is correct as far the notion of “available” refers to new, publicly announced, correct or false or misleading capital market information. For market efficiency at large, as well as for investors, the latter unpredictably have a negative impact on share price formation.

II. The Negative Effects of False Information on the Capital Markets

The eventually explored falsehood of capital market information will lead to two severe negative effects, which strike at the private level of investors’ assets and at the public interest concerned with an optimally conditioned capital marketplace.

1. Private Losses of Investors that rely on the Information’s Accurateness

The first is to be seen on a micro level: investors might face painful damages while possibly losing their investments in total. This is especially bitter, if like in the US’ Enron case the shares are the basis of the employee’s pension funds, of which these people’s future living standard is depending on.\footnote{For an analysis of US scandals, Ribstein, Larry Edward, “Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002”. Journal of Corporation Law, Vol. 28, No. 1, 4 et sqq.}

2. Inefficiencies of Capital Markets due to Investors’ lower Commitment

The second effect is linked to the first one and to be observed on the macro level: the false information causes inefficiencies in secondary\footnote{The secondary market has to be delineated from the first capital market. Basically the first market refers to the emission of new shares by the public corporation. This usually occurs in the IPO or when a increase in share capital is performed. The differences between the markets make also differing liability regimes necessary. This analysis will focus only on the secondary capital markets, in which investors trade stock among themselves. See for the delineation of the two markets, see Baums, Theodor, Mittelständische Unternehmen und Börse – Eine rechtsvergleichende Betrachtung, Festschrift für Ernst-Joachim Mestmäcker zum 70. Geburtstag, p. 816; Schwark, Eberhard, Kapitalmarktzogene Informationshaftung, Festschrift für Walther Hadding zum 70. Geburtstag am 8.Mai 2004, p. 1116, 1138.} capital markets and thereby diminishes its overall size.

A basic concern of the market economy is to allocate it’s limited capital efficiently. Private funds are supposed to be invested in companies with businesses whose ideas are expected to bring high returns, and to withdraw from companies with poor prospects.\footnote{Wurgler, Jeffrey, Financial Markets and the Allocation of Capital, NYU Stern School of Business; National Bureau of Economic Research (NBER), July 1999, Yale IFC Working Paper No. 99-08. Available at http://papers.ssrn.com/paper.taf?abstract_id=171921, p. 3.} Thus, if private assets are invested in those companies that are most valuable to the national economy, then the capital is being used efficiently. This condition identifies investments that lead, a sufficient level of security, at the same time to the potentially highest return on investment for shareholders. Thus, if the capital market is efficient, then invested funds will gain the optimal most possible yield. The instrument utilized in order to achieve this target is mainly to obtain wide and detailed information for investors about the possibilities of diverse investments in general\footnote{Fleischer, Holger, Verhandlungen Des Vierundsechzigsten Deutschen Juristentages, Berlin 2002, Band I, p. F 38.} as well as for

own dramatic crash.
chances and risks of a specific investment. In this fashion, society allocates its resources toward investments that promise the greatest return and steers away from less promising firms. This will improve the allocative efficiency of the resources’ utilization and will ideally achieve “Pareto optimality”, in which no reallocation of resources can be achieved that would make a single individual better off without harming another individual.

If available information is false, the allocative function of the market is abrogated. Then the assets will not be invested in the best performing company that has optimistic future prospects, but in the one that has been cheating while at the same time providing the “best” information. When stock investors purchase stocks, they are exchanging cash for a promised future return. The disappointment of asserting that this promise has not been kept, leads to a fundamental distrust in the market itself. Investors will have paid too much for inferior shares, thereby consequently losing faith in the capital market at large and will increasingly invest their funds in other sources such as bonds or traditional savings. Consequently, a strong capital market will only enhance efficiency if the private and institutional investors evolve sufficient faith in the fairness, stability and integrity of the market.

Nevertheless, if potential investors mistrust the market because of frequent wrong or misleading information by the Board, the national economy will - due to inefficiencies – undergo major losses.

Especially in the German economy there is a steady undersupply of fresh stockholder’s equity. Even though the second capital market has no direct link to the IPO-market in a way that companies directly profit from a higher stock price, nonetheless the lost faith in secondary markets fires back to the initial market of new shares and decreases the chances of corporations to raise funds by going public. Capital costs are on the rise, and if investors lose faith in buying stocks they will not differentiate between new and old shares. They will just refuse to participate in this type of investment. Hence it follows that growth of the economy through financing companies with stockholder’s equity is inefficient and thereby is unequivocally improvable.

C. Incentives of Board Members to Disseminate False Information

I. Entrepreneurial Reasons for the Dissemination of False Information

There are entrepreneurial grounds as to why members of the Board might tend to provide the capital market with false information. This argument is based on the contingent fact that Board members are highly motivated, occasionally conceited, corporate professionals who want to be in charge of what is considered to

36 Lenenbach, Kapitalmarkt- und Börsenrecht, Fn. 1.40.
be a successful company and will adjust their decision making tactics according to that goal.

Frequently, Board members have an interest in high market capitalization of the employing enterprise. The market capitalization is expanding with both, a higher share price and an increase in share capital, whereas the latter is facilitated when the share price is at a relatively high level. Hence, negative news about the enterprise’s market performance will decrease the share value and impede on higher market capitalization. To avoid this scenario, managers could take the bait and suppress or euphemize negative capital market information.

Decidedly, members of the Vorstand have in their day-to-day decision-making, situations in which high market capitalization is advantageous so as to achieve aimed targets. For instance, the decision about conditions for a bank credit will be indirectly influenced by the stock price of the owing enterprise. A high market capitalization signals successful entrepreneurship as well as a solidly, durable, market participation. Consequently the creditor might reduce interest rates due to a lower risk of default in back-payment. Since the management wants to reduce credit costs, it is possible that prior to entering into negotiations about obtaining credit, information that could negatively influence the share price will not be announced to the capital market.

Circumstances are comparable when management seeks to finance its expansion through bonded capital. The costs of corporate bonds depend on the company’s credit status that is assessed by rating agencies such as Moody’s, Standard & Poor’s or Fitch.\(^{41}\) The lower the rating are by the agencies, then the higher the interest rates are for the company to discharge in order to sell bonds on the market. To give an example of the power of the rating agencies’ appraisal,\(^{42}\) as ThyssenKrupp was downgraded one step to a moderately weak/marginal “BB+-”-rating, the annual costs of their bonds increased by 20 million €.\(^{43}\) The assessment criteria for the rating comprise - besides a detailed analysis of the financial status \(^{44}\) a general assessment of the quality of management. As an analyst of the third largest rating agency, Fitch stresses, the Board’s performance will also be reviewed according to the share value at the date of the appraisal.\(^{45}\) Therefore, important rating partly depends on the stock price, which the Board members can influence by a selective disclosure of value-relevant information. This observation identifies another aspect that might lead the management to engage in disclosure policies that finally might not be a picture of the current entrepreneurial setting of the company.

Furthermore, the threat of a hostile takeover by competitors fosters the Board’s affinity to mind a high value of the stocks\(^{46}\) as well as the disposition to avoid its decline by disseminating false price information influences into the market. In a competitive and well-functioning capital market, competing companies permanently expose other public corporations to risk a bid for a takeover. There is coherence between poor management performance and share price. The worse the market assesses the quality of management, the more investors will sell. In this case, fewer investors will buy stocks so that supply will outweigh demand.

\(^{41}\) For details see moody’s.com, standardandpoors.com, fitchibca.com.

\(^{42}\) See detailed Müller, Mario, Die zweite Supermacht, Frankfurter Rundschau, 19.7.2003, p.12.


\(^{44}\) For instance long-term lending, pension funds obligations, whether M&A transactions are depth financed etc.


and the prices will decline. Consequently, the opportunity for a takeover bid increases as well as the Board’s risk to be dismissed by the new majority owners of the corporation. Therefore the threat of abrogation and - this should not be underestimated - fear of a flawed reputation as an unsuccessful corporate manager in the public opinion will create an incentive to prevent a hostile takeover. 47 A means to circumvent passage of title; this is possible merely for a short period of time - is to manipulate investor’s opinions by announcing false news that holds up or increases stock prices.

II. Motivational Biases aggravate the Disclosure of False Information

Research in the branch of Law and Behavioral Science has shown that human decision-making is influenced by motivational biases. The recovery of these human dispositions has clarified many Law & Economics’ insights, because the movement traditionally applied - thinner or thicker 48 interpretations of rational choice theory that led to predictions, which intelligibly deviated from the actual human process of decision-making. 49 To explain Board members’ aptness to supply capital markets with false information even though they do not intend to do it, analyses of Law and Behavioral Science provide helpful insights.

The German capital market scandals revealed that from an investor’s perspective, the most interesting and for that reason prominently recognized information are predictions of an enterprise’s future performance. Even though retrospective (un)-consolidated financial statements 50, (un)-consolidated management reports 51 in compliance with section 325 Commercial Trading Act (HGB) 52 or interim reports according to section 40 Exchange Act (BörsG) 53 are providing detailed information about the issuers past market participation, the current reports 54 according to section 15 Securities Trading Act (WpHG) 56 and especially plain statements of Board members in the news(-papers) that are not regulated de lege lata, will significantly influence the financier’s investment decision.

The “confirmatory” or “self-serving” bias is justifying the conjecture that especially the publicly most recognized predictions about entrepreneurial future performance can be systematically too positive and misguide potential investors to purchase overpriced shares. 57 The “self-serving” bias generally leads actors to

48 As rational choice theory is used in the law-and-economics scholarship, it is understood alternatively as a relatively weak, or “thin” presumption that individuals act so as to maximize their expected utility, however they define this, or as a relatively strong, or “thick” presumption that individuals act to maximize their self-interest. See for details, Korobkin, Russel/ Ulen, Thomas, Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics, California Law Review, Vol. 88, 2000, also available at http://papers.ssrn.com/paper. ta?abstract_id=229937, p. 5.
50 In German: Einzel- und Konzernabschlüsse.
51 In German: Einzel- und Konzernlageberichte.
52 In German: Handelsgesetzbuch.
53 In German: Börsengesetz.
54 In fact the Lagebericht also provides an outlook of the prospected development. Usually it nonetheless is only evaluated and assessed by professional market analysts.
55 In German termed as Ad-hoc Meldungen.
56 In German: Wertpapierhandelsgesetz.
a perception of information, which is approving their preconceived beliefs.\textsuperscript{58} Moreover actors frequently interpret information in ways that serve their own interests. These self-serving biases can lead managers to provide objectively wrong information, even though they are not aware of it: empirical research has shown that people generally overestimate their skills in - and their contribution to - courses of action they are concerned with.\textsuperscript{59} If one transfers this general observation to the subject of corporate disclosure, one might assert that Board members, as they are personally committed to a projected business venture, occasionally process in-house data concerning the probability of success in a not strictly rational manner.

Primarily, Board members might overestimate their managerial prowess\textsuperscript{60} and thus have an overoptimistic prior opinion about their ability to succeed.\textsuperscript{61} Hence they often might downplay hints that indicate obstacles, just because they truly and adamantly belief in their own expertise. Secondly, as far as the company’s prosperity reflects the interest of the Board members, they might process pessimistic information too positively or might just unconsciously suppress bad news because it does not fit into their concept of targeted success. Central to this theory is a mechanism that leads endogenously to an agent being relatively overly optimistic about the likelihood for success of her own actions. This phenomenon of human decision-making might set off an overly optimistic assessment of future corporate performance and will therefore necessarily influence the quality of disclosed information that is circulating into capital markets. Due to this “confirmatory” or “self-serving” bias, investors will get information as to upcoming business projects that will not correctly indicate the actual risk of the investment, while underestimating the probability of a flop for the venture.

Moreover, to scrutinize the exhaustive, motivational predispositions one has to refer to the “over-confidence bias”. Numerous studies support, even when actors are acquainted with the actual probability of a particular unwanted event to occur, their predictions as to the likelihood that the event will happen to them is going to be underestimated.\textsuperscript{62} This bias is grounded on the general belief of decision makers that good incidents are more likely than average to happen to them then bad ones. Going forward with the issue of false information, they will be too prone to believe in the success of the project even though they might process the data concerning the probability of failure correctly. Thus, the “over-confidence bias” refers to the fact that Board members over-estimate the accuracy of their estimates and predictions, of which they themselves are occasionally overly optimistic.

To sum it up, immoderate confidence in the ability of “their” enterprises to overcome obstacles and the self-serving perception of information that might objectively signal future problems could lead Board members to


\textsuperscript{59} See Babcock, Linda/ Loewenstein, George, Explaining Bargaining Impasse: The Role of Self Serving Biases, The Journal of Economic Perspectives, Vol. 11, No. 1, p. 109-126. The “above average effect” shows that managers are also overly optimistic concerning their managerial prowess.


\textsuperscript{61} Larwood and Whittaker, 1977. (1977) ‘Managerial myopia: self-serving biases in organizational planning,’ Journal of Applied Psychology, Vol. 62, pp. 194-198; Babcock, Linda/ Loewenstein, George, Explaining Bargaining Impasse: The Role of Self Serving Biases, The Journal of Economic Perspectives, Vol. 11, No. 1, p. 109-126. This bias can refer to a disposition of people who see themselves as having a greater than average share of some desirable quality. E.g., most drivers consider themselves above average in their level of skill behind the wheel, while almost nobody thinks they are below average in their ability to get along with others.

C. Incentives of Board Members to Disseminate False Information

- unintentionally - mislead those who would invest in their securities.

III. Board Members are Holding Shares

Especially in the New Economy, the members of the Board purchased shares of the company they founded or worked for. Since one condition of the capital market bubble in 1999 and following years was that the share price in the IPO was usually significantly below the first listed market price and that Board members could; different from outside investors; assure attaining shares through the procedure of public offering. So, very often they purchased stocks for their own private portfolios. Secondly, in the frequent cases in which the Board members were also the company’s founders, usually they have been convinced of the chance to make profits on their business ideas so that Board members have preferred to hold shares in their “own” company.

This observation reveals an important endeavor of Board members’ to enhance the share price. The holding of one’s own shares provides the incentive to influence the market by disseminating information that triggers trade and thereby increases the market value of the stock. To increase the share price in the already mentioned scandals, insiders sometimes purposefully or frivolously - but in good faith and in the hope that the prediction will finally come true, have publically announced false information.

To exemplify the argument one can refer to the EM.TV case. The Vorstand of EM.TV Mr. Thomas Haffa was - very likely - against the best of his knowledge convincing the market of a prosperous future of the entity - the share price increased sharply - so that shortly after announcing the false information his sale of 200.000 shares gave him private gains of approximately 20 million €. In the following the prospected gains had to be corrected down to a much lower level. The market got suspicious and the share price broke down from 115.50 € in early 2000 to 6.75 € in December of the year. EM.TV’s “high-speed crash” left numerous private financiers with major damages that lost trust in the capital market and might not again invest in the capital market.

The EM.TV case shows that the sole fact that Board members are holding shares offers an incentive to disclose false information to secondary capital markets. This finding of course does not imply that Board members who hold own shares will always be prone to disclose false information about the enterprise to make extra profits, but the incident can contribute to a netting of incentives that will be examined deeper in the following example.

IV. Stock Options as a Compensation Model

Just as the holding of shares, as well as partial payment through Stock Options can trigger incentives for the Vorstand (Board of Management), this can result in providing potential share traders with false

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65 EM.TV’s high-speed crash, The Economist, 7 December 2000
66 In Germany the legitimacy of compensating the Aufsichtsrat (Supervisory Board) with Stock Options is disputed among scholars. The German High Federal Court (BGH) recently judged (II ZR 316/02 - 16.02.2004 – BGHZ 158, 122) that members of the Aufsichtsrat are not allowed to take part in Stock Option-plans. Even though there is one way to grant the Supervisory Board with
The central claim of the Shareholder-Value-Approach is to govern an enterprise according to the objectives of the shareholders and not to primarily regard the interests of other stakeholders such as the employees. In the Shareholder-Value-Discussion Stock Options have been implemented to increase the stock price and by this means serving the shareholders’ interests. This instrument is useful in linking parts of the management’s salary to price advancements of shares. The obligees of the Options will have the incentive to align their acts to a progression of the enterprises’ value in the capital market. The economic reason behind Stock Options is to abate the agency costs of management, i.e. costs to limit the extent to which managers of public corporations place their own interests above those of their shareholders.

While the use of Stock Options has been widespread in the US for a long time, this trend is emerging in Europe in recent years. In Germany, there is a progression to observe in the application of Stock Options. Already more than half of the enterprises that are listed in the Deutsche Aktienindex (DAX) utilize this compensation scheme. Some established and influential German enterprises that use Stock Options as part of their variable salary are Siemens, DaimlerChrysler, Deutsche Bank, Puma, Continental, BHF Bank and Henkel. In addition to their ability to attenuate the Principal-Agent-Conflict, Stock Options can be assessed as a useful remuneration scheme because they burden the enterprise’s liquidity less than classic compensation does and at the same time reduce the personnel costs. These previous functions can be seen as an explanation for the increasing use of this instrument in German capital markets.

Nonetheless, despite the fact that Stock Options align incentives of members of the Board of Management and shareholders, they thereby outplay the Principal-Agent obstacle of moral hazard, which is the same fact that creates problems for dissemination of capital market information. Stock Options are providing Board members with the incentive to undertake endeavors towards increasing share prices. As a negative appendage, the Options promote an inducement to disclose false information about the company’s performance, so that the managements’ Stock Options will also increase their value. Thus, with the focus on their own salary, management could be inclined to disseminate information that clearly draws on the enterprise’s market performance in an excessively positive light so that the share price increases or at least

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68 See Achleitner/Wichels, Stock Options, p. 2.


71 See Kessler/Sauter-Babel, Handbuch Stock Options, marginal number 1, 2.

72 Since 2005 on, the Board of Management of DaimlerChrysler is not paid in Stock Options any more. See http://www.spiegel.de/wirtschaft/0,1518,368197,00.html, (Accessed on the 4.8.2005).


will not decline. By the same the token, it is also possible that Board members will disclose information that is too negative, or hold back positive news to keep down share prices. This is likely to occur shortly before new Options will be granted. Since the value of the Stock Option depends on the difference between the strike price and the actual price at the date of exertion, the management has an interest to get the Option granted at the lowest strike price that is achievable. So, it is possible that the management might (mis-) use capital market information to perpetuate its interests.

From the perspective of potential investors, false information could mislead purchase of shares at a price that is above the real value or the sell of shares at a too low of a price when in reality, it’s actual value is well above that. But this adheres to the fact that the motivation described of the Vorstand or Aufsichtsrat will not lead to regular and persistent wrong information for potential investors, while the vast majority of Option obligees will dispute the mentioned temptation to not steal investors’ money. Still, one has to assert that a clear aptitude is created by Stock Options. This proneness to disclose false company news is closer fortified through granting new or exerting expiring Stock Options.

One can generally claim that the enhanced utilization of Stock Options among German public corporations creates a double-edged sword as they mitigate the Principal-Agent-Conflict and save agency costs, yet coevally increase the risk of potential investor’s and shareholder’s losses due to augmented published false information.

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77 Investors that already have shares could profit from the increased market price, but will not. First, shareholders lack the information that there is a gap between the value and the price of the share and secondly, they don’t know when to sell the shares, so that they probably will hold onto it until the falsehood about the information is revealed. Hence they will also undergo losses.
§ 3. The Necessity of Government Intervention to Cope with False Information

The question as to whether the obstacles caused by false information in capital markets require the lawmaker’s intervention has long been debated, notwithstanding that there is no unitary answer, especially from stakeholders.

In the US, the Council of Economic Advisors, in its discussion of a capital market law reform in the 2003 Economic Report of the President, agnostically stated that “whether SEC-enforced disclosure rules actually improve the quality of information that investors receive remains a subject of debate among researchers almost 70 years after the SEC’s creation.”

A basic insight in capital market law is that over-regulation can be just as damaging as under-regulation. Jennings/Marsh/Coffee are posing the correct question: "Initially, however, there is an antecedent question: why regulate?"

This question leads to a theory of regulation, which in its normative part deals with problems of market failure. An approach to this theory refers to economist’s search for Pareto Efficient markets, in which the allocation of society’s scarce resources is optimal and the agent who most values the resource will achieve it. In the case of market failures this prerequisite has not yet been accomplished, due to problems, which are outside the range of Smith’s invisible hand, that assure the Pareto Efficient equilibrium in perfect competitive markets. But regulation is only an efficient tool if markets are not able to help themselves and, probably even more importantly, if it does not create a greater damage than it should prevent.

The problem is addressed by the “Nirvana-approach” that reminds us of the fact that government intervention is not a value in itself and that its costs must be traded off against the damages that are induced by an unregulated market.

Since it is practically impossible to compute the damages, the approximation of the private losses and market deficiencies require a deeper knowledge about the factors that influence their extension. Thus, the question to pose is, actually how effective are the market forces?

As already pointed out, several arguments give reason that Board members have the tendency to provide capital markets with false information either on purpose or unintentionally. If market forces would be able to embank this tendency effectively, a costly legal remedy would be superfluous. But if the capital market alone cannot affect the damaging impact on private investors and market efficiency as explained above, the implementation of a legal remedy might appear to be reasonable. Hence, it is arguable whether a securities market that faces the problem of false information can be characterized by a failure that market forces cannot themselves correct.

A. Asymmetric Information in Secondary Capital Markets

82 According to the content of the KapInHaG suspicious, Semler/ Gittermann NZG 2004, p. 1081.
A puzzling fact is that investors disburse enormous amounts of private funds to a “strange” corporation for shares that are entirely intangible rights, and whose value depends mostly on the quality of the information that the investors receive based on the companies’ truthfulness.  

Moreover, investors are unable to scrutinize the quality of shares before the purchase, so the latter are not search goods. However, whether the satisfactory performance of shares after the purchase is the result of a good management or just due to general positive market development can frequently not at all or only be judged at high information cost. Since securities are not experience goods either, they are credence or trust goods, whose actual performance does not allow an assessment of future quality attributes. Thus, in the category of information economic terms securities are not search- or experience goods, but they are credence goods.

As the credence good character of securities provides very limited possibilities for potential investors to assess the adequateness of the share price, there is a fundamental problem of the different levels of knowledge about the company’s situation in its market among outsiders and well-informed insiders. Generally the imbalance of information between parties to an exchange can be so significant that exchange is impeded. Severe asymmetries can disrupt the market so much that the Pareto Efficient optimum will not be achieved by voluntary exchange of information. This discrepancy is termed as the market failure of “asymmetric information.”

Applying this insight of economic theory, one can derive that a prudent financier will just make securities investments if he has reliable information about the primary credibility and the later abidance of the given plights. The peculiarity of information asymmetry on secondary capital markets is that actually neither the seller nor the buyer has the necessary information to assess the quality and the price of the shares. Potential investors and sellers depend on third party dissemination of information that allows scrutinizing the value of shares. Hence, financiers are primarily dependent on the revelation of data by the company’s insiders, who are members of the Board. Besides the confidence that company’s insiders won’t cheat investors out of most - or even out of all of the value of their investment through self-dealing, is the announcement that credible information is the crucial aspect for well-functioning capital markets that are not disrupted by a market failure.

However, when market failure is apparent, the intervention of lawmakers in the market can ideally correct information asymmetries and induce an advanced, efficient and enhanced flow of information. The sole fact that asymmetric levels of information characterize the secondary capital market is occasionally seen as sufficient to justify government intervention.

B. Agency Cost-Theory/ Application of the Principal-Agent-Problem

As a remedy for the market failure of asymmetric information between investors and insiders of public corporations, one could apply an argument supporting the existence of incentives for the company’s insiders to deliberately disseminate truthful information. This argument can be derived from the agency-cost theory and basically stands against the call for government intervention.

The initial point of the idea is the contractual connection between the shareholders (principals) and the Board members (agents). This principal-agent relationship induces agency costs that are the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss. The incentives of both principals and agents to minimize agency costs can have a positive impact on the quality and quantity of disclosed corporate data, therefore alleviating asymmetric information.

The separated control over the publicity of entrepreneurial decision-making and ownership of public corporations creates obstacles since the interests of principals and agents differ. Shareholders want the Board to adopt decisions that maximize profits and therefore value shares. These decisions inevitably involve a certain degree of risk that only managers, being the most informed party, can estimate ex ante. By the same token, Board members might exploit the information asymmetry shareholders undergo by adopting post-contractual opportunistic behavior aimed at the maximization of their personal utility to the detriment of shareholders’ interests.

Thus, the principal-agent relation includes a hazard that agents will behave rationally self-serving and deprive shareholders of their enterprises’ value. The monetary equivalent of the reduction in welfare, experienced by the principal as a result of this obstacle is also a cost of the agency relationship that Jensen/Meckling refer to as the residual loss. But characteristics of the relationship also provide shareholders with the ability to control the risk of a too high residual loss and to embank on the opportunistic behavior of Board members.

As can be shown, shareholders can induce agency costs by discounting the share price and coevally contribute to mitigating the market failure of asymmetric information.

Many shareholders or –prior to purchase- numerous potential financiers have the power to influence the share price. If the management perceivably acts opportunistically, that includes also intentionally publicizing

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false information, shareholders will increasingly sell their stocks, whereas potential capital providers will
refrain from purchasing the company’s stocks - they will preferably invest in another enterprise - so that the
price declines. Actually a similar mechanism applies to the unintended disclosure of false information. After
the market becomes aware of the disclosed information’s falsehood, the share price will decline, because the
discounted future profits of the corporation that are included in the price diminish with the sobering
knowledge about the company’s real prospects.95

As market participants lose faith in the Board members that have applied frivolous disclosure politics or even
shown opportunistic behavior, there will be an additive reduction of the share price. Financiers will consider
the risk that the Board again might abstain from serving their interest in the future and impound it onto the
price. As a remedy for the risk of managerial self-dealing, shareholders and potential investors will embark
on the above mentioned peril by discounting the share price down to the level that they believe the losses
caused by the agency costs will do to damage them.

The agents on the other hand will have an incentive to diminish agency cost, i.e. to avoid discounts on share
prices. Board members have an interest to avoid offering a discounted stock price.96 The main reasons being
the frequent equation of managerial expertise and increasing stock prices97 as well as the higher risk of a
hostile takeover98 that might leave them behind and unemployed with a blemished reputation. Consequently,
insiders have a psychological interest and an economic advantage in satisfying the agent’s perceptions and
thus will try to meet them. Thus, this theory provides for the threat of high agency costs that give Boards the
incentive to act favorably towards potential investors and shareholders.

By signaling that the interests of the shareholders are seriously taken into entrepreneurial consideration by
the Board points out that this party has it in its own hands involved to reduce the discount on stock price and
to minimize agency cost. An effective tool is to comply with disclosure policies that are not opportunistic
and avoid blatant mistakes in the announcements.99 Hence, Boards have an incentive to report to the
shareholders that they are driven by efforts to maximize shareholder value. This indeed includes also the
truth as to the disseminated data so that insiders will disclose both good and bad news of their performance.
Also the latter, because markets would become suspicious if only positive performance was frequently
revealed which would typify the company as being a “sunshine-publisher” which could cause a question of
trust. Conclusively, a loss of faith after acquaintance with falsehood could lead to even higher agency costs.

To sum this up, the inefficiencies in secondary capital markets due to the market failure of asymmetric
information can be embarked by the agency cost-theory. But it is questionable as to whether the deterring
forces of shareholder “retaliation” are effective enough to actually solve this problem. It presumes that there
exists “rational ignorance” of every single investor as to it’s own contribution not being able to influence the

95 For details as to price formation see, Fama, Eugene F./ Jensen, Michael C./ Roll, Richard, The Adjustment of Stock Prices To New
Lorie and R. Brealey, eds., Praeger Publishers, 1972; and Strategic Issues in Finance, Keith Wand, ed., Butterworth Heinemann,
212.
99 For instance the confusion of “at least” and “at max.” while referring to the value of a contract in the case of Infomatec. Details are
provided for See Ryan, Patrick S., “Understanding Director & Officer Liability in Germany for Dissemination of False Information:
behavior of the indeed powerful Board that weakens this theoretical consideration. Moreover the “thin” market for corporations that impedes frequent takeovers\textsuperscript{100} of suboptimally managed corporations is counterproductive and allows Board members to deviate from the shareholders’ ideal without suffering “punishment”.

Hence, to allow market forces to have a free-hand, will not entirely correct the market failure of asymmetric information; thus governmental intervention appears indicated.

C. The Problem of Adverse Selection

There is another obstacle to well functioning of the secondary capital market that is related to the apparently persistent asymmetric information. The fact that Board members possess exceptional knowledge about inside materials facilitates a source for inefficiencies that are termed adverse selection.

This concept has been explored by Akerlof\textsuperscript{101} who observed the used car market to exemplify this problem of market distortion. His basic findings are that buyers do not know whether the cars offered are - as Akerlof phrases it - “lemons” (bad cars) or “cherries” (good vehicles), their willingness to pay lies between the price for lemons and cherries.\textsuperscript{102} Thus, sellers will trade fewer cherries since they consider the price to be too low, but will sell a higher number of lemons as they can get a good price for them. After some time, purchasers realize the undesirable quality, and refuse to pay the old price for used cars, as they are still unable to evaluate the quality of the car. The price will lower and even fewer cherries, and even more lemons, will be put up for sale. Using an extreme, the cherry sellers will have been driven, as it were, out of business.\textsuperscript{103}

Used cars and securities are comparable in a way that they are both not search goods. Their quality can hardly be assessed \textit{ex ante} of the purchase. From the perspective of consumers, securities are even worse to scrutinize than used cars, as one \textit{ex post} will find numerous influencing effects that have determined the market performance of the share, while a mechanic will easily find the reason, for instance why the brakes of a car are malfunctioning. Thus, used cars are experience goods whereas securities are - as already stated – rather in the category of credence goods. Against this background it is worthwhile to apply Akerlof’s observation to the securities market.

The result of asymmetric information between public corporations and potential investors is that the latter do not know whether they are about to purchase costly shares that are actually of high quality and worth their price. Usually this problem is seen from the perspective of consumers who lack information. But the obstacles also are apparent in the case of disseminated information that is false. Due to tampered material, data investors are misled and will, as they realize this by facing losses, lose faith in the corporation’s management and - as the scandals in Germany have shown - also in the market at large.\textsuperscript{104} Thus, they will discount the share price of all market participating public corporations, including accurately managed ones.

\textsuperscript{100} Cooter/ Ulen, Law and Economics, 4th Ed., p. 140, 141.
\textsuperscript{101} Akerlof, Q. J. Econ. 84 (1970), p. 488.
\textsuperscript{102} Akerlof, Q. J. Econ. 84 (1970), p. 488.
\textsuperscript{103} Akerlof, Q. J. Econ. 84 (1970), p. 488.
\textsuperscript{104} In the year 2000 151 corporations had their IPO in the Neuer Markt, where the volume of the emissions amounts to 29,2 billion €. However, in 2001 only 18 corporations went public where a volume of emissions amounted only to 2,97 billion €. Hence the number of IPOs has declined significantly due to deterred investors. See www.ipo-reporter.de/w6/stat.asp. (Stand 15.10.2001) and Ostrowski/ Sommerhäuser, WPg 2000, S. 961.
These circumstances result in the same problem of adverse selection:

Potential financiers might search for a compromise between the handicap of being relatively uninformed about the management’s quality and - on the other hand - the fact that typically a higher price signifies higher quality. Accordingly, there is a tendency that investors will not be willing to purchase shares in the highest price segment and are more active in a medium segment. This leads to fewer sales of highly priced stocks. Supplier of these stocks will suffer from the buyers’ reluctance to purchase at the price that their stocks are actually worth, because they have good management that does not disseminate false capital market information to influence share prices. These corporations might refuse to go public, because they are probably able to bargain better conditions when the growth is dept financed or they will be driven out of the market and will be forced to go private again. But corporations that have less than rewarding prospects are not deterred by the negative development of prices, as for them the average market price reflect their real value so that these firms will still go public. In a later period, the market will adjust to a lower level so that even lower quality shares will be traded. At the same time, the discounted price will not discourage dishonest issuers. The Boards of these firms will see an advantage to going public. This increasingly worsens market consistency of its participants. Akerlof’s market for lemons is identifiable in secondary capital markets whereas the adverse selection constantly exacerbates.

Equivalent to the granting of guarantee and warrants in the used car market, there are singalling devices that allow the Board to inform the market about its honesty and the priority that is given to maximize the shareholder value. These tools will make it easier for potential investors to separate “lemon-” from “cherry”- corporations, so that divergent share prices that are related to the signaled quality can be achieved.

One of the possibilities for corporations to signal their quality is to reacquire their own stocks, i.e. the issuing company buys its own shares on the market. The signal to the market is that the Board of the issuing corporation believes that the shares on the market are undervalued, so the purchase is a profitable business. Other times, companies do this to prepare for the implementation of performance-based compensation plans for employees, for instance to serve Stock Options. Rather than receive cash, the recipient would get an asset. The background of the reacquisition of it’s own stocks signals that entrepreneurial prospects surpass what market participants estimate them to be. The Board would face serious difficulties with uncompensated employees - and a personal loss - if all the granted Stock Options would be “out-of-money” at the time of exertion. Hence the reacquisition of own stocks is a relatively credible signaling device.

But in Germany the reacquisition of own stocks has tight restrictions. The reason for these restrictions are mainly the risk of the buyback that leads to a partial liquidation of stockholders’ equity, which only the apparent shareholders are benefitting from. Thus the jurisdiction allows the application of this instrument only in exceptional cases. But it is useful to attenuate the problem of adverse selection, because in cases of hardship it can be used to signal trust towards the market and to sustain the share price. Nonetheless it faces restrictions, for good reasons that are not mentioned here in detail, which impede the buyback to become a

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105 A detailed description for the reacquisition of stocks (Aktienrückkauf) is provided for by Hirte, Heribert, Kapitalgesellschaftsrecht, 4. Auflage, Köln, 2003, p. 238 et sqq. After buyback (repurchasing), the company can either retire their shares or hold onto the shares for later resell. As the total quantity of shares decline, due to the amount of outstanding stocks in the open market being reduced, the shortage will trigger the rise in the price.
more effective tool to cope with asymmetric information in public corporations.

D. Externalities Caused by the Disclosure of False Corporate Data

Another failure that preserves serious distortion of markets is termed “externality”. From the perspective of welfare economics the identification of an externality legitimates a legal rule that coerces or allows the actors to internalize the negative respectively positive effects of their conducts.109

In economic theory a negative externality occurs when a decision causes costs to stakeholders other than the actor making the decision.110 In other words, the decisionmaker does not bear all of the costs that her action causes. Thus, she will also not consider them while accomplishing a Cost-Benefit-Analysis to assess the economic sensibility of her conduct. As a result, in a competitive market, there will be too high a level of the damaging activity that has caused the failure. Due to the unbargained for cost caused by the externality, the market is characterized by Pareto inefficiencies.111 The remedy for externalities is to force the damaging agent to internalize the effects of the conduct, i.e. make her take into account the cost she is creating for others. This is usually accomplished by legal regulations that levy a tax on the injuring party or that create the duty to compensate the claimant.

Brought forward by the obstacles with false information in secondary capital markets, there is a negative externality to identify what causes the mentioned effects. As businesses have different options to finance their endeavors, there are dept or equity financed funding methods that are applicable. Frequently employed to achieve liquid financial resources are bank loans and - for corporations – shareholder- or private equity options. The cost of the financial instrument have a major influence on the entrepreneurial decision, of which modus operandi is utilized. From the perspective of the enterprise, the instrument that entails the lower capital cost is superior. Capital costs are the expenses for the provision of funds, which are mainly the interests for a credit and the costs of the offering procedure, plus possibly unsold shares in an IPO.

The new shares created in IPOs or in an increase in capital are preferably placed in bull markets, because in these situations the probability is higher that all new shares will be sold above their nominal value. Since the total nominal value of the sold shares will found in the actual corporation’s equity, firms are seeking to minimize the risk to sell (some of) the offered new shares below the nominal value or even not at all. Indeed, this would increase the capital cost significantly relative to dept-financed funds. Thus, the capital costs will be lower as the targeted amount of equity will be accomplished.

The problem of false information in capital markets is that investors lose not only faith in the disseminating company but also in the integrity and accurateness of the market at large. They will conduct lower commitment and restrain from purchasing shares, so that a longer lasting bear market will occur, as could be seen in German capital markets in the years 2000-2002.112 The capital market’s size will diminish, as financiers invest their funds preferably in other financial instruments that provide save - but also probably

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109 Cooter/ Ulen, Law and Economics, 4th Ed., p. 44.
112 In the year 2000 151 corporations had their IPO in the Neuer Markt, the volume of the emissions amount to 29,2 billion €. But in 2001 only 18 corporations went public at a volume of emissions amounting only to 2,97 billion €. Hence the number of IPOs declined significantly due to the deterred investors. See www.ipo-reporter.de/wb/stat.asp. (Stand 15.10.2001) and Ostrowski/ Sommerhäuser, WPg 2000, S. 961.
lower - returns at a lower risk. Thus, not only the capital cost of the disseminating firm will increase but also from all other corporations that are in the market. The company that is providing flawed news about its market performance will thereby cause negative externalities on other enterprises that are seeking to supply the need of equity on the capital market, as well.

The other companies will be carrying the not compensated for increasing capital cost, because of the overall lower commitment of investors in the securities market. A suggested remedy is a legal rule that forces the disseminating firm to take the costs into account. This can be achieved by an effective liability rule.

E. Free Riding Behavior of Market Participants in Cross Section Analyses

Finally an application of a traditional economic argument indicates the general need of regulating the disclosure of material data. Recent research shows that public corporations that disclose information are creating positive externalities to their peer.

In the terms of economic theory, capital market information is a public good. This is related to two characteristics that determine the commodity. Firstly, capital market information is defined by its partial nonexcludability. The corporate data is disseminated to convince potential financiers to invest their funds in the disseminating corporation. Thus, this information has to be available to investors at very low search cost. This necessity implies that once the information is available to investors, it is practically impossible to exclude competing firms that will make professional use of the data. Secondly, the consumption of information is nonrivalrous. If investors ground their decision on this information, they do not leave less of it for competitors of the corporation that will utilize it. In view of that, there is a strong inducement for peer firms of the privately provided public to obtain good information for a free ride.

The discerning observation is that free riding behavior is apparently problematic in cross section analyses. These analyses are the analytical comparison of specific market participants by underwriters or potential investors to assess the value of competing firms in different branches. Cross section analyses are crucial for the efficiency of capital markets and increasing share prices.

If a firm discloses, it affords the conditions for cross section analyses in the market, of which every single peer will benefit. But the disclosing firm will totally not be compensated, whereas the competitors will free ride on a fraction of the benefits, since their performance will also be comparable in the following. Therefore one can derive from this thesis that the overall supply of information will be too low, because the incentive to disclose is malfunctioning due to the peer’s free riding behavior.

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116 Jennings/ Marsh/ Coffee/ Seligman, Securities Regulation Cases and Materials, p. 239 et sqq.

http://www.bepress.com/gwp/default/vol2006/iss1/art2
Thus, according to this approach there is a steady undersupply of information, because information is costly and the investors or peers who use it will not pay for it. Therefore, they are free riding on the information cost of the disclosing company. It will only supply information until it’s own marginal information costs are equal to the marginal benefit it expects from providing it. This can be judged as less information for a complete evaluation of the risks that the purchase of a specific share is providing.

This argument states that the market itself is not able to provide the optimal of disclosure, so that a legal rule to stipulate the quantity material information in capital markets appears to be a necessary remedy.

F. Results

The incentives to reduce agency costs are not sufficient to remedy the obstacles with asymmetric information. Even though signaling devices can embank the adverse selection, the aptness of Board members to disseminate false information is not effectively solved. Moreover, enterprises that disclose false information are causing negative externalities on other public corporations. Conclusively, the peers of a disseminating firm might free ride on it’s information cost to thereby trigger a reduction of the overall quantity of information that is necessary for an efficient capital market.

A mandatory law that regulates the quantity and the quality of capital market can embank mistakes in the process of disclosure and might thereby prevent painful damages. The practical experiences with the German corporate scandals are revealing that market failures indicate a need for state regulation to enhance the allocative efficiency of the capital market.

In order to give a full evaluation of this task, one also has to take into account the cost a managerial liability rule would create in total. These costs can be tremendously high\textsuperscript{120} and the cost-benefit-analysis might reveal that the damages in an unregulated market are lower than in a regulated one. Consequently, to approximate the regulation cost, the following question is how the optimal legal rule is designed to cope with the obstacles of false capital market information by Board members.

\textsuperscript{120} See, the Economist, May 21\textsuperscript{st} –27\textsuperscript{th} 2005, A price worth paying?, p. 73, stating that the private cost of the US’ Sarbanes-Oxley Act might cause private cost to 1.4 trillion $.
§ 4. The Optimal Legal Remedy – An Approach to the Efficient Liability Rule

Probably the most inventive approach to traditional legal scholarship has been that Law & Economics applied the principles of microeconomic price theory to the analysis of legal rules. The application of the theory is founded on the insight that people basically act rationally and adjust their decisions to prevailing incentives. The law has within it’s scope to make socially unwanted behavior costly to the addressees of the rule, while attaching a deterring price, i.e. a fine or a claim of compensation to this type of conduct. Thus, a suggested legal rule creates a mechanism that deters the decisionmakers of disseminating wrong statements on behalf of the public corporation while inventing or improving investors’ rights to compensation for losses that will occur.

This is a fundamental task of this analysis, since it must appraise that the optimal law has to balance two important issues in one legal rule: firstly, it shall effectively deter the Board members to provide the capital market with false information, however at the same time it has to make sure that the relevant material information is made available to the market, so that the value of the investment can be accurately judged by potential investors.

This analysis will scrutinize German jurisdiction and therefore will focus on the drafted Kapitalmarktinformationshaftungsgesetz (KapInHaG) that shall reform the German liability system for false information in secondary capital markets. Furthermore the optimal standard of care is going to be analyzed from an economic perspective. The further prerequisites of a liability rule such as, which data is in the rule’s scope, how is the notion of causation and recoupable damages are to be interpreted, will be examined in another survey.

The development of Germany’s capital market liability law has proceeded over decades and lacks a superordinated dogmatic, in which the drafted KapInHaG can systematically fit in. Thus a brief overview about the German liability rules for disseminating false capital market data law is provided.

A. The legal framework in German Capital Market Law

I. The Situation de lege lata

1. Section 37 b, c Securities Trading Act (WpHG)

As a primary reaction to the scandals in German secondary capital markets, the lawmaker has enacted a - highly disputed - legal remedy in the fourth capital market advancement act: if investors face damages

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125 For an instructive overview see Ryan, Patrick S., ”Understanding Director & Officer Liability in Germany for Dissemination of false Information: Perspectives from an Outsider”. German Law Journal, Vol. 4, No. 5, 2003, 439, 447.
126 Gerber, Olaf, Die Haftung für unrichtige Kapitalmarktinformationen – Zugleich eine Besprechung der BGH-Entscheidungen vom
because of false ad-hoc announcements, the corporation has to compensate the financiers’ losses according to section 37 b, c WpHG.\textsuperscript{128} Currently, there is no personal liability of Board members that has been enacted.

In German scholarship the rule is judged to be quite ineffective for different reasons. Indeed, the claim is a blunt sword when the public corporation has no funds and goes bankrupt.\textsuperscript{129} This has actually happened in the cases of Infomatec, Metabox and Biodata, in which the investors’ legitimate claims are finally completely worthless.\textsuperscript{130} A further point of criticism is that the claim is applicable only on false ad-hoc announcements. These are current reports according to section 15 WpHG, which refer to data that can influence the share price extensively and therefore have to be disclosed immediately. Even though the protection of ad-hoc disclosure is a central issue, frequently there is a call for a general clause that copes with the issue.\textsuperscript{131} The drafted KapInHaG steers a middle path and emphasizes the claim of the WpHG, personally and contently. It creates a direct claim against Board members and is applicable for almost every false announcement that is disseminated on behalf of the corporation. \textit{De lege lata}, states that shareholders do not have a right at all, when the disclosed information is not an intentionally disclosed false ad-hoc announcement.

2. Rights of Shareholders against Board Members for Disclosure of False Data

The private liability of Board members for damages of investors is de lege lata in Germany based solely on the tort system.

a) Section 826 Civil Code (BGB)\textsuperscript{132}

This claim according to section 826 BGB requires an intentional and immoral damnification of the tortfeasor.\textsuperscript{133} The German High Federal Court (BGH)\textsuperscript{134} judged that the manipulation of a market with malice aforethought is a breach of basic principles of capital market law.\textsuperscript{135} Purposeful false information that are tempting the damaged party to an action, i.e. to buy or sell securities, are adjudicated to be immoral in the sense of section 826 BGB.\textsuperscript{136}

b) Section 823 II BGB with “protective laws”

Section 823 II BGB is a general provision that provides for the award of damages to plaintiffs if another...
“protective law” (Schutzgesetz) has been violated. Generally a “protective law” is a law whose aim of protection patronizes both the general public as well as an individual.\footnote{MüKo-Mertens, § 823, marginal note 162 et sqq.}

It is traditionally highly debated, as to which legal rules have the character of a “protective law”.\footnote{MüKo-Mertens, § 823, marginal note 191.} Section 263, 266 Criminal Code (StGB)\footnote{Strafgesetzbuch.} and sections 400 Stock Corporation Act (AktG)\footnote{Aktiengesetz.} and 331 Commercial Trading Act (HGB)\footnote{Handelsgesetzbuch.} are approved “protective laws” that are debated in this context.\footnote{See also Ryan, Patrick S., "Understanding Director & Officer Liability in Germany for Dissemination of False Information: Perspectives from an Outsider". German Law Journal, Vol. 4, No. 5, 2003, 456 et sqq.} The discussion as to whether the new section 37 c WpHG is a “protective law”, and thus would create a direct claim against Board members for false information below the barrier of scienter,\footnote{See for details about “protective laws”, Edelmann, Hervé, Haftung von Vorstandsmitgliedern für fehlerhafte Ad-hoc-Mitteilungen – Besprechung der Infomatec-Urteile des BGH, BB 2004, p. 2031 et sqq.} has ended with a negative result. Section 37 c WpHG definitely does not have the characteristics of a “protective law”.

c) High Demands on the Plaintiffs who carry the Burden of Proof

The German private liability system for socially unwanted corporate practices is quite weak and that relatively ineffective. The root for this is that its fundament is the traditional German tort system.

Customarily problematic is the prerequisite of scienter that bases both on claims according to 823 II with “protective law” and 826 BGB required. This is typically not easy to prove by the damaged plaintiffs. Basically, and in compliance with German civil procedure law, simply denying the accusation would be enough for the sued Board member to dismiss the action. This has actually happened in the civil actions after the capital market scandals frequently.

Moreover, the claims under sections 823 II and section 826 BGB require a proof of causation. Under the German jurisdiction the required causation between damaging conduct and damage is strictly construed.\footnote{Palandt-Sprau, § 823, marginal note 53} The unwanted conduct must be “condicio sine qua non” for the occurred loss. Thus, de lege lata causation can only be found in a false ad-hoc disclosure, if the investment does not have taken place without publication of the material data.\footnote{Palandt-Sprau, § 823, marginal note 60.} This indeed is not easy to prove due to the fact that usually diverse factors are influencing the investment decision.\footnote{To be considered are for instance the hints of finance consultants and bank employees.}

Most of the court actions were dismissed, because of either the practically impossible proof of scienter or the obstacles with strict interpretation of causation, that both create a very high threshold for the damaged plaintiffs.\footnote{Baums, ZHR 167 (2003), 139, 141.}
3. Internal Liability of Board Members

According to section 93 I, 116 AktG Board members are liable for a breach of duty of loyalty or fiduciary duty that they have on behalf of the corporation. It is the corporation that has the title against the Board members. The latter have to compensate for the damage they have caused. This legal claim is the traditional German internal liability of both the Board of Management and the Board of Directors.

To prove this claim, the court has to be convinced that the Boards breached their professional duties. Admittedly this it is not easy to accomplish.149

II. The Situation De Lege Ferenda

The present German government has sketched out the KapInHaG that might bring changes to the WpHG. The major change the KapInHaG proposes is a reformed section 37 c WpHG, which creates in a quasi general clause a direct claim of shareholders against the members of both the Board of Management and the Board of Directors for disseminating false information on the market. Hence, the targets of the drafted law are primarily the members of the Boards and are not the public corporation itself.

By doing this, the German corporate liability system is undergoing a fundamental and systematic change. Besides the prospected direct claim, the tort law framework will remain, as well as the internal liability receivable from the Boards, which itself will probably be reformed in the near future.152 Sünner, as a practicing in-house legal adviser, assesses the proposed direct claim as debris, which is rather based on a general economic adverse disposition in current Germany than it is on a well-advised reform act.153

B. Economic Rationales in Favor and Against a Direct Claim

To examine the optimally designed legal remedy, one primarily has to address the target of the law, i.e. who shall be held liable if the representatives of a public corporation are disclosing wrong information. This can be either a claim against the corporation itself or a personal and private liability rule against the Boards. The question is whether economic theory is revealing, which of the tasks is superior.

I. Creating Incentives to Disseminate less False Information

Again microeconomic price theory allows for a prediction of Board members’ professional behavior.154 If the damaged investor has a direct claim against the active publishing corporate representative to recoup the losses that occurred because of the false information, the latter will take more precautions in the disclosure

149 Spindler, Gerald, Persönliche Haftung der Organmitglieder für Falschinformationen des Kapitalmarkts, WM 2004, P. 2089, 2096.
150 There will be a new election in Germany in September 2005. If the current government will not remain it appears quite likely that the drafted KapInHaG will never be enacted, because the new parties that might create the new government (CDU/ FDP) have signaled their disapproval of the regulation’s content.
152 See the sketched Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), www.bmj.de (EntwurfUMAG.pdf)
B. Economic Rationales in Favor and Against a Direct Claim

process. As the price for excessively imprecise information increases, the manager will disseminate less wrong or misleading information so as to avoid liability. So, the reasonable aim of the KapInHaG can be reached by creating a personal liability for the company’s insiders.

On the other hand the currently applicable German law is already influencing the incentives on Board members. Hence, it has to be considered to assess the impact of the new-implemented direct claim properly. As mentioned above, the German corporate law provides in section 93 I, 116 AktG the concept of internal liability (Innenhaftung) of managers and supervisors that act against the duties they have in operating on behalf of the company. Since the disclosure of false information causes a clear damage to the company, the Board members’ behavior will basically cause their internal liability according to section 93 I, 116 AktG. Thus, there is an argument that the internal liability is already influencing the manager’s behavior in a deterring way, so that a direct claim against the members of the Boards is not necessary or - even worse - over deterring.\(^{155}\)

The conditions and the content of both the direct claim and the internal title are quite similar as they are equally related to the identical legally unwanted conduct, which is the false disclosure of material data. The damages, which are deducible from the differences of the share prices following the false announcements and its discovery, are recoupable under both titles as well as the proof of causation is necessary. But there is also a significant discrepancy between the direct claim and the title of the corporation against its Board members, which might have an impact on the managers’ incentives.

According to section 112 AktG, actions on behalf of the corporation against the Board of Management following section 93 AktG have to be executed by the Supervisory Board and according to section 78 AktG and it also has to be filed vice versa.\(^{156}\) Not astonishingly it is asserted that there is a hazard that Board members might not effectively protect the corporation’s interests.\(^{157}\) According to the saying: "There’s honor among thieves", one actually has to doubt that every breach of duty of loyalty or of fiduciary duty will be pursued seriously. This allegation is fostered by a noteworthiness of Germany’s corporate reality. The fact remains that many retiring chairmen of Boards of Managements go over to the Supervisory Board, and usually have chosen their successor in the Management Board beforehand. Thus, the relationship between the two Boards is characterized by multiple dependencies and personal solidarity. This weak and often criticized aspect in the German corporate governance system\(^{158}\) is that the possibilities of managerial internal liability is not used effectively, because the two mentioned organs are two close to each other, so that the necessary control is not occurring.\(^{159}\)

In German as well as in US law, the regulator copes with the former issue and provides a remedy for the


\(^{156}\) Wiesner, Georg, Münchener Handbuch des Gesellschaftsrechts, Band 4, Aktiengesellschaft, p. 154.


\(^{158}\) See Baums, ZHR 167 (2003), 139, 142.

\(^{159}\) A detailed survey on the divergences and the deficiencies of the German as well as the US corporate governance systems is provided by Schwarz, Günter Christian/ Holland Björn Enron, WorldCom … und die Corporate-Governance- Discussion, ZIP 2002, p. 1661-1672.
§ 4. The Optimal Legal Remedy – An Approach to the Efficient Liability Rule

rather ineffective enforcement of the corporation’s interests. In section 147 AktG the Gesellschafterklage, i.e. the equivalent of the US derivative suit, is regulated. These specific suits are actions brought by a shareholder in the name of the corporation to correct a wrong done to the corporation. As persons who are in control of the corporation are unlikely to authorize the corporation to bring suit against themselves personally, the Gesellschafterklage or derivative suit permits a shareholder to prosecute these claims on behalf of the corporation.

As the Gesellschafterklage in Germany theoretically remedies the weak protection of corporation’s and therefore eventually shareholder’s interests, this reality is quite sobering. Just as the derivative suit in US law the Gesellschafterklage is a rather blunt sword. Only very few Gesellschafterklagen are actually filed, because there are prerequisites to be met (section 147 AktG) that are quite complex and time-consuming: either the interested shareholders have to effect a shareholders resolution about the issue or the shareholders need a minority quorum of at least 10 % of the shareholder equity. Moreover, the minority of shareholders face the risk of paying the court costs if the corporation eventually loses the action (see section 147 IV AktG).

As the provisions of the Gesellschafterklage are laborious and risky for the shareholders, there is an ongoing discussion of reforming it. But de lege lata it is not a successful remedy for the weak protection of shareholders’ interests. Hence, the claim of the corporation against its Boards is not an effective tool to deter the Board to disseminate false share price relevant information.

Thus, this argument recommends the direct claim of the KapInHaG as a sensible completion of the existing but weak internal liability. In the further process of reforming the capital market law one has to trade off the effectiveness of the internal liability – especially the Gesellschafterklage – with direct claim, since both provide Board members to disclose information more carefully.

II. “Endgame Problems” in Corporate Disclosure Policies

The German corporate scandals reveal that Board members did increasingly provide the capital market with false and misleading information especially when “their” corporations were in crisis and the fear of dismissal of the employment contracts as well as the loss of managerial reputation was apparent or - in the worst case - the corporation itself was close to bankruptcy. This was notably the case in the already mentioned scandals of EM.TV, Comroad and Metabox.

162 See for details also Hüffer, Uwe Aktiengesetz, 6th Edition, § 147, marginal note 8.
165 Hüffer, Uwe Aktiengesetz, 6th Edition, § 147, marginal note 3 et sqq.
166 Köhler, Annette/ Meyer, Stephanie/ Mauelshagen, Jan, Umsetzungsstand des 10-Punkte-Plans der Bundesregierung zur Stärkung des Anlegerschutzes und der Unternehmensintegrität, BB 2004, p. 2623, 2624. The UMAG (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts) aims to make it easier for shareholders to file a suit. The threshold is lowered down to 1 % of the shareholder equity, or the shares are worth at least 100.000 €. But again there are obstacles involved, such as a judicial preliminary proceeding that might deter shareholders from filing the action.
Spindler, Gerald, Persönliche Haftung der Organmitglieder für Falschinformationen des Kapitalmarkts, WM 2004, P. 2089, 2096.
In game theoretical terms, this could be seen as an “endgame problem”\textsuperscript{168}. Generally game theory can help to explain the strategic behavior of principals and agents in specific situations in business relationships.\textsuperscript{169} These cooperations confront situations in which the optimal action for the principal to take, frequently depends on what strategy the agent chooses. The “endgame problem” describes the unwinding of cooperation as a repeated game approaches its final round.\textsuperscript{170} Usually the principal-agent relationships is about to last for a long time so that it is characterized by frequent exchanges between the actors in different periods.\textsuperscript{171} Hence both parties have the incentive to behave well, as the agent knows that if she appropriates the principal, it will retaliate in the next period (tit-for-tat situation).\textsuperscript{172} However the principal has no power to retaliate in the last round of the game so that the agent lacks the taming constraint and might change her strategy and appropriates. Thus the end game problem creates obstacles for the principal in the last period.\textsuperscript{173}

The application of the “endgame problem” to the German capital market scandals shows that usually Board members have an incentive to provide investors with accurate information, because the market would reveal falsehood of the information in a later period and then punish the Board member and the corporation severely by selling stocks and spoiling their reputation, bad ratings of rating agencies etc. Vice versa for Board members there would also be positive returns awarded for the dissemination of truthful information. However, if Board members believe that there probably is no further period to come, or that things are worse anyway, usual constraint has vanished and the incentives have changed. The Management might be in good faith belief so as to have the entrepreneurial crisis under control. In these circumstances the probability that wrong information will be disclosed to hide bad facts or to borrow some time to get over the current crisis is increasing.

A direct claim against Board members as it is drafted in the KapInHaG could put into place a counter balancing threat in cases of corporate crises that practically triggers the classic “endgame problem”.

III. The German Advocate Association’s Provisos

The business law committee of the German Advocate Association \textit{(Handelsrechtsausschuss des Deutschen Anwaltverein)} comments upon the proposed direct claim rather critically.\textsuperscript{174}

1. Legal Title follows the Lost Reliance in the Corporation

The written opinion of the Association points out that the perspective of investors in the disclosure process gives hint against the proposed direct claim. More precisely, it states that a direct claim is inferior to the traditional internal liability, because it cannot be justified with the argument of “disappointed investor reliance”: from the perspective of investors the dissemination of information is a task of the public

\textsuperscript{168} See for a short description of the Game Theory, Cooter/ Ulen, Law and Economics, 4\textsuperscript{th} Ed., p. 226 et sqq.

\textsuperscript{169} Cooter/ Ulen, Law and Economics, 4\textsuperscript{th} Ed., p. 229.

\textsuperscript{170} Baird, Douglas G./ Gertner, Robert H./ Picker, Randal C., Game Theory and the Law, p. 165.

\textsuperscript{171} Bicchieri, Cristina, Rationality and Coordination, Cambridge University Press, 1993.

\textsuperscript{172} See for the “tit-for-tat”-strategy in detail, Cooter/ Ulen, Law and Economics, 4\textsuperscript{th} Ed., p. 229.

\textsuperscript{173} This problem can exacerbate since the principal does not know which period is the last one. She might not cooperate from the beginning of the first period, because the second period could theoretically be the last one.

corporation itself rather than of the Board member personally. Even though the expertise and the integrity of Board members occasionally influence the investment decision of financiers, usually capital market information is receipted as announced by the public corporation. The Association’s opinion asserts that this fact gives reason for the liability of the corporation, which itself should pay for the compensation investors can claim, because it also aggregates the investors’ faith.

As the German Advocate Association is holding stakes in the corporate world, it cannot be completely barred that the argument is prone to the interests of the mandators, who are practically Board members who act on behalf public corporations. Nonetheless, the provided argument is sensibile prima facie. In particular it is legally accurate, as it seeks to focus on the equity aspect of “disappointed investor reliance”. As traditional legal scholarship is concerned with the balance of interests, it also wants to provide legal remedies exactly in relationships that are characterized by specific trust.

But – at closer inspection – from the perspective of Law & Economics, which is concerned with the actual effects of specific legal rules, the legal title of the investors against the public corporation appears to be rather ineffective. In fact, it might be correct that investors lose faith in the corporation itself and think e.g. DaimlerChrysler is underperforming the market because the CEO Mr. Schrempp frivolously disclosed entrepreneurial targets that could not be accomplished at all. But the legal remedy has to cope with both the material losses and the lost faith of investors, which is best accomplished if the CEO will be deterred to disclose false information. As already stated, the current German law lacks a rule that effectively deters false information so that a direct claim is prevailing.

Considering the actual German jurisdiction, the view on its effects, i.e. specially the incentives it provides, reasonably makes a call for the proposed direct claim against Board members for disclosing false information.

2. Systematic Advantages of Investors compared to other Stakeholders

The direct claim that is proposed by the KapInHaG provides the investors with a systematic advantage compared to other stakeholders that are also exposed to false information. For instance, the conditions of long-term supply agreements or bank credits are influenced by material data that is disseminated before the transaction. The creditors might only conclude the deal because of the information and lose their stake if the corporation goes bankrupt or will not be able to recoup their losses, if they - due to the false information – granted information that was too positive.

The German Advocate Association sees no justification for this unilateral advantage of the group of investors. But the opinion of the Association overlooks an important aspect, which actually legitimates the mentioned difference among the stakeholders. First, it has to recognize that stakeholders that have concluded a deal because of intentionally false information will usually have a claim of rescission on the contract as well a title of compensation (see section 123 BGB). Secondly, and even more importantly is the difference

176 See supra the analysis of the German law, § 4 A I 3.
177 Stellungnahme des Deutschen Anwaltereins durch den Handelsrechtsausschuss zum Diskussionsentwurf eines Kapitalmarktforma-

http://www.bepress.com/gwp/default/vol2006/iss1/art2
C. Approaching the Optimal Liability Regime

between the losses that investors and other stakeholders undergo. The damages of investors are - different from the losses of e.g. lessors or lenders – not a zero-sum-game in which one actor gains what the opponent looses. The false information causes inefficiencies in the capital market, because of lower investor-commitment that finally goes far beyond the actual private losses. Thus, from an economic point of view it is justified to privilege investors as their abstinence from the capital market creates excessive damages on the macro level.

IV. Outcome

The former arguments prove the advantage of a direct claim against members of the Board. Notwithstanding this observation, one has to take into account that a new direction in the German corporate liability system will be taken. This fundamental change has to be initiated cautiously, because there are various interdependencies - such as the reform of the internal liability and the discussion about more severe criminal law - with already existing rules, which already influence the Boards behavior.

But still, the direct claim’s clear advantage of instantaneous incentives for Board members is to increase precaution in the disclosure process appears striking and call for the implementation of the new rule.

C. Approaching the Optimal Liability Regime

It is notable that the liability rule certainly yields the Board members’ accountability for purposeful dissemination of false information. To scrutinize in the following is the impact of regulation on Board members’ behavior that is below the notion of scierter.

An application of the Nirvana-approach is to research for the superior remedy for socially unwanted conditions by comparing the social costs that occur if the market is unregulated and when it is regulated.

As could be pointed out, if the capital market is under-regulated, there are social costs that comprise investors’ private damages and losses due to increased market inefficiencies, as financiers will abstain from trading. On the other hand, a liability rule creates also costs that need to be balanced against the former. These costs include administrative costs, i.e. the costs of putting the case through the legal system and the costs of avoiding damages, i.e. reducing the activity level of the risky conduct. Hence, the costs of a liability rule include the expenses that Boards incur to avoid false announcements and the market inefficiencies that occur, because there will also be less valuable information available on the market to assess worthwhile investments.

A prerequisite for the necessary Cost-Benefit-Analysis is to design the liability rule that minimizes the social costs that it generates. An essential aspect for this task is which standard of accountability is optimal to

179 See supra § 2 B II 2.
181 See supra § 2 B II 2.
pursue the goal of balanced deterrence and entrepreneurial freedom of decision-making in disclosure policies. To pinpoint the accurate level of effort that managers should invest to provide the market with correct information about the company’s performance one has to scrutinize the scale of fault or standard of due care, which is set in the liability rule.

On the one hand, a legal mechanism that deters effectively from disclosing false corporate data is necessary. But the risk that information about the company’s prospects will turn out incorrect is the other side of the coin of the expected benefits related to any potentially profitable investment. Thus, it is part of the matter that the investors also share a fraction of this risk. Therefore the peril that entrepreneurial prognoses will be erroneous in an ex post evaluation has to be spread efficiently between the Board members and the shareholders.\textsuperscript{184}

I. The Effects of a Strict Liability Rule

Under a strict liability rule the Board members would have to pay monetary damages in every case the ex post assessment of published information reveals that it was false, and because of that, shareholders sustained monetary losses.\textsuperscript{185}

Rational shareholders will only sue a Board member if the given information, e.g. the prospected profitability of an M&A-transaction, will ex post turnout to be incorrect. As a result the corporate decision-makers would bear all downside risk that material prognoses imply, whereas shareholders are liberated of any of its negative consequences.

The rule would increase the costs of disseminating wrong information for Board members significantly. Hence, the entrepreneurial decision-makers would give more effort to avoid liability. The incentive not to pay for the shareholders’ losses would increase the level of precaution Boards take to evade wrong information. The effects are twofold:

Firstly, this is boosting information cost since the Board members will hire business consultants, legal advisers or accountants to double-check on the entrepreneurial prognoses that will be published. Moreover, they will insure the risk of being held liable with a costly D&O-insurance.\textsuperscript{186} Since the shareholders as the residual owners of the corporation are entitled to all the net profits of the enterprise, the former will eventually bear the increased information cost and lose profits.

Second, besides the negative effects on the information cost there is an even more severe inefficiency arising from a strict liability regime. The decision-makers would become risk averse. They would be deterred from taking potentially desirable risks. Assuming investors that are risk neutral because they diversify their portfolio, they don’t want too conservative managers. The excessive precaution triggers an inefficient level of risk that impedes the disclosure of information, which is necessary for the accurate evaluation of the corporation’s share price. Therefore the share price will have a discount, because of the lack of knowledge

\textsuperscript{185} Insights on the effects of a standard of strict liability are provided by Schäfer, Hans-Bernd, Tort Law: General, Encyclopedia of Law and Economics, Volume II. Civil Law and Economics, file 3000, p. 603.
\textsuperscript{186} Hamilton, Robert W. The Law of Corporations, 5\textsuperscript{th} Edition, p. 532.
potential investors will have about the company’s prospects.\textsuperscript{187}

Moreover, the strict liability rule creates no incentive for the investors to make any efforts to valuate the market information on their own.\textsuperscript{188} Since financiers have a title against the Board member if the announcement is false they might take information for granted and base their investment-decision on it, which is obviously exaggerating or suspiciously overoptimistically describing the company’s prospects. This indeed yields also suboptimal allocations of resources in capital markets, even though a financier could attenuate the most obvious false statements at low costs.

A strict liability rule appears to be quite inefficient and therefore is not the instrument to minimize the costs of regulation.

II. The Impact of a Negligence Rule

A negligence rule would disburden Board members from the accountability of compensation when they can prove the adoption of the standard of due care, which has to be defined by the law.\textsuperscript{189}

Theoretically a negligence rule comprises the optimal remedy for the obstacles with false information in capital markets. The decision-makers would adopt the level of precaution in the disclosure process that is necessary to avoid liability. Potential investors would know that they could rely on the information as far as the negligence standard goes.\textsuperscript{190} If non-diversified investors are risk averse, they have the incentive to control the information further at their own expenses. This is because financiers know that the decision-makers will not be held liable if they comply with the standard of due care.

In general, one can assert that the higher the potential private damages and market detriments are, the more justified information cost, such as expenses for legal opinions and business consulting are.

But to get closer to the point at issue, the crucial prerequisites of a negligence rule have to be observed: the efficiency of a negligence rule depends on two suppositions, which are not easy to accomplish. Thus, they account for obstacles in its practical application.

First, the legal system, i.e. the lawmaker and the courts, has to define the ideal level of precaution. Abstractly expressed, the law has to locate the point at which the marginal costs of the disclosure process, i.e. the costs of verification of specific information by Board members equal the marginal damages that false information will generate. The latter are the private investor losses and the negative effects on the economic growth due to a diminishing capital market. Since these costs and damages are very difficult to compute in practice, it appears to be a challenging venture to define the efficient level of due care.

Secondly, the negligence rule requires to verify ex post whether managers did comply with the standard of

\begin{footnotes}
\footnotetext{187}{Peter O. Mülbert, Empfiehlt es sich das Kapitalmarkt- und Börsenrecht neu zu regeln? JZ 2002, p. 826, 834.}

\footnotetext{188}{Schäfer, Hans-Bernd, Tort Law: General, Encyclopedia of Law and Economics, Volume II. Civil Law and Economics, file 3000, p. 603.}

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\end{footnotes}
due care. Since this examination will occur only after damage is to deplore, there is a basic insight of the analyses of Law and Behavioral Science that provides an argument, which reveals the systematic defectiveness of the negligence standard to solve the problem of false information in capital markets.

The phenomenon of the hindsight bias implies that the probability of an incident to occur will be overestimated in a subsequent evaluation of a process.\textsuperscript{191} Consequently the likelihood that a specific event would happen will appear higher if the event actually did happen.

If this empirically tested and found quite robust bias of human decision-making is adapted to a trial situation, the Boards will be convicted of being negligent more often than the negligence standard did arrange for and than it’s members deserve it.\textsuperscript{192} The judges or juries will decide the case while knowing that the predicted gain or the anticipated successful acquisition of a competitor that was disclosed in the announcement did not eventuate. Even though the failure might have been quite unpredictable and the action was economically right-minded ex ante, the judgment will be biased by the only fact that the incident occurred. Thus, the hindsight bias will make the decision-maker even more risk averse,\textsuperscript{193} which is eventually unfavorable for shareholders’ pursuit to amend the performance of their investment.

The outcome of the hindsight bias is that the basically sensible negligence regime will be transformed in a “quasi-strict liability” standard, which has the outbalanced disadvantages described above.

Hence, a pure negligence standard appears not to be the first best solution to minimize the costs of a regulated capital market.

III. Applying Interpretations of the Business Judgment Rule

Neither a strict liability nor a negligence rule could be identified as the instrument to cope with false information in German capital markets efficiently.

Since in the US, the Business Judgment Rule (BJR) is a traditional as well as controversial instrument in corporate law, it might be worthwhile to scrutinize its impact on the obstacles with false information in the German capital market.\textsuperscript{194}

This analysis will not deeply assess the various arguments in favor and against the BJR, which Stout\textsuperscript{195} as well as Branson\textsuperscript{196} have already compiled accurately. It will rather take the customary applied interpretations of the BJR in US corporate law to utilize them for the German capital market law.

Basically, in US law the BJR is a legal instrument that provides protection for corporate decision-makers not


\textsuperscript{194} Recently, also in the German debate about managerial liability courts and scholars try to harness the BJR.


to be held personal accountable for mistakes in business ruling. It comprises a standard that shall liberate the Board from not taking objectively necessary entrepreneurial decisions, because of the threat of damaged shareholder’s lawsuits. It permits a wide leeway for corporate decision-makers to publish information about the company’s performance that finally might turn out to be wrong, so that also the disseminated information itself will be false ex post. It is different from a negligence rule with a low standard of due care, because it basically does not define a standard at all, except the undisputable damnation of self-dealing and insider trading.

As categorized by Bainbridge, the US corporate law broadly interprets two different concepts of BJR. The perceptions are divergent in their standard of defining the level of fault that can be judged by the court. Thus, these two concepts will be applied to the obstacles of false information in capital markets to assess their impact on corporate disclosure processes.

1. The Abstention Doctrine

The more traditional application of the standard is merely a rule of abstention. That means, courts will not assess the entrepreneurial decision of the Board members. The reason behind this is the insight that “judges are not business experts” and the knowledge about the prejudice in the assessment of business decisions following the above-mentioned hindsight bias.

A US court stated in a significant judgment: “By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.”

Hence, courts restrain themselves from assessing the decision except for fraud, illegality and an obvious conflict of interests. Consequentially, there is no standard of due care that could be applied to consider the merits of the business decision and therefore coevally the effort, which is made to verify disseminated capital market information.

Following this definition of the BJR the professional behavior of the Board members will be mostly uncontrolled by a legal mechanism. This absence of legal monitoring is influencing the disclosure process in different ways:

Since courts only will check whether in the disclosure process is intentionally self-dealing involved, the worst and most damaging behavior of Board member will be deterred. In addition to that one can argue that the hindsight bias problem is solved.

But keeping in mind the severe asymmetry of information that weakens the position of investors by making

201 Shlensky, 237 N.E.2d at 780.
them dependent on the published news, there is a problem with the BJR as abstention doctrine. It reduces the information costs for Board members significantly and provides an incentive to disclose information rather unaudited. They might reject to consider facts, which are objectively necessary to assess the whole risk of a specific business operation properly and therefore lead to false information that is available to the capital market.

Moreover, once more analyses of Law and Behavioral Science indicate that the former risk of an inefficient influence of false information is exacerbating under the abstention doctrine. There are doubts that the mentioned content is pinpointing the optimal balance of the two important issues, which have to be combined in the legal rule: it shall effectively deter the management not to make announcements frivolously but at the same time it has to make sure that the necessary information will be disseminated courageously and at the perfect time.\(^\text{202}\)

As mentioned, people in general - and corporate managers especially -, are biased to be over-optimistic, systematically underestimating risks and are unaware of their clear cognitive limitations.\(^\text{203}\) Experiments reveal that people in general overestimate their skills in - and their contribution to - courses of action they are concerned with ("above average effect").\(^\text{204}\) The over-optimism-bias makes corporate decision-makers announce objectively to fast and too less revised venturesome maneuvers, which might have required a more careful assessment of available data.\(^\text{205}\) Hence, the disclosure process is executed by too self-confident decision-makers, which will lead to too frivolously published announcements.

As a result, the abstention doctrine is quite inefficient concerning the obstacles with false capital market information.

2. "Process Monitoring Standard of Gross Negligence"

Compared to the abstention doctrine a softer interpretation of the BJR is practically applied, too. This understanding of the rule is allows the court a deeper analysis of the decision.

But, under this notion of the BJR the courts still do not measure, weigh or quantify the board’s decisions, judges will not even decide if the ruling is reasonable in its context. However, under this interpretation ‘directors’ decisions will be respected by courts unless the directors are self interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available".\(^\text{206}\)

The application of this excerpt to the problem of false information in capital markets reveals that the criteria


\(^{203}\) See supra § 2 C II.


\(^{206}\) Brehm v. Eisner, 746 A.2d 244, p. 264, 266 (Del. 2000)
of assessment are different from the ones under the abstention doctrine. The courts will apply a standard of
due care according to the process of disclosure.\textsuperscript{207} Even though the information will turn out objectively
wrong in the trial, this fact alone will not lead to the liability of the Boards, if the process to gather the
information itself was not grossly negligent.

Hence, there are two aspects to adhere. The information itself will not be – but the process to attain it is
going to be assessed by courts. Secondly, the standard to evaluate the procedure will be “gross negligence”. As a
consequence, if members of the Board are grossly negligent not using data or material that was
reasonably available in the disclosure process they will be held liable.

What are the possible consequences for the actual behavior of corporate decision-makers if this interpretation
of the Business Judgment Rule is applied to information disclosure procedures in the German capital market?

The threat of over deterrence is banished, because the decision-makers are allowed to make mistakes in their
rulings without the fear of being sued by shareholders. In the borderlines of looting behavior, i.e. self-dealing
even objectively wrong information can be published. This indeed bears a hazard of frivolous and
overoptimistic announcements and private losses of investors relying on false information. But at the same
time it allows the Board to take risks that are in the interests of a risk neutral shareholder.

To reduce the risk of frivolous and overoptimistic disclosure of information, under this interpretation of the
Business Judgment Rule the courts will assess the method the information was evaluated. Therefore, Board
members will know that they are free in their business decisions but will have to utilize the “reasonably
available” material data. This creates an incentive to take a reasonable level of precaution while processing
the information that is to announce to the public.

But, to assure that in hindsight not too many data and materials appear “reasonably available” the standard of
assessment must not be pure negligence. It has to be gross negligence so that the practical circumstances of
time constraint and pressure under which the decision-makers are operating are taken into account. Thus,
Board members are allowed to make mistakes in their day-to-day appraisal of entrepreneurial future
prospects. If their estimation was false, courts will ask for the underlying data that was utilized in the
disclosure policy.

Thus, the “process-monitoring standard of gross negligence” is the first best solution and minimizes the costs
of a regulated market.

\textsuperscript{207} Stout, Lynn A., "In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business
§ 5. Conclusions

Recent German financial scandals are evoked by false capital market information that was intentionally or frivolously disseminated by Board members of public corporations. The incentives to approve this disclosure policy are based on structural, systematic and motivational grounds.

The false material data are causing a divergence between the corporation’s discounted intrinsic value and its present market value. When the market recognizes the misdirection, the share price will abruptly downswing. The damages occur on the private sector as shareholders face major losses and on the public sector, because of increased and excessive inefficiencies in the capital market.

According to the theory of regulation, an intervention of the lawmaker is indicated when the damages are based on market failures. False information derogate the efficient allocation of funds and impede enhanced Pareto optimality, because of obstacles with asymmetric information, negative externalities as well as free riding-behavior by competitors. Thus, the apparent market failures call for regulation.

Following the aim of maximizing social welfare, regulation is only legitimate when its total costs are below the damages without state intervention. Besides the damages in the free market, the provision of this Cost-Benefit-Analysis is an optimal liability rule that minimizes the total costs of the regulated market.

The current German capital market law is not complying with this requirement. The traditional regime of the corporation’s external liability combined with the internal liability is – de lege lata - ineffective. The KapInHaG with its proposed direct claim of investors against Board members is prevailing, especially because of the implementation of clear as well as straight incentives to decision-makers.

However, by proposing the standard of due care of “gross negligence” the KapInHaG will not be efficient and remains amendable. Creating a standard of due care that allows courts to scrutinize the objective merits of the capital market information - except outstanding circumstances as intentional self-dealing – will over deter Board members. To pinpoint the optimal standard of fault, the US’ Business Judgment Rule is promising also for German capital markets. But the abstention doctrine would stay below the optimal threshold and therefore is under deterring. It increases the probability of major investor losses and - in the long run - of inefficient capital markets, because of lower commitments of discouraged investors. The first best solution is the “process-monitoring standard of gross negligence”.

This standard of “process-monitoring standard of gross negligence” will not allow courts to assess the sensibility of a false capital market information in an ex post evaluation. But it will allow the analysis, whether the disclosure process was not influenced by grossly negligent not considering necessary data.

A legal rule that comprises the former standard of fault of a moderate Business Judgment Rule appears to be a close approximation of the optimal answer to this analysis.
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